

**Anton MARCINČIN**  
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editors

# ECONOMIC POLICY IN SLOVAKIA 1990 - 1999



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POLICY  
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**INEKO**

# **ECONOMIC POLICY IN SLOVAKIA 1990-1999**

ANTON MARCINCIN AND MIROSLAV BEBLAVÝ  
editors

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## Foreword

I am writing these lines over the Atlantic and that is somewhat symbolic. I am travelling for talks that are a part of an effort at Slovakia's accession to international economic structures (OECD) and I am writing the foreword for a text that is very important in this respect in terms of its content, but especially in terms of its authors. These are young Slovak economists who represent (as this book clearly confirms) the hope that this process will be successful.

Economic policy in Slovakia within the last ten years has been marked with many changes, often downright turbulent in character. This is related mainly to the fact that it was the first decade of post-communist transformation, connected with not only dynamic, but frequently controversial political developments, as well as with the split of the former federation and the formation of a new independent state.

The first decade of post-communist transformation is generally viewed as a complicated process in all countries affected - a process that has proven that, in addition to simple technical solutions regarding free elections and macroeconomic stabilization, it involves a much more complex transformation tied with deep structural changes, the creation and functioning of new institutions, changes in ownership relations and a fundamental change in the role of the state in the economy.

The past decade has shown that distortions of the communist regime were deeper than most people were willing and able to realize. They rested not only with the distorted structure of the economy and insufficient competitiveness of economic entities, the lack of a functional system of formal rules of the game, but perhaps to an even greater degree with the strongly distorted informal rules - with the prevalent ethic, shared values and generally accepted patterns of behavior.

At the onset of transformation, all countries - including Slovakia - were in a situation where there were no solutions proven in practice and the question of economic policy was in this respect an open technical problem. Every post-communist transition is also, at least in its early years, connected with a transitional recession, growing unemployment, and a decline in living standards. People's dissatisfaction with this situation, along with a very low level of knowledge and information on the real causes and realistic possibilities of resolving the situation then often allow populists and demagogues capable of politically exploiting this wave of discontent. Their economic arguments or the arguments of their "economic experts" often take the form of naive folklore. This, however, does not imply that such tactics may not succeed (and in many countries including Slovakia they indeed have succeeded).

Social and national demagoguery and populism are the greatest obstacles to successful and swift reforms. The best weapon to combat these phenomena and the most effective way to create pre-requisites for real reforms is to raise the level of information in the expert community and within the public at large on the causes of problems, paths to their resolution, as well as on the consequences of not resolving the existing situation.

With ten years of experience with reforms, most of them do not pose a technical problem anymore. Various countries have attempted different approaches and we can thus say there now are sufficient positive and negatives experiences with respect to effective and ineffective economic policies. The argument of exclusivity or the peculiarity of the conditions will not stand, since centrally planned economies were similar and the laws of economics apply to every country.

The book in front of you serves as a good example and a tool for raising public awareness of the problems of economic policy in the period of post-communist transformation, both through its professional approach and its erudition. It is also a book reflecting the latest findings of economic research in the world.

The book describes developments in economic policy in a highly expert, matter-of-fact and critical fashion, not only scratching the surface, but hitting the core of the issues it deals with. Although most of them are young, the authors clearly have substantial practical experience from their involvement in research, government, banks, think-tanks or international financial institutions, in addition to good theoretical training.

I am pleased that the authors prepared a comprehensive assessment of economic policy in Slovakia in the past decade and even more pleased that they came to terms with this task in such a competent manner.

I also see the economic policy recommendations for the future as very useful and, in general, I share with the authors their views of the priorities and the need for changes in the general approach to the implemented economic policy. The cabinet, of which I am a member, is already moving in this direction, as evidenced by several conceptual documents, e.g., the medium-term economic policy priorities, industrial policy, the bank restructuring and privatization plan, and also several proposed laws such as the amendment to the bankruptcy law, etc.

I bring this book to the attention of all those interested in economic developments and economic policy, in particular to students of economics and economic journalists. For all those who will read the book, it will certainly serve as a light in the labyrinth of often highly contradictory and controversial claims and assessments of any government's economic policy.

*Ivan Mikloš*

*Deputy Slovak Prime Minister for the Economy*

# 1 Introduction<sup>1</sup>

The transition process has affected an estimated 1.65 billion people, and with its importance and complexity, it became one of the most important economic events of the twentieth century. Since the subject contributes to a better understanding of capitalism as an economic system, economists' interest in the process is limited not only to transition countries themselves, but also to the implementation of large institutional changes. The former is true because of its relevancy to the relationship between incentives and markets, incentives and ownership rights, legal rules and social norms, government and economic agents, and the political system and economic interest groups. For example, it can help to determine how to ensure that a government is neither too strong nor too weak to fight organized crime and to encourage economic agents in productive activities rather than rent seeking behavior. The latter is true, due to the relevance of the transition process, and to economic environmental factors, as well as to the dynamics of political games, which cause large institutional changes or, on the contrary, oppose them.

Economists were not prepared to assist in the transformation of economies, and even the most accepted theories of macroeconomic stabilization assumed that a market environment was already in place. However, stabilization has been only one of many aspects of the transition, and attention must also be paid to the following: the creation and development of markets (including financial ones), to the establishment and enforcement of ownership rights, to changes in legislation and policy, and to privatization and restructuring. These complementary reforms were meant to produce as few economic disturbances as possible and maintain political support. It is obvious that the majority of knowledge about the transition was formed *ex post*, after an unexpected fall in production, privatization by insiders instead of external investors, an increase in organized crime, splits of countries and sometimes after the return of communists to power.

The initial economic conditions of reforms included: the absence of real price and market systems, the deformation of the production structure, the dominance of heavy industry and scarcity of services, and the existence of large enterprises at the expense of small ones. The lack of a consistent production plan for particular goods led to permanent shortages, to the accumulation of existing commodities and workforce, as well as to forced substitution and investment cycles. Some countries

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<sup>1</sup> A large part of this chapter is based on G. Roland's forthcoming book entitled *Politics, Markets and Firms: Transition and Economics*. Roland's book is perhaps the first complex summary of theoretical and empirical studies of the transition process and will certainly become a popular textbook.

gradually withdrew from central planning (Yugoslavia in 1965; Hungary in 1968; Poland in the 1980s) and thereby gained, in our opinion, a head start in essential reforms.

The goals of reform were:

- improving efficiency by introducing flexible prices and creating a competitive open market;
- stabilizing the macroeconomy as a precondition for the correct functioning of the price system;
- providing enterprises with incentives to adjust to market signals by means of privatization and the foundation of a corporate governance system;
- establishing the government institutions necessary for the functioning of the market.

In relation to government institutions, it is also necessary to ensure political and institutional stability, the protection of private ownership rights not only against the government, but also against the mafia, and the protection of taxpayers against the influence of interest groups.

Barriers to reform consisted of:

- outcome uncertainty that influences the behavior of economic agents;
- interactions among complementary reforms;
- the political goals of parties and interest groups.

Economic literature today explains the original fall in production by the horizontal monopolistic structure of production and the disorganization effect of price liberalization on existing production lines due to information asymmetry. The question of the reform government, however, has not yet been satisfactorily answered. Why are some governments too weak to enforce the abidance of laws, while others are not? Evidently, the explanation is related to geopolitical factors and the perception of the mafia as a sub-optimal substitution of the government as an enforcement agency.

The insufficient restructuring that followed the privatization process disappointed many. Privatization ultimately aimed at increasing enterprise efficiency by putting in place better managers and providing them with better incentives; however, in reality, privatization was only a change of ownership within a given framework of constraints.

These constraints included the following:

- low volume of domestic savings;
- insufficient foreign resources caused by imperfections in the functioning of international capital markets;
- exchange rate risks and uncertainty;
- need to counterbalance the loss of tax revenues, and especially the political opportunity to gain power.

The lack of restructuring itself has been caused more by the underestimation of the corporate governance framework than by the selection of privatization methods. The distortion of hard budget constraints through bank and inter-enterprise loans developed into a moral hazard when agents expected the state to bail out their liabilities; therefore, making it compatible with profit maximizing behavior.

In our opinion, disappointments from the transition process are connected with the overall understanding of it, as well as with the understanding of the way the economy functions. First of all, the initial understanding of the transition process did not consider the goals and roles of particular interest groups, as if it were possible to separate economic reform from the political world. Economic models, somewhat paradoxically, considered post-communist governments as solid entities that maximized national welfare. Furthermore, nomenclature managers were assumed to give up their leadership of enterprises voluntarily to new private owners. On one hand, the models neglected the costs connected directly with reform; on the other hand, they underestimated the revenues connected with privatization, which was understood as a one-time opportunity. Secondly, too much attention has been paid to macroeconomic indices, based on an implicit assumption of a perfect correlation with microeconomic development. It was exactly the Slovak case that proved this assumption wrong. Without a change in the incentives of the behavior of economic agents, all macroeconomic successes are only temporary and may signal the postponement of reforms, with consequent costs to the economy.

This book, which is the result of a yearlong project and two seminars, has two goals. The first of which aims to offer analysis of a decade of developments of the Slovak economy, of applied economic policy, and of their consequences for and impacts on agents, as well as to formulate recommendations for future economic policy. The second aim is to contribute to the general understanding of economic transformation.

All chapters in this book have led to the same conclusion: countries pay a huge price if immediate success is preferred and reforms are postponed. Slovakia recovered relatively quickly from the negative effects of the preliminary transformation period, although at the cost of high unemployment. In 1994, the country appeared on the path toward recovery. However, that same year saw a fundamental reversal in Slovak politics and in economic policy. The linkage between nomenclature managers and political parties was openly manifested and was strengthened through privatization to such an extent that it had a significantly negative influence on the further economic development of the country. This “privatization of the country” led Slovakia to international isolation and in 1998 almost to economic collapse.

The following thirteen chapters document and analyze the development of the Slovak economy from different angles during the period of 1990-99. The chapters present the scientific work of several experienced professionals in the area of transition as well as of many young authors who did not previously have an opportunity to publish their work.

Karol Morvay of the Slovak Academy of Sciences in Chapter 2 draws a picture of the country's overall macroeconomic development. Ján Tóth, of ING Barings, addresses issues relating to fiscal policy in Chapter 3. Miroslav Beblavý, of the Institute for Economic and Social Reforms (INEKO) deals with monetary policy in Chapter 4. Developments on the global market and their connection to the Slovak economy are analyzed in Chapter 5 by Andrej Salner of the Center of Social and Media Analysis (CSMA). Foreign trade is pursued in Chapter 6 by Marek Jakoby of M.E.S.A. 10, while Martina Lubyová of the Slovak Academy of Sciences covers the labor market in Chapter 7. Lucia Haulíková of the Project Coordination Unit of the Ministry of Health analyses the current status and possibilities of social security reform in Chapter 8. Miroslav Beblavý writes about industrial policy in Chapter 9, and Daniela Zemanovicová of INEKO addresses the subject of competition policy in Chapter 10. Anton Marcincin of the Research Center of the Slovak Foreign Policy Association (RC SFPFA) deals with privatization in Chapter 11 and with enterprise restructuring in Chapter 12, while Martin Barto and Tomáš Kmet, both of the bank Slovenská sporiteľna, analyze in Chapter 13 the status of bank privatization and restructuring. The final chapter, written by Miroslav Beblavý, includes a summary of the main conclusions of all the chapters as well as recommendations for future Slovak economic policy.

The opponents contributed significantly to the success of the book. They are: Eugen Jurzyca of INEKO; Radek Lastovicka of Venture Capital Fund, Prague; Katarína Mathernová of the Government Office; Michal Mejstřík of Institute of Economic Studies at the Faculty of Social Sciences (IES FSS) of Charles University, Prague; Ján Oravec of the Ministry of Economy; Juraj Rencko of the Finance Ministry and the Slovak Academy of Sciences, Olga Reptová of M.E.S.A. 10; Mario Stravec of Center for Economic Research and Graduate Education - Economic Institute (CERGE-EI), Prague; Vladimír Tvaroška of the Government Office and Zdenek Tuma of the Czech National Bank, Prague. It was splendid to observe the commitment with which they shared their knowledge and experience with the authors of the individual chapters.

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The opinions and conclusions presented in this book are, of course, the opinions and conclusions of its authors, who together with the editors take full responsibility.

*Anton Marcincin*





## 2 Overall Macroeconomic Development

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From a macroeconomic viewpoint, the transition from a supply-constrained centrally planned economy towards a demand-constrained market economy represents a search for an acceptable relationship between growth and a balanced economy. This has been complicated by conditions related to insufficient restructuring and a distorted institutional framework. Slovakia has given the impression of successfully achieving this transition. However, opportunities for economic growth based on the stimulation of the demand side of the economy have been exhausted.

The macroeconomic development of Slovakia's economy reflects a diversity of economic approaches during the transition process of the last decade. Disputes have involved the shape of the mix of politics and economics, the overall perception, and the direction of transition itself. At first, development reflected the transition-related recession and export-driven revitalization. Later, excessive unbalanced growth and attempts to re-stabilize the economy resulted in a return to the economy's pre-transition performance level. This was accompanied by persistent structural distortions that tended to impede development.

The transition's questionable outcome suggests that it is necessary to complete the setup of the institutional framework of the economy as well as to stimulate the economy from the supply side. Ten years after the fall of communism, the economy nears the completion of the transition process. It will require better coordination among individual economic policy segments, an improved transparency, and a better conceptual approach.

## 2.1 Introduction

The purpose of this chapter is to describe Slovakia's macroeconomic development during the transition process. This section will shape a background for subsequent chapters and will characterize the individual segments of the economic policy. Despite the short history of Slovakia, economic policy has created many different concepts and some dubious outcomes. The macroeconomic development assessment presented will be based on so-called soft data, i.e., currently published and accessible data.<sup>2</sup>

The chapter is divided into two sections. The first section focuses on the assessment of key macroeconomic parameters. The second section analyzes macroeconomic development as a result of various economic policies implemented. This section is presented chronologically by individual stages. These stages were selected based on the occurrence of specific macroeconomic phenomena and the marked changes in concepts, with additional analysis provided in relation to typical problems. The objective has been to point out the differences in development depending on the perception of economic policy priorities. Another objective has been to confirm the hypothesis concerning the exhaustion of the opportunities that enabled the achievement of seemingly outstanding macroeconomic results, i.e., the blocking of the restructuring process and distorting of the institutional framework. The chapter also examines arguments supportive of new priorities of economic policy, with a more pronounced support for institutional reforms of the economy's supply side.

## 2.2 Characterization of the Development of Principal Macroeconomic Parameters

In this section, we shall describe problems related to the development of key macroeconomic indices and attempt to describe the development of economic performance. The macroeconomic results of Slovakia's economy have been evaluated regularly by a number of domestic and international institutions and analysts. The 1993 OECD study represented a comprehensive analysis of the macroeconomic development during the federal Czecho-Slovakia as well as during the first months of the independent State's existence. Its conclusion stated that there would be good prospects for revitalization of the Slovak economy in the medium term. It stressed that the disturbing split of the country created a need of increased attentiveness to macroeconomic stabilization. A 1995 World Bank study highlighted the relatively unfavorable macroeconomic heritage and the necessity for a cautious macroeconomic policy at the threshold of the establishment of the

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<sup>2</sup> We may recall that during the period in question, statistics would be subject to substantial changes.

new State. The study also pointed out the necessity of restructuring the economy to assure revitalization. The analyses of the macroeconomic development conducted within the period of 1994 – 1995 emphasized the positive development of macroeconomic parameters and, at the same time, questioned the sustainability of this development. Rencko (1996) stated that the micro-level would determine the nature of further development. It is at the micro-level that some risks associated with the shaping of the ownership structure and the functionality of the allocation mechanism appears. Okáli et al. (1996) expressed their doubts about the permanent nature of the economy’s positive breakthrough. This was attributed to structural weaknesses and banking sector problems. Later analyses suggested a number of economic problems. One study noted a growing “fragility” of economic growth (Kárász and Rencko, 1997). Another analysis discussed the economy’s imbalance associated with unsatisfactory progress in microeconomic adjustment and the low effectiveness of the redistribution processes in the area of public finances (Kárász, Rencko and Kárász ml., 1999). A problem noted by another analysis was the chronic nature of the imbalanced development and the necessity to slow down economic growth (Okáli et al., 1999). Another one noticed the insufficient coordination of the economic policy segments and the need of principal reforms (OECD, 1999). A retrospective analysis of the major macroeconomic parameters for the entire duration of the Slovak Republic’s existence was offered by a study of INFOSTAT analysts (Haluška and Olexa, 1999). This study stated that the 1996 - 1998 development showed the typical features of an overheated economy.

TABLE 1. GDP Volume Index in Constant Prices (1989 = 100)

Year	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP index	100	97.5	83.3	77.9	75.0	78.7	84.1	89.7	95.5	99.7	102.4

Note: 1999 data according to the forecasts by the Slovak Statistical Office. Source: Author’s own calculations according to the data provided by the Slovak Statistical Office.

### 2.2.1 Performance of the Economy

In 1999, the economy’s performance (in terms of the volume of gross domestic product, GDP generated) oscillated around the 1989 level, which was prior to the commencement of the reforms (Table 1). The fact that GDP returned to its pre-reform levels after one decade is disappointing since it was not expected at the time the reforms were started.<sup>3</sup> Certainly, a return to the original level of GDP generation does not mean that the economy has reached the same position it

<sup>3</sup> E.g., see Federal Ministry for Strategic Planning (1990), Ministry for Economic Strategy of the Slovak Republic (1991), and Government of the CSFR in the Memorandum on Economic Policy developed for IMF (1990).

had at the start of the reforms. The quality of the economic developments themselves had changed. A prevailing part of GDP (about 85 %) is now generated by the private sector. During the transition process, the services share of GDP increased while those of industry and agriculture decreased. On the other hand, there has been no substantial improvement in the level of valorization of inputs and the level of economic efficiency after reaching the initial performance level as mentioned.<sup>4</sup> The performance restoring process has been and continues to be accompanied by chronic disturbances of the macroeconomic equilibrium. A relatively high unemployment rate remains, the decline of inflation has stopped, and problems with the negative current account balance has become acute (see Chart 1).

The positive economic growth achieved in Slovakia after 1994 was influenced from the demand side in a variety of ways (Chart 2). While there still were signs of transition-related recession in Slovakia during 1993, economic growth started showing some signs of recovery in 1994. This growth was associated with an increase in exports of goods and services. The decrease in imports was so significant that it even caused a further reduction in domestic demand.<sup>5</sup>

The first positive increment of domestic demand occurred in 1995, particularly in the area of capital investment. Gross capital formation grew 37.4 % in real terms (thereof gross fixed capital formation only contributing 5.3 %). Increases in exports of products and services started to decline, resulting in continuing reductions in annual net export surpluses. These surpluses so far have been the last positive result of the transition process.

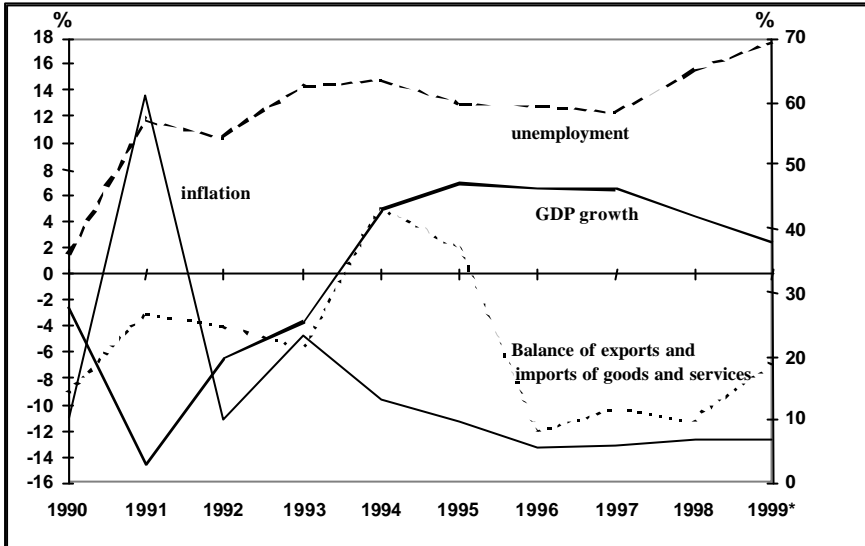
In 1996, a reduction of exports (by 0.3 % in constant prices) was accompanied by a marked growth in imports (by 20.3 %). This trade imbalance was accompanied by a record growth in domestic demand (by 19.6 %) to sustain a high GDP growth dynamics. In 1997, foreign demand again represented a positive contribution to Slovakia's economic growth. Net exports were still in red figures (Sk -44.4 bn in 1995 prices), but less negative than in the preceding year (Sk -55.8 bn). On the other hand, there was a significant reduction in domestic demand.

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<sup>4</sup> Added value that is at the basis of GDP generation, still was keeping a markedly smaller share on gross production than intermediate consumption. After 1995, this only changed little, suggesting problems with respect to raising the effectivity of the economy. Also see Kárász, Rencko and Kárász ml. (1999).

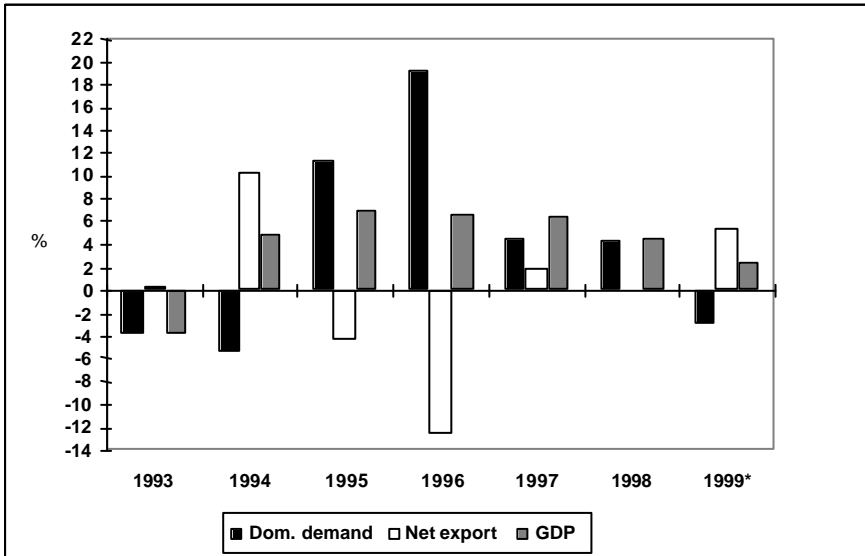
<sup>5</sup> The specific developmental parameters are shown in the Annex to this book.

CHART 1. Development of the Principal Performance and Equilibrium Parameters of Slovakia's Economy



Notes: The development of inflation rates measured by consumer price index is at the right axis. For 1999, data is for only the first six months. Source: Slovak Statistical Office

CHART 2. Contributions of Domestic Demand and Net Exports to the GDP Growth Recovery



Source: Author's own calculations based on data from the Slovak Statistical Office (1999)

In 1998, the growth was driven almost exclusively by domestic demand; the negative value of net exports remained almost at the 1997 level. A change in economic policy along with an accumulation of problems caused the restriction of domestic demand in 1999. This caused a slow-down in GDP growth. However, the growth of exports acted against a more pronounced reduction of growth rates.

Taking a look at the supply side, i.e., GDP generation offers a view of the economy's tertiarization process. According to estimates of 1989 GDP (World Bank, 1995), agriculture had a 9.4 % share, industry had a 58.5 % share, and services had a 32.2 % share. In 1999, the service sector almost reached a 60 % share of GDP whereas agriculture's share was only 4.4 %.

GDP generated after 1995 could not cover domestic demand. This is documented by a non-sustainable trade balance deficit. The pre-transition GDP level was reached at a time when the overall status of the Slovak economy and the status quo of the transition required the adoption of new stabilization measures.

### **2.2.2 Inflation**

In a transition economy, inflation rates are influenced by non-standard factors. A peculiar feature of price development is the problematic relationship between the growth of monetary aggregates and the growth of the overall price level.<sup>6</sup> The relationship between the development of monetary aggregates and the development of inflation rates is masked by numerous non-standard measures that affect the growth of prices in such countries. They include:

- Price liberalization and deregulation - the unavoidable systemic steps in the establishment of a market economy. Price liberalization is within the framework of a broader liberalization (i.e., within the scope of economics/politics and how these effect the proper functioning of an economy). This created an inflationary stimulus that caused inflation rates in Slovakia and/or the Czech and Slovak Federal Republic to reach historic levels (see Chart 4). The adjustment of prices that had been capped contributed to a short-term destabilization of price levels. This occurred throughout the process of transition (see Chart 5).
- Tax reform (implemented as of January 1993 in Slovakia). Out of the total growth of prices during 1993, a substantial portion (about 40 % of consumer prices and about 50 % of industrial production and construction works prices) occurred at the beginning of the year due to tax reform (according to Okáli et

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<sup>6</sup> The questionability of the „M2-inflation“ links in countries in transition supplied one argument to abandon M2 as a criterion of the monetary policy of the Czech National Bank and the using of inflation targets. See Šmídková and Hrnčíř (1998), and Janáček et al. (1998).

al., 1994). Charts 4 and 5 illustrate the price variations that followed implementation of the new tax system.

- Strong influx of foreign resources. Under certain conditions, an influx of foreign resources may induce inflationary effects. Dvorák (1996) indicated that this will depend on whether such an influx is driven by an increased demand for money on the part of domestic entities (low inflation-enhancing impact) or by an enhanced supply of money.<sup>7</sup>
- Equalization of price levels. The price levels of a country in transition are usually lower than those in the developed countries it is doing business with. There is also a discrepancy between the structure of relative prices in both the domestic economy and abroad. If the economy is quite open, as is the case with Slovakia, there is a tendency for price levels to equalize. The structure of relative domestic prices tends to adjust to those abroad while countries undergo transition.
- Public finance imbalances - chronic deficit of public budgets. In the interest of financing a budget deficit, the State enters capital markets where it attempts to draw on a portion of its national savings. This practice pushes out private investments and also causes interest rates to rise. When interest expense is a significant share on total expenditures, prices of outputs will increase.
- Tendency of domestic demand to prevail over generation of GDP. Unsatisfactory microeconomic restructuring may cause domestic supply to become inflexible and not respond sufficiently to the development of domestic demand. When such a condition persists, it creates a constant pressure on price levels.
- Business environment distortion. During the early stages of a transition, a distorted competitive environment and the monopolization of many sectors can cause price levels to soar. This type of environment does not generate sufficient incentives to keep prices low.

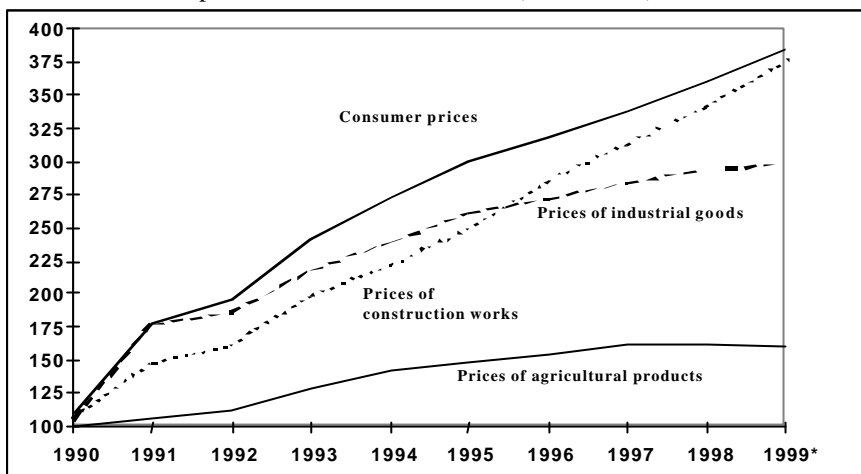
An irregular and unequal development of various price indices occurred during the process of transition (Chart 3). In mid-1999, a consumer would have to pay Sk 385 for a fictitious consumer basket that would have been priced at Kcs 100 in 1989. Using a 1989 price of 100, construction works prices reached an index of 378; industrial producer prices reached 299; agricultural products reached 160.

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<sup>7</sup> If the influx of resources is supply-driven due to institutional changes and excess of financial resources abroad, such an influx will likely create pressure, via growing monetary aggregates, on prices. On the other hand, if the influx is due to a growing demand for money, the positive effects of the influx will likely prevail, and its impact on inflation rates will be not very marked.

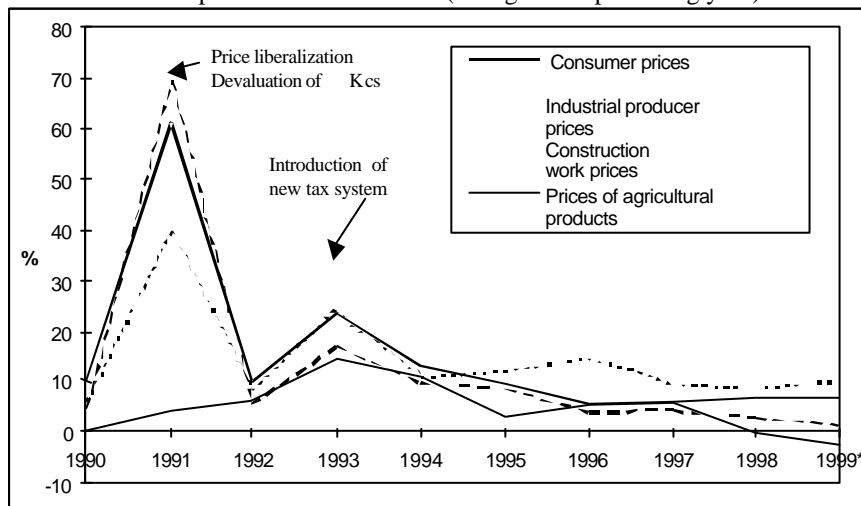


CHART 3. Development of Price Indices Level (1989 = 100)



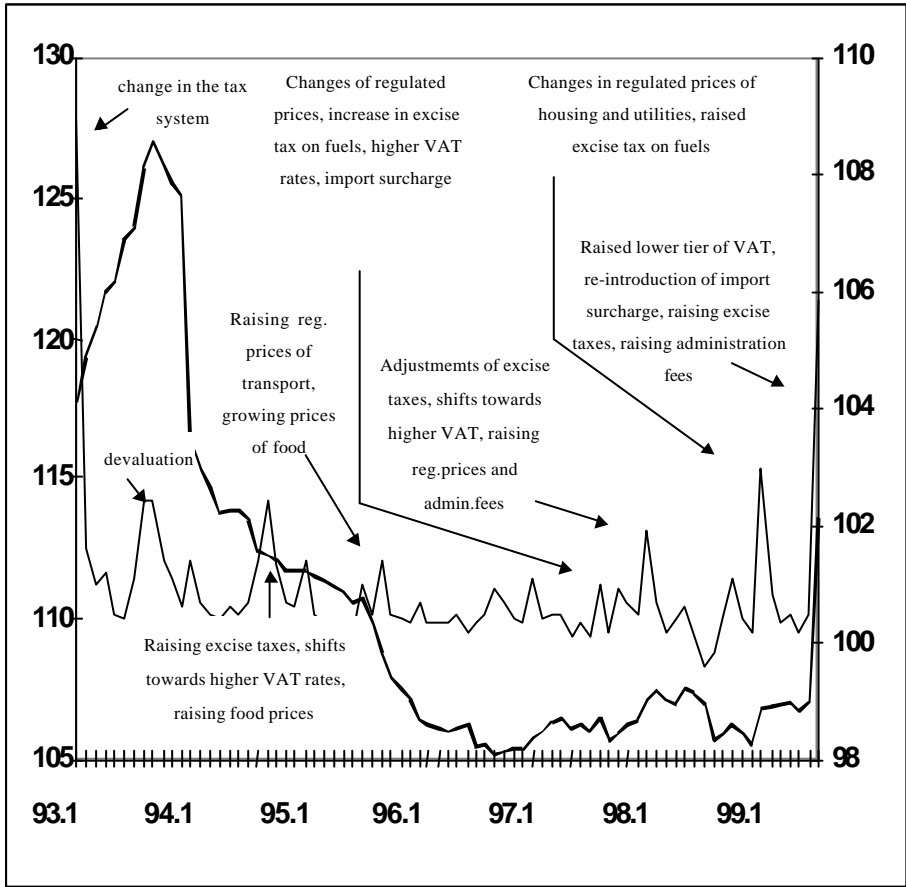
For 1999, data for the first six months. Source: Author's own calculations based on Slovak Statistical Office data

CHART 4. Development of Price Indices (change from preceding year)



Source: Slovak Statistical Office

CHART 5. Development of Consumer Price Indices in Slovakia within 1993-1999, and Description of Non-standard Influences



————— Left Axis = Index for the same period of the preceding year= 100  
 \_\_\_\_\_ Right Axis = Index for the preceding period = 100

Note: Since prices of food vary in dependence on specific factors, the growth of food prices is also included among "non-standard factors" in the diagram. Some more pronounced periods of inflation rate growth cannot be clearly accounted for by some non-standard factor. Source: Slovak Statistical Office

As illustrated by Chart 4, the Slovak economy experienced two strong impacts on inflation rates after the start of the economic reform (shown as two notches on the curve). The first was the price liberalization of 1991, which was also associated with changes in exchange rates. The other inflation-promoting factors are the tax system changes of 1993 and the currency devaluation that occurred six months later.

Chart 5 illustrates the changes in overall price levels from 1993 to 1999. It indicates times when price levels jumped due to some non-standard factor (mostly interferences of central institutions with the price development). Due to a cautious monetary policy, such pro-inflationary stimuli had one-time shock effects that were short-lived and did not cause a more pronounced inflationary spiral.

In our opinion, the strengthening of several symptoms of macroeconomic imbalance stopped the decline of inflation rates in 1996; inflation rates remained at a relatively low level in 1996. That low level of inflation could only be achieved by establishing a gradually more restrictive monetary policy,<sup>8</sup> keeping a fixed exchange rate, and by postponing deregulation of capped prices (and of the tackling of the status of natural monopolies).<sup>9</sup> The postponement of price deregulation perpetuated the distortion of relative prices and the economy's allocation mechanism. It also contributed to the distortion of the microsphere and caused negative impacts on the fiscal sector.

### **2.2.3 Unemployment**

Unemployment was not officially recognized at the start of the transition process. By 1999, however, it represented the most acute problem of both social and economic policies.

During the early stages of the transition process, unemployment rates increased as a logical consequence of recession. The cumulative reduction of employment rates during the recession years, however, was much less than the cumulative reduction of GDP. Assuming that there was over-employment during the period of a centrally planned economy, over-employment also persisted during the first years of the transition process. Okáli et al. (1995) pointed out that a significant portion of employed labor was only partially utilized by the economy. After restoring economic growth, the productivity of employed labor can be raised; at least for a certain period of time, there is no need to hire new labor. This has been one of the reasons for the paradoxical occurrence that changes in employment remained small even in periods of strong economic growth. To a great extent, strong economic growth resulted from economic activities where growth in production was not tightly linked to the growth of employed labor.<sup>10</sup> However, the reduction of the high GDP growth rates in 1998 and during the first half-year of 1999 was accompanied by a drop in employment and growth in unemployment (see Table 2).

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<sup>8</sup> It is expressed by reducing increments of the M2 monetary aggregate.

<sup>9</sup> A typical example are the prices of electricity for the domestic sector that remained unchanged within 1993-1998.

<sup>10</sup> To these issues, also see the chapter dealing with labor market.

Table 3 indicates how employment rates responded to GDP development. It is evident that there was an unambiguous link between economic growth and employment growth. The significance of the link between economic growth and employment development is expressed in two ways. First, it concerns the elasticity of changes in employment with respect to changes in GDP.<sup>11</sup> Second, it is expressed in terms of the so-called threshold of employment growth (for details, see Okáli et al., 1999). The relatively high positive values of this parameter suggest that employment responds rather insensitively to high economic growth. Thus, employment growth can only be expected to occur during periods of very high economic growth rates.

The high overall unemployment rates represent only one dimension of the unemployment problem in Slovakia. Another pronounced aspect is regional differentiation due to a low mobility of labor, poor professional qualifications and an unsatisfactory educational structure. In addition, long-term unemployment represented more than 50 % of overall unemployment.

TABLE 2. Development of Unemployment Rates \*

In %	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Unemployment	1.6	11.8	10.4	14.4	14.8	13.1	12.8	12.5	15.6	17.7

\*Figures as of the end of the corresponding period. Data for 1999 relate to the first half-year. Source: Slovak Statistical Office, National Bank of Slovakia

TABLE 3. Interlinkage of GDP and Unemployment

Parameter	1993	1994	1995	1996	1997	1998	1999
A. GDP Growth (%)	-3.7	4.9	6.9	6.6	6.5	4.4	2.4
B. Employment Growth* (%)	-0.1	-1.8	1.7	3.6	-0.9	-0.3	-3.7
$\Delta$ Employment / $\Delta$ GDP (B/A) **	0.03	-0.37	0.25	0.55	-0.14	-0.07	-1.54
Employment Growth Threshold (A-B)	-3.6	6.7	5.2	3.0	7.4	4.7	6.1

\* According to changes in the numbers of employees. Data for 1999 relate to the first half-year. \*\* Flexibility of the response by changes in employment to changes in GDP. Source: Data from Slovak Statistical Office and author's own calculations

Changes in the employment structure are related to changes in GDP structure. In the secondary sector, the share of the processing industries' share of overall employment dropped from 27.2 % in 1993 to 26.7 % in 1998; in industry, the share of manufacturing materials and semi-products sectors increased from 36.3 % in 1993 to 39.8 % in 1998. This phenomenon suggests that labor is not adequately

<sup>11</sup> The positive value of this parameter suggests that both indices studied – economic growth and employment, were changing in the period monitored in the same direction; and vice versa (for a negative value). The closer the absolute value of the index to 1, the tighter the correlation between GDP growth and employment growth.

transitioning to sectors characterized by a high degree of processing, sophistication, and generation of added value.

Slovakia's unemployment problem has led us to conclude that it cannot be considered as cyclic unemployment; it is evidently of a structural nature. The lack of a successful economic policy in dealing with unemployment issues has also led us to believe that the high economic growth showed insufficient quality.

#### **2.2.4 External Equilibrium**

Chart 1 shows that during the transition process there were alternating developments with respect to external equilibrium. External imbalance presents a view of internal imbalance because it provides a link between domestic demand and GDP, and also a link between savings and investments. Chart 6 illustrates the key components of the current account balance of payments. The illustration suggests that export levels<sup>12</sup> (measured as the share of exports of products and services on GDP) exceeded import levels (imports of products and services to GDP) only in 1994 and 1995. The sum of exports and imports that represent the so-called openness of the economy has been above 120 % of GDP in recent years. This indicates the economy has an extraordinarily high level of openness.

A pronounced deficit in the current account occurred after 1995. At the time, the overall macroeconomic imbalance of Slovakia had intensified. It was also a reflection on the opening of the shears between the development of domestic demand and GDP. This reflected the diminishing competitiveness of Slovak producers in both domestic and international markets. The current account of payment balance and its assets is considered a measure of the competitiveness of the economy. The prevailing deficit of the current account, along with some other symptoms of imbalanced development, has been an obstacle to further economic growth.

The deficit of the current account resulted in a loss of foreign currency. This was compensated for an influx of resources to capital and financial accounts. The influx of resources from abroad always exceeded their outward drain. This left the structure of foreign resources as a problematic area.

The most valuable foreign resource was direct foreign investments. Their influx showed stagnation (Chart 7) while the growth (before 1998) of other capital (loans) is conspicuous. Its growth reflects internal imbalance between the generation and utilization of resources. Foreign indebtedness reflected this development and grew to 62 % of GDP in late 1998. Half of this indebtedness had a maturity of less than one year. Slovakia's net international debt level represented

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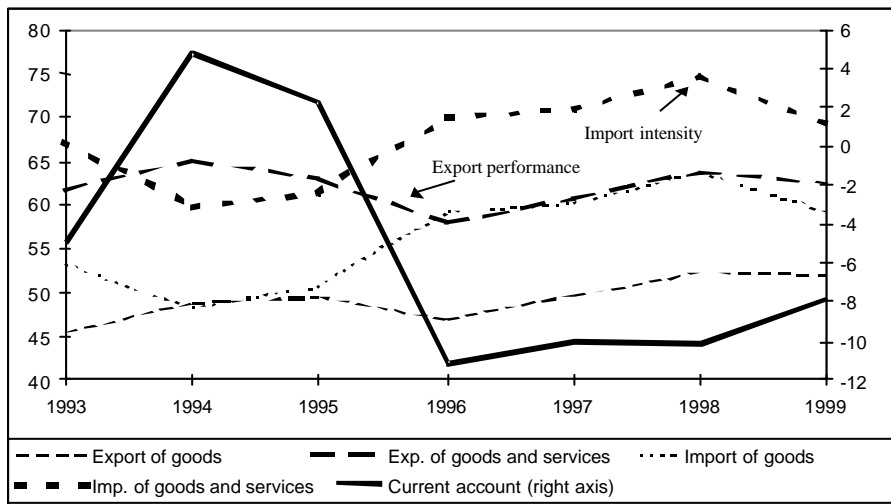
<sup>12</sup> The export performance of Slovakia is still based on a relatively narrow range of products that is markedly sensitive to demand cycles in OECD countries. For details, see OECD (1996) and the chapter on foreign trade herein.

almost 30 % of GDP. This level of net foreign debt and its rate of growth contributed to a reduction of Slovakia's credit rating. Another year of debt growth, at the same rate as was seen from 1996 through 1998, could increase the net debt to GDP ratio to 40 %. This level, based on the experience of other countries, may be considered as the upper limit (according to OECD, 1999).

### 2.2.5 Macroeconomic Results Compared to Other V4 countries

A comparison of Slovakia's macroeconomic achievements to other post-communist economies is shown in Charts 8 and 9, which provide the so-called magic quadrangles of economic policy success rates. They illustrate the dynamics of economic growth as well as the principal imbalance characteristics, i.e., inflation rates, unemployment rates, and the status of the current account of payment balance. The more a monitored parameter deviates from the point of intersection of the axes (thus the larger the area of the quadrangle), the more impact it has had for the country's success at developing the principal macroeconomic characteristics.

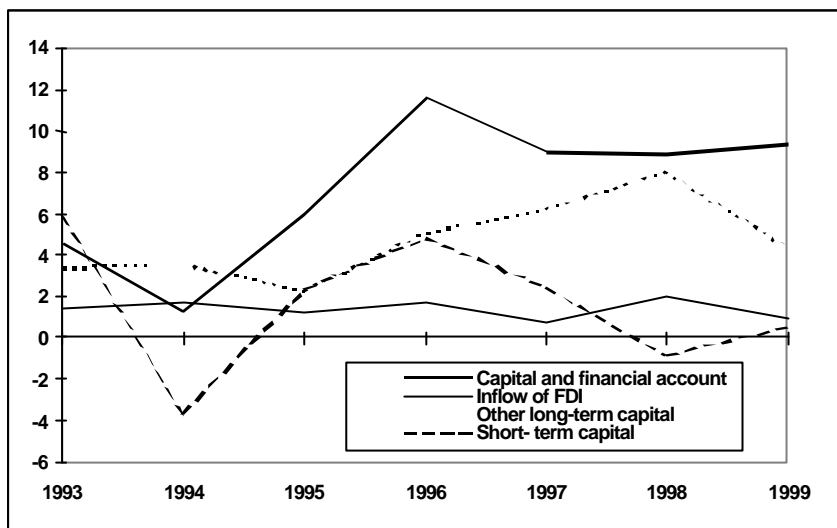
CHART 6. Development of the Key Components of the Current Account of Payment Balance<sup>13</sup>



Data expressed in terms of GDP percentages. Data for 1999 relate to the first half-year. Source: National Bank of Slovakia

<sup>13</sup> With the exception of the data shown in Chart 1 data since 1993 have been used to illustrate issues of external economic relationships. The reason is that the meaning of the term „other countries“ changed after the establishment of the independent Slovak Republic, and this has been associated with some risks in using statistical data.

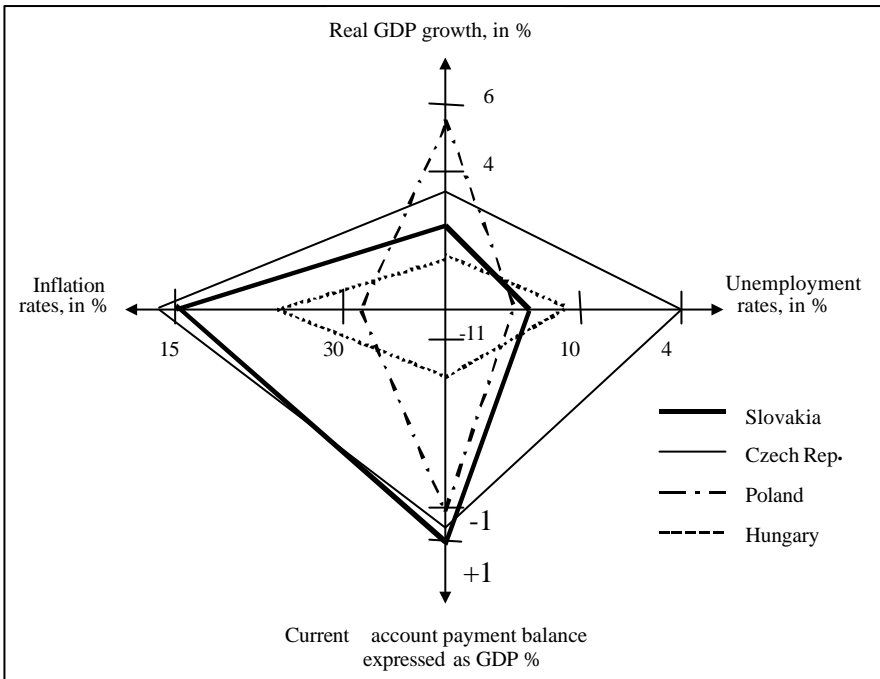
CHART 7. Selected Components of the Capital and Financial Accounts of Balance of Payments



Data are expressed in terms of GDP percentages. Data for 1999 refer to the first half-year. Source: National Bank of Slovakia (1998)

It is evident that the position of Slovakia was significantly different in the two separate three-year periods. Both periods had a relatively great success rate in the development of price levels, and a relatively weak success rate concerning unemployment. The difference is attributed to Slovakia's position with respect to external imbalance. During the first period, Slovakia showed the most successful development of the current account of all countries within the monitored group, but this development decreased during the second period. This was a result of high economic growth. Comparing the countries in transition requires that we examine the implementation of reform steps.

CHART 8. Comparison of the Macroeconomic Results Achieved by the Slovak Republic with Those Recorded by Poland, Hungary and the Czech Republic (1993-1995)



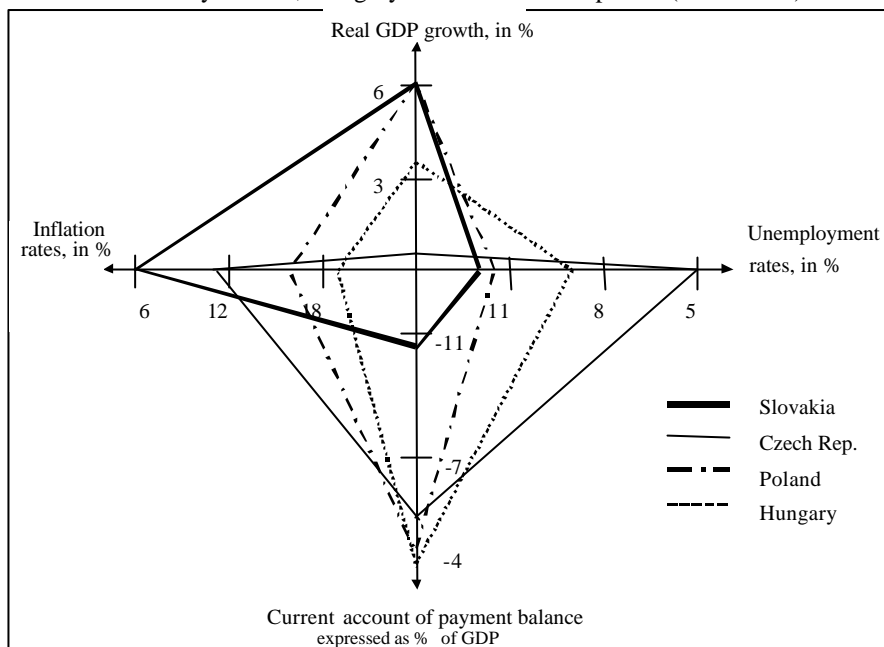
Comparison based on the average values of parameters for the given period. Source: OECD (1999), Nachtigal (1997) and Slovak Statistical Office

## 2.2.6 Conclusion

The successful development during 1994 and 1995 was only temporary. Compared with other countries, Slovakia was relatively successful if judged by economic growth rate and inflation rates. That success was partially achieved at the expense of external equilibrium (and the associated indebtedness) and by the postponement of some necessary measures. The alternation of macroeconomic successes and failures during the transition process requires a closer chronological examination that is presented in the sections that follow.



CHART 9. Comparison of the Macroeconomic Results Achieved by Slovakia with Those Recorded by Poland, Hungary and the Czech Republic (1996-1998)



Based on average values of parameters during the period of monitoring. Source: OECD (1999), Nachtigal (1997), Slovak Statistical Office

## 2.3 Macroeconomic Development During the Various Stages of Transition

The chronology of the Slovak economic development examines alternating approaches to the understanding of economic policy and the process of transition. It is a story of searching for possibilities of sustainable (balanced) growth and for opportunities of convergence with EU countries. This section focuses on the results achieved at the macroeconomic level and also seen in function of policies. The monitored period has been divided into several stages, as illustrated in the Scheme (see Annex), and supplemented with some characteristic features of the individual stages. The stages cannot be strictly delineated because they overlap. For each transitional stage, an analysis is given for economic policy, characteristic technical discrepancies, and principal macroeconomic problems.

A gradual transition from a supply-side constrained economy towards a demand-side constrained economy was necessary and has been analyzed by Kornai

(1981a, 1981b, 1982).<sup>14</sup> Laski et al. (1993) have presented transition possibilities with an analysis of the first Slovakian experience. Jonáš (1997) developed characteristics of an ideal transition background for the common Czecho-Slovak State environment. He also provided evidence for the necessity of a transition-associated recession. The initial reform approach, within the framework of the federal State, was critically assessed by Lysák (1997) and Plachtinský (1992). They believed a pronounced respect of national specifics was required. In contrast, Danco (1996) noted the risks associated with the use of various “third” ways and warned against the lack of clarity, non-transparency, and the potential of abuse from “specific” ways of transition. Nemeč (1998) and Okáli (1998) analyzed recurrent imbalanced developments after a relatively successful primary stabilization. They both point to the linkage between the condition of the business sector and recurrent imbalances at the macro-level.

### **2.3.1 Characteristics of the Baseline Status Quo**

The goal characterizing a baseline status quo is to offer a description of relevant factors. At the time when the first transition steps were contemplated, the factors influenced the macroeconomic parameters as well as the transition process.

Prior to WWII, Czechoslovakia ranked among the dozen or so countries with the highest volume of national income per capita (Jonáš, 1997, Solimano, 1991). It achieved high rates of economic growth in the 1950s and 1960s. At the beginning of the transition period, Czechoslovakia ranked between 40<sup>th</sup> to 50<sup>th</sup> based on its GDP per capita. The reason was that the opportunities to enhance economic growth had been exhausted by utilizing production inputs. Rectified values of economic growth for the period of 1981-1989 suggest a stagnation and/or a slight reduction of the economy’s performance level (Nachtigal, 1991).

Economic imbalances emerged as demand prevailed over supply in global relationships and their structure. This would be a constant phenomenon throughout the entire economic development of Czechoslovakia. The imbalance<sup>15</sup> also manifested itself in the domestic consumer market, being relatively mildest there since, unlike enterprises, households were very restricted in their budgets. Imbalances were also manifested in intermediate and investment markets. Imbalances were a continuous phenomenon of the Czechoslovak economy and

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<sup>14</sup> For the originals in English language, see Kornai (1971,1980).

<sup>15</sup> The term „disbalance“ should however be used with respect to the assessment of centrally planned economy with the understanding that there was no actually functioning market and equilibrium-creating prices. The key criterion of the plan development was material balance (as a certain replacement for the term balance). For details on this issue, see Kocárník (1987).

were also accompanied by inflation, which reflected economic imbalances.<sup>16</sup> When assessing the relationship between imbalances and inflation in a centrally planned economy, we should distinguish between structural imbalances in the individual markets and global imbalances. Structural imbalances, where shortages exist in some consumption sectors and a growth of idle stocks exists in others, means that forced substitution processes exist, that consumption focuses on several basic commodity groups, and/or that surplus money gets realized in shadow economy. Any or all of these factors cause prices to substantially increase. A structural imbalance typically produces hidden inflation. A global imbalance is a situation where an overall supply of goods does not cover the disposable income of the population and, at the same time, the structure of this supply differs markedly from the preferences of the consumers. This situation is reflected in suppressed inflation.

The imbalance in the consumer market, unlike that in intermediate and investment markets, was structural rather than global in nature. Inflation manifested itself as a way to treat hidden inflation imbalances in the Czechoslovak economy of the 1970s and 1980s. The parallel (shadow) economy worked as a specific mechanism to restore economic equilibrium.

The general irrationality of the price system and price distortions also intensified. The price development, which was based on cost pricing, was unable to react to changes in the demand structure. Price could not be the criteria for the allocation and reallocation of resources. Retail prices did not fulfill a regulatory role with respect to equilibrium due to the fact that the link to supply generation at the producer level was rather weak. The distorted price system was also a result of the State's pricing policy that gave preference to the social function of retail prices.

The imbalanced tendencies of the economy was one of the reasons for the national economy's changing structure. Klaus (1991) states that the willingness of consumers to purchase low-quality instead of expensive products led to the erosion of quality, an inadequate supply structure, and hidden price increases (pseudo-innovations). The elimination of imbalanced tendencies would unavoidably require use of market forces in the management of economy. Without these forces, this phenomenon would recur because of systemic conditions (Dlouhý, 1988). At the same time, however, the pressures of economic imbalances would be a threat. If market forces were used, such pressures might manifest themselves as inflationary shock and create trade balance problems.

Central planning contributed significantly to the preservation of outdated structures by emphasizing the proportionality of materials and on subordinating prices to this objective. These actions later manifested themselves as an

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<sup>16</sup> Overt, hidden or suppressed inflation occurred frequently in communist-type economy. For details, see Dlouhý (1988).

underlying reason for the transition-related recession. The reform steps, at the early stages of the transition process, were prepared in a macroeconomic environment. The environment suffered from growth stagnation, suppressed inflation, chronic symptoms of imbalances, and structural defects. All of these problems arose as a manifestation of failures of centrally planned economy processes. Many of them remain in various forms and contribute to present day problems.

## **2.3.2 The Period of Initial Stabilization (1990-92)**

### **2.3.2.1 Direction of Economic Policy**

During the early stages of the reform (see stage 1, Scheme 1), the decision-making sphere in Czechoslovakia chose the method of so-called “shock therapy”.<sup>17</sup> The decision was influenced by economic neo-liberalism. The reform steps should have been implemented immediately because of the likelihood of a transition trap, i.e., a situation where the rules of the communist-type economy are already weakened but not fully functioning, and economy is marasmic (Kornai, 1990 and Jonáš, 1997).

In 1990, a transition scenario was developed. A significant number of prices were liberalized on 1 January, 1991. Price regulations remained for prices that covered about 15 % GDP (5 % later on). The aim of this regulation, along with a restrictive fiscal and monetary policy, was to prevent the shock of inflation from evolving into an inflationary spiral, to suppress speculative and excessive swings of prices, to prevent cartel agreements, and to weaken the differences between the prices of inputs and final prices.

From a macroeconomic viewpoint, it was important that the first reform step gave preferences to stabilization, to the establishment of equilibrium, to hinder inflation, and to eliminate State budget deficits. In the short term, economic demand had to be suppressed because of the need to convert from a supply constrained economic system to a demand constrained economic system. Some reduction in GDP generation was also expected for a transient period of time. The success of that stage was measured by the fact that the shock of inflation could be stopped in a way compatible with a market based economy, i.e., by openly raising prices. The weakening of the economy’s performance, the growth of unemployment rates, and the reduction of real wages have demonstrated its failure.

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<sup>17</sup> Laski et al. (1993) warned however of intellectual dogmatism in the form of outlining slogans such as „shock therapy“ versus „gradualism.“ Also see Balcerowics (1993).

### **2.3.2.2 Disputes Concerning the Pace of Liberalization**

The need for price liberalization did not evoke any intensive disputes. The method and the pace of the price liberalization was the subject of more discussions. Criticisms of rapid liberalization and a parallel restrictive monetary policy can be summarized as follows (see Seják, 1991):

1. At the time of price liberalization, the economy of Czechoslovakia was still characterized by a monopolistic or oligopolistic structure in all sectors. Without the assistance of an effective antitrust policy, monetization of the originally demonetized economy threatened to confirm price distortions. Price liberalization was not preceded by necessary institutional reform. Consequently, price liberalization strengthened the monopolistic positions of Czechoslovak producers in 1991.

2. With a market exchange rate of Kcs, a pronounced depreciation of the domestic currency occurred. The prices of foreign substitutes for domestic products were so high that they did not present any competition to domestic goods. This paradox softened economic criteria.

3. Anti-inflationary actions of the government were in the form of a restrictive monetary and budgetary policy that enabled a gradual stabilization of price levels. The policy fiercely suppressed the economy. It resulted in either companies or households being unable to implement the necessary structural changes because of their adverse revenue situations.

While an oligopolistic market structure actually existed, the initial devaluation of the currency was aimed at helping corporations to overcome the first transitional shocks, to gradually equalize the prices of domestic and foreign substitutes, and to eliminate the monopolistic position of domestic corporations. Based on model simulations, Hanousek and Krkoška (1997) have suggested that the pre-announced, pronounced shock liberalization, in the end, had the least inflationary effect. One-time liberalization may have had the strongest inflationary impact at implementation, but it had the least impact in the cumulative form. The “shock” method caused inflation rates to decline substantially faster than any other simulated impacts. Due to rational expectations of businesses, gradual liberalization made inflationary expectations become an integral part of the economy. Under the conditions that existed then in Czechoslovakia, it was the announcement of radical and extensive price liberalization that would have achieved the best results.

### **2.3.2.3 Transition-related Depression**

A reduction of production was expected but underestimated. The government prognoses, laid down in the Memorandum on Economic Policy for 1991, projected a production decrease of only 5 %. This proved to be only a half of actual decline

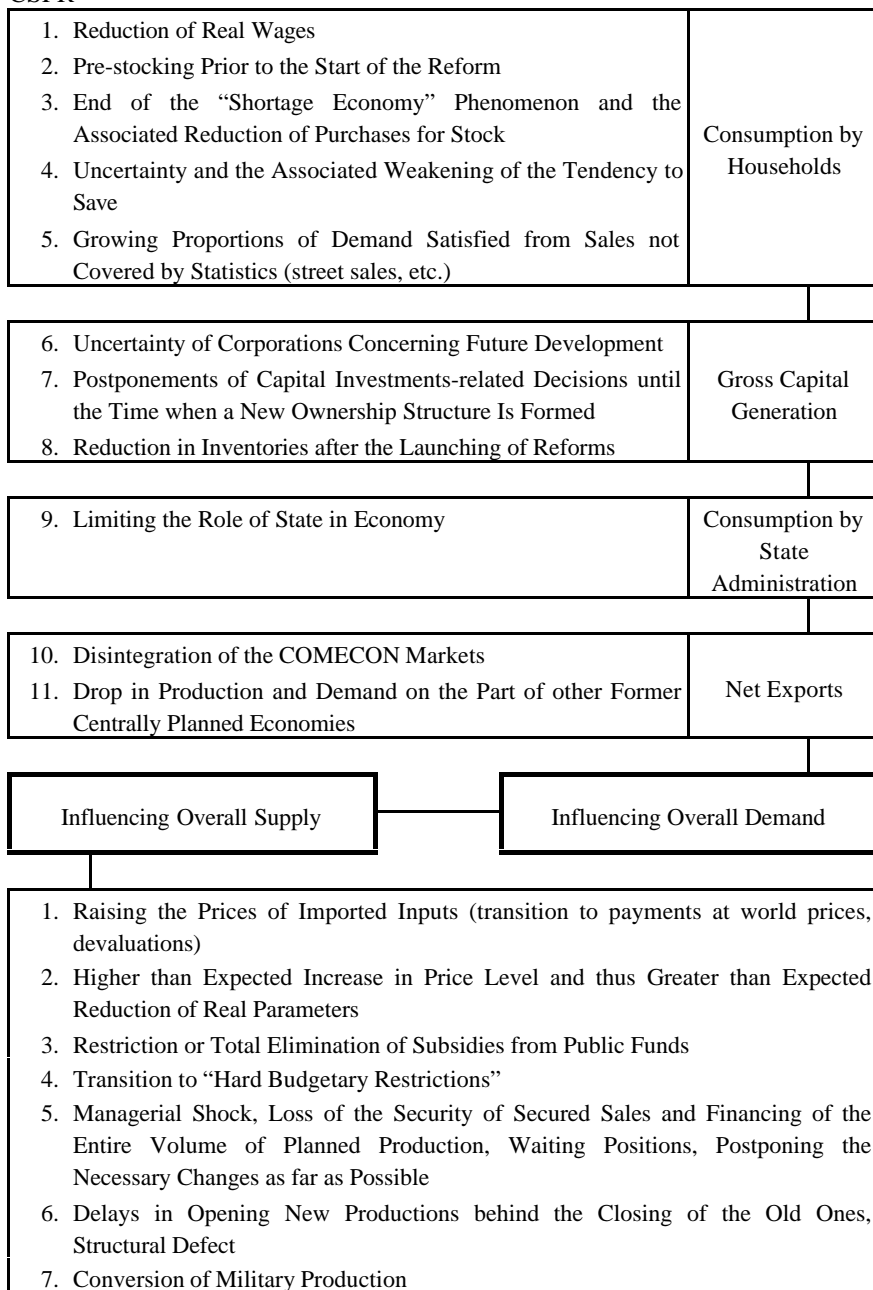
in production. The cumulative drop of GDP in Slovakia between 1989 and 1993, when the transition-related depression came to an end, was about 25 %. This decrease was comparable with what was experienced in the Czech Republic, Poland, and Hungary. It was also less than declines of GDP in a majority of less developed post-communist countries (see Fischer et al., 1996).

In assessing reasons for the transition-related depression in Slovakia, the World Bank (1995) brought COMECON disintegration into the foreground. This disintegration was not the only reason for the depression. Other probable reasons include the consequences of inflation, impulses stemming from uncertainty, and structural defects, etc. (see scheme 2). The pronounced drop in production that occurred from 1990 to 1993 evoked numerous discussions concerning the necessity of its extensiveness and whether economic policy makers could have prevented it. This issue was frequently considered an index of deterioration in the population's standard of life. This became a politically sensitive issue. However, Jonáš (1997) pointed out that the officially recorded drop of production overstated the actual decline in the standard of life. Statistics were unable to record some production and consumption data due to the rapid growth of the private sector and the emergence of a hidden economy. Distortions also occurred due to the use of ratios. The weights used to construct aggregate figures for the individual sectors were outdated. Sectors that recorded higher than average reductions were therefore overstated.<sup>18</sup> One reason for the distortion of production volume and price indices was the difficulty in measuring improved product quality. The statistics for production volumes both before and after implementation of reforms may hide substantial differences concerning the ability of the production to meet needs.

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<sup>18</sup> The changed production structure thus resulted in an overstatement of its reduction. The production of rapidly developing services was statistically measurable but with great problems.

SCHEME 1. Causes for GDP Reduction after the Reform Implementation in the CSFR



Recommendations on how to overcome the production decline included the stimulation of aggregate supply. Another recommendation was that the State take a more active role within the framework of industrial policies to support prospective sectors. During the early stage of transition, the production drop was of a different nature than what occurred during the economic cycle. Therefore, the usual instruments of fiscal and monetary policies for stimulating demand could not be used to treat transition-related depression. Ineffective production attenuated much faster in a short period of time than the starting of new activities. As a result of this asymmetry, changes in the production structure may have temporarily produced a reduction in the overall volume of production (Jonáš, 1997). Artificial stimulation of demand would allow corporations to postpone the eventual changes and to continue production under temporarily sustainable conditions. Jonáš argued against a more active State industrial policy by contending that such a policy would result in a softening of some corporate budgetary restrictions. Over the long run, support given to sectors or corporations of “strategic importance” cannot bring in any pro-growth benefits. Conversely, similar measures have anti-growth effects because, in their framework, the State guarantees softer than market conditions for some companies. This enables them to postpone the necessary shifts of resources to places where they can be most effectively utilized. Doing this, the economy’s structural defects get preserved and the long term potential for growth gets restricted.

With a better understanding of rules that govern the development of a post-communist society, the production decline might not have been as severe. In our opinion, the idea of transition without any recession is little weight. There is no transition economy that escaped a decline in economic performance, including Hungary that pursued a different process of transition (see Kornai, 1998).

### **2.3.3 The Reversal and Revitalization Stage (1993-95)**

#### **2.3.3.1 Direction of Economic Policy**

There were pressures to change the nature of reform from “Klausian” to a reform that would respect Slovakia's specifics. These pressures were growing in parallel to the establishment of the new State. The OECD study (1993) pointed to the opinions of economic policy makers who believed the 1991-1992 reform path was too fast. The study reports that the government born out of the 1992 parliamentary elections had wished to slow down the pace of economic reform, especially in the area of privatization. The critics<sup>19</sup> of the previous method of reform argued that the “erroneous Czechoslovak reform” disproportionately harmed the Slovak economy because it was tailored to the Czech economy. The

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<sup>19</sup> These arguments were used by Plachtinský (1992) and Lysák (1997).



restrictions triggered the population's subsequent mistrust of the new State. The reason for the mistrust was that the reform paralyzed the economy and threatened social peace. Plachtinský (1992, s.5) presented the position of professionals who were committed to the continuation of the reforms: *„There were three variants to be considered. Uniform reform in the common Czecho-Slovak State – this was the first one, tested to result in enormous losses of Slovakia's economic potential. Exactly the logical opposite was the combination of a genuine Slovak reform with an independent Slovak State. Evidently, the least understandable variant was selected – Slovak State and Czecho-Slovak reform.”*

This pressure to change the reform path resulted in a diversion from the original Czecho-Slovak reform to a new approach in the transition from 1993 through 1998. The first government of the independent Slovak State set forth its vision of building a socially and environmentally oriented market economy. The priority of the Slovak economy was made to be the restructuring and revitalization of sectors that would produce long-term economic effectiveness and advantages.<sup>20</sup>

According to OECD (1993), the government confirmed its commitment to a socially oriented market economy without having explicitly defined it in any way. “Strategy of Economic Revival” was adopted in November 1992. The major points of this Strategy were: (1) stimulation of macroeconomic expansion by relieving fiscal and credit policies, (2) an active trade policy that included support of exports to European countries and CIS, and (3) restructuring of industry under the leadership and financial assistance of the State.<sup>21</sup> This program was developed further and supplemented in 1993 with an emphasis on the need to keep a restrictive fiscal and neutral monetary policy. In 1993, the decision-making sector found it had to pay more attention to managing the consequences of economic policy failures, including an increase in the budgetary deficit, the disintegration of the monetary union with the Czech Republic, and the loss of FX reserves by the Central Bank. These activities diverted decision makers away from the development of a coherent reform strategy. The reform (according to OECD, 1993; similarly, Danco, 1996) actually recovered even though it had been slowed down. Mikloš (1993) noted that the announced divorce with the so-called Klausian reform could be questioned. There were attempts to introduce a cautious and rather restrictive fiscal policy and a more relaxed monetary policy because the proclaimed change in the transition strategy was not fully implemented yet. The reform process was therefore slowed down.

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<sup>20</sup> See: Updated Tasks of the Slovak Government's Programme Declaration after the Establishment of Independent Slovak Republic (1993), and Slovakia's Economic Policy Doctrine for 1993 (1993).

<sup>21</sup> For a description of this Programme, see OECD analysis (1993).

### 2.3.3.2 The Temporary Nature of the Successful Macroeconomic Development

There were signs as early as 1992 that the bottom cusp of transition-related depression and subsequent revitalization had been achieved. The most important influence was arguably the establishment of a new State even though it caused a temporary recurrence of economic problems. The World Bank study (1995) and Mikloš (1993) noted that the recurring macroeconomic instability and the unavoidable economic drop in 1993 were economic consequences of changing the legal form of the State.

Declines in GDP generation in 1993 were at a milder pace (see Chart 1). Public finances and FX reserves produced negative results while inflation rates increased. From a macroeconomic viewpoint, the subsequent period of 1994 and 1995 can be determined, with a certain caution, to be the most successful to date (Chart 1). Changes in Slovakia's economy in 1994, compared to the preceding period, have been explained by Okáli et al. (1995) using the following arguments:

1. A relatively stable macroeconomic framework of economic activities emerged thanks to restrictive fiscal and neutral monetary policies;
2. Economic policies were established to improve exports and foreign trade balances through a devaluation in the second half of 1993, anti-import measures introduced early, and pro-export measures introduced late in 1994. These actions were strengthened by favorable upswings in developed market economies and CEFTA countries;
3. The effects of recurrent economic recession caused by the split of Czechoslovakia and the establishment of independent Slovakia came to an end.

The 1994 revitalization of Slovakia was achieved exclusively through the growth of exports. Slovakia's structural weakness of having an excessive proportion of production of semi-products then became an advantage for quickly overcoming the recession. The trade in such products is dependent on prosperity. The demand cycle on the part of Slovakia's trade partners improved in 1994 and stimulated Slovakia's exports of its existing export product range (for details, see OECD, 1996). That development creates the risk of not recognizing the pressing nature of structural changes. Slovakia's economic situation confirmed that semi-products and/or products with low level of processing can be produced with enough quality, at least reaching the lower limit of world standards, more easily than sophisticated final products.

Revitalization from the outside gradually translated to re-growth of additional GDP components. As a result, there was a substantial change in factors that produced economic growth during 1994 and 1995. While GDP expenditures, in constant prices, equaled the value of 1994's exports of products and services, all GDP components grew without exception in 1995 (compare with the Annex

attached to this chapter). The remaining problem was that domestic demand grew faster than GDP and caused a strong growth of imports. Simultaneously, export rates started a downtrend. This development threatened to produce repeated destabilization of Slovakia's economy. Slovakia did not seize the opportunity offered by revitalization to implement the necessary structural and institutional changes. This meant that the positive macroeconomic development was at risk of reversing to adverse conditions. Additional performance gains could not be possible until the capacity of transition-related depression resources became involved. There was no sound microeconomic base in place yet to provide for a self-sustaining harmonic development.

### **2.3.4 Disbalanced Growth Stage (1996-98)**

#### **2.3.4.1 Direction of Economic Policy**

At this stage, there was a more pronounced implementation of the ideas from the end of 1992 that concerned the “strategy of economic revival.” The economic policy deviated from liberalist models. Social motif and State responsibility views became stronger; strong economic growth was preferred. It was supported by the growing acceptance of a demand-oriented economic policy that included stimulation of demand through expansion of public expenditures, realization of extensive public infrastructure investments, deficit-generating management in the interest of the stimulation of so-called developmental stimuli, etc.

The defense of the “own path” outlined in Scheme 1 frequently relied on social arguments that highlighted features of Slovakia's transition from centrally planned to market economy. On the other hand, Danco (1996) warned that the “own path” policy was blurred and actually prevented realization of the transformation.<sup>22</sup> The most important segments of the economic policy lacked adequate coordination. The Central Bank responded to excessively expansive fiscal policy by requiring a restrictive monetary policy orientation. As a result, private loans became restricted and interest rates started soaring. There was also a lack of coordination between macroeconomic policies and progress in structural reforms.

During this period, economic policy gave preference to high growth rates and ignored institutional change requirements. There was no pronounced success in restructuring the economy and no completion of transition-related steps. It ignored and underestimated the potential of imbalances to produce questionable outcomes.

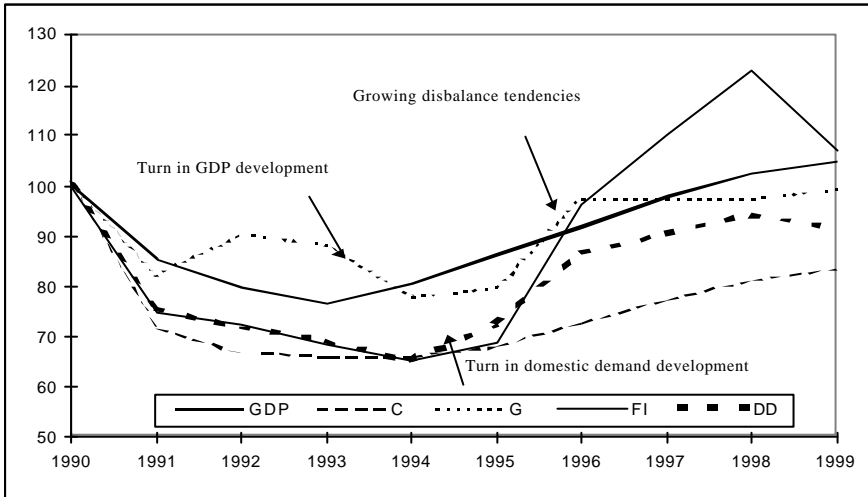
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<sup>22</sup> The same author also warned against the abuse of the „own path“ (which, moreover, has never been defined and publicly supported by considerations on the potential advantages or disadvantages of this procedure) for the purposes of special-interest groups such as the State-owned industries lobby.

### 2.3.4.2 Unsustainability of Disbalanced Development

In 1996, macroeconomic development was seen as a breakthrough year. From 1994 to 1995, several positive forces resulted in a changed development pattern. In the presence of high economic growth, there were still problems of both internal and external imbalances,<sup>23</sup> requiring marked interventions. Chart 10 illustrates changes in the components of domestic demand and GDP compared to 1990 levels. Domestic demand components, except for consumption by households, were growing in this period at rates substantially faster than GDP. This caused domestic demand and GDP imbalances to recur, which naturally produced external imbalances.

CHART 10. Domestic Demand and GDP Components Levels (1990 = 100)



C – end-consumption by households, G – end-consumption by State administration, FI – gross fixed capital generation (fixed investments), DD – domestic demand,  $DD = C+G+I$ . Data for 1999 relate to the first half-year. Source: author's own calculations based on data from the Slovak Statistical Office and OECD.

With domestic demand exceeding GDP, it raises the question of how domestic demand could be met and to what extent economic imbalances participate in this coverage. Domestic demand can be met by gross domestic product and a surplus of goods and services imports over exports (passive balance). If price change issues are to be considered, the statement as above will have to be extended to include the following formulae:

<sup>23</sup> So, the OECD study (1999) identified an excessively expansive fiscal policy as the major reason for the macroeconomic disbalance.

$$DD_t = HDP_{t-1} + EM_{t-1} + DD_t - DD_{t-1}$$

$$DD_{RC} = DD_t - DD_{t-1}$$

where  $DD_t$  = domestic demand in prices of the year  $t$ ,  $DD_{t-1}$  = domestic demand in prices of the year  $t-1$ ,  $HDP_{t-1}$  = GDP in prices of the year  $t-1$ ,  $EM_{t-1}$  = surplus imports of products and services over their exports (passive balance) in prices of the year  $t-1$ , and  $DD_{RC}$  = domestic demand covered by growth of prices.

With these formulae, percentage shares of the three components of domestic demand can be expressed, as shown in Table 5. In the real economy, there is passive balance and growing prices. The sum of the components  $EM_{t-1}$  and  $DD_{RC}$  may therefore, for this purpose, be called factors of imbalance.<sup>24</sup> Table 5 indicates that a reduction in the share of factors of imbalance of domestic demand could be stopped in 1996. Since then, factors of imbalance have been covering 14 % to 15 % of domestic demand. The tendencies for imbalances fully manifested themselves in 1996, due to a pronounced contribution of fiscal policy. The policy provided a marked expansion of expenditures to cover the end-consumption by State administration along with a strong growth in capital investments, with an extraordinary portion allocated by State.

The tendency to imbalance was shown in the part of domestic demand that is produced by the surplus imports of goods and services (passive balance). There was no marked change caused by price increases in the value of demand.<sup>25</sup> It may be stated that the imbalance between domestic demand and GDP generation was shown by a disturbance of external equilibrium, while the impact on prices was substantially less. Various countries in transition were found to have quite similar economic behavior at respective stages of development. In the Czech Republic, Poland and Hungary, the GDP volume covers on average about five-sixths of the domestic demand volume; the space for imbalance takes almost one-sixth a part of the domestic demand volume.<sup>26</sup> Under conditions of an inflexible supply side of the economy, a growing domestic demand results in an insufficient GDP increment. This relationship is illustrated in Table 6. Domestic demand

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<sup>24</sup> In small and open economies, the volume of GDP almost entirely covers the volume of domestic demand, and the effect of factors of disbalance makes up an almost negligible contribution (see Morvay, 1999).

<sup>25</sup> Certainly, the individual components of domestic demand will have to be understood as a mathematic construction. In reality, there are no demand components that would be exclusively covered by, e.g., growing prices.

<sup>26</sup> However, there are differences in the structure of factors of disbalance. Import surpluses over exports have a substantially greater share in Slovakia and the Czech Republic than in Hungary and Poland. This means that the disbalance in covering domestic demand arising in Poland and Hungary was accounted for by prevailing growing prices, whereas in Slovakia by prevailing growing surpluses of imports of goods and services over their exports.

increments in current prices were reflected partly in real GDP growth after 1995. So, any additional 1 Sk of domestic demand only induced a real GDP increment amounting to Sk 0.38. In such a situation, stimulating domestic demand cannot enhance economy growth. The stimulation of domestic demand without a principal revitalization of the supply side of the economy means the stimulation of imbalance.

An analysis of the imbalance between savings and investments provides an alternative view of the imbalance phenomenon. When more is invested in an economy than saved, the difference must be covered from savings of other economies. Table 7 indicates that the economic growth in this period was markedly dependent on foreign resources. Slovakia's economy could be characterized by unusually high investment rates (GCG/GDP ratio). Such a high ratio is unusual not only in developed industrial economies but also in countries in transition. It is evident from Table 7 that domestic savings cover only 40 % of, which is shown in this example as gross capital generation.

TABLE 5. Structure of Domestic Demand Coverage and Disbalance between the Development of Domestic Demand and Performance (GDP) in Slovakia

(%)	1993	1994	1995	1996	1997	1998	1999
DD <sub>t</sub>	100	100	100	100	100	100	100
1. DD <sub>RC</sub>	14.7	12.3	8.4	5.9	6.9	5.4	5.8
2. EM <sub>t+1</sub>	3.2	-5.0	-1.2	8.7	8.1	8.7	6.0
1+2 Factors of disbalance	17.9	7.3	7.2	14.6	15.0	14.1	11.8
3. GDP <sub>t+1</sub>	82.1	92.7	92.8	85.4	85.0	85.9	88.2

Note: Data for 1999 relate to the first half-year. Source: Morvay (1999)

TABLE 6. Sensitivity of Real GDP to Nominal Domestic Demand

Parameter	1994	1995	1996	1997	1998	1999
GDP <sub>t+1</sub> growth / DD <sub>t</sub> growth	0.64	0.34	0.25	0.49	0.38	0.61

Note: Data for 1999 relate to the first half-year. Source: author's own calculations based on data from the Slovak Statistical Office

TABLE 7. Generation of Savings and Investments in Slovakia

Parameter	1993	1994	1995	1996	1997	1998	1999
GDP	369.1	440.5	516.8	575.7	653.9	717.4	378.3
- End-consumption by Households	196.2	221.9	252.7	286.1	325.0	363.0	193.1
- End-consumption by State	92.3	93.9	108.1	132.1	143.5	151.8	76.4
- Domestic Savings (DS)	80.6	124.7	156.0	157.5	185.4	202.6	108.8
Gross Capital Generation (GCG)	101.0	101.8	146.6	226.7	252.9	282.7	134.3
- Covered by Domestic Savings, %*	79.8	122.5	106.4	69.5	73.3	71.7	81.0
- Covered by Not-own Resources, %**	20.2	-22.5	-6.4	30.5	26.7	28.3	19.0
Need for Not-own Resources***	20.4	-22.9	-9.4	69.2	67.5	80.1	25.5
Absolute GDP Increment	36.9	71.4	76.3	58.9	78.2	63.5	30.5
- Covered by Not-own Resources, %	55.3	-32.1	-12.3	117.5	86.3	126.1	83.6
GCG / GDP (%)	27.4	23.1	28.4	39.4	38.7	39.4	35.5

Data in Sk bn current prices, unless indicated differently. Source: Slovak Statistical Office and author's own calculations. \* DS / GCG (%)\*\* Not-own resources / GCG,\*\*\* GCG – DS

Also noteworthy is the data describing the share of foreign resources used to finance our investments on GDP increments. Foreign resources covered more than 100 % of the absolute GDP increment in 1996 and 1998. Consequently, this growth was “on credit.” Certainly, this phenomenon could not be taken as a clear negative aspect if highly effective investment activities were financed from foreign resources. That would show a marked positive effect on export sectors of the economy. The structure of investments implemented in Slovakia during this period does not warrant a fast return or a pro-export effect of the investments.

An additional phenomenon of this period was the degradation of financial indices for the corporate sector. Table 8 indicates that after 1995, expenditures were growing faster than revenues. This certainly reflects an unhealthy microeconomic environment that can be translated, via insufficient tax revenues, to the macroeconomic level.

In summarizing the monitored period, it may be stated that changes in economic policy priorities after 1995, to the benefit of growth and to the detriment of equilibrium, became clearly reflected in the macroeconomic development. The high growth rates of the period were forced and some manifestations of imbalance were no more acceptable during the subsequent development.

TABLE 8. Development of Some Parameters for Non-financial Organisations

Parameter	1993	1994	1995	1996	1997	1998
Revenue Growth, in %	22.3	12.3	15.3	14.6	9.3	8.4
Growth of Expenditures, in %	20.7	12.6	14.4	16.1	9.7	10.6
Profits/Losses, in Sk bn	30.3	31.9	44.7	34.5	32.3	22.7
Cost Efficiency, in %	3.2	3.4	4.2	2.8	2.5	1.2

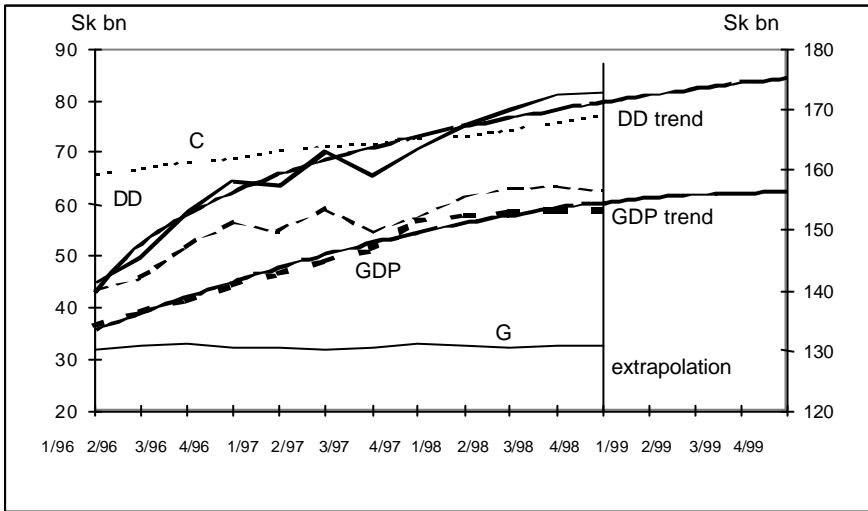
Source: Nemeč (1998) and Slovak Statistical Office

### 2.3.5 Equilibrium Recovery Stage (1999-)

#### 2.3.5.1 Direction of Economic Policy

The deep macroeconomic imbalance of Slovakia has shown a need for pronounced changes in priorities of economic policies. There has been no reason to assume that any significant positive change would occur spontaneously while retaining the previous direction of the macroeconomic development. The trend functions of the warning prognosis (Chart 11) show that the domestic demand-GDP generation differential might even grow by an additional 14 % in 1999 compared to 1998. This would mean further intensification of the macroeconomic imbalance.

CHART 11. Warning Prognosis of the Development in Domestic Demand-GDP Differential<sup>27</sup>



In constant prices of 1995. C, I and G are presented on the left axis, DD and GDP on the right axis. C – end-consumption by households, G – end-consumption by State administration, I – gross fixed capital generation, DD – domestic demand C+I+G (changes in inventories not accounted for). The DD trend formula reads:  $Y = 139.5 * t^{0.0822}$  (t is the time variable). The GDP formula reads:  $Y = -0.0976 * t^2 + 3.1857 * t + 130.38$ . Source: data of Slovak Statistical Office (1999) and author's own calculations

There was a significant change in transition process concepts towards the end of 1998. Efforts spent to eliminate the macroeconomic imbalance could not be sustained, even at the cost of temporarily weakening economic growth. The pillars

<sup>27</sup> Extrapolation of season-abstracted series of GDP components. This method is not sufficient to develop prognoses, but it may serve to outline the extrapolation of trends.



of economic growth were defined as first, a new institutional framework, and second a restructuring and improvement of competitiveness of the corporate sector. These pillars arise from the goals proclaimed by the government, that the values close to classical liberalism and institutionalism and/or neo-institutionalism should be approached (proclaimed need for changes in formal but mainly informal rules of the behavior of economic entities).

The criticism of economic policy was based on different assessments of the need and the acceptable depth of restrictive measures needed to slow down domestic demand growth.<sup>28</sup> Critics attacked the concept of restricting domestic demand as well as the idea of a temporary slow-down of GDP growth rates as presented by Husár (1999, p.10): *„It is a huge mistake that the government economists have focused on reduction of domestic demand just because, as they state, our domestic demand exceeds GDP, and thus domestic demand has to be reduced... It does not arise from the fact that our domestic demand exceeds GDP that we should reduce domestic demand; the logical way is to understand it as the need for increasing domestic production to make it exceed domestic demand – and then we turn into exporters.... The correct objective is not only 3 % GDP growth. This is not enough, and I already blamed the preceding government that they satisfied themselves by having 6 % GDP growth. If we take the history of many countries when they were getting out of recession – they were reaching real GDP growths of 12 %, we only achieved 6 %... A growth rate of three percent however cannot save us, pull us through the poverty we witness. This is not a good policy.“*

The actual problem is that the launching of the required high growth rates is a long-term process whereas imbalance requires rapid treatment. It is easier to slow down the growth of domestic demand than to speed up the growth of domestic production (for details on this issue, see Laski, 1993). In our opinion, future development of Slovakia's economy concerns the establishment of a stable base for long-term growth of performance. Reliance on restriction of domestic demand would be an excessively simplistic and shortsighted solution to imbalance without supporting the supply side based on restructuring and improving the competitiveness of the economy.

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<sup>28</sup> Partisans of restrictions base their considerations on the assumption that excessive growth of domestic demand and the associated disbalance and current account deficit are due to the expansion of public expenditures and the persisting deficit in the management of the so-called general government. Then, to remedy this condition, the place where everything should be started is public budgets. This is also connected with the need to raise revenues and reduce expenditures within the entire fiscal sector.

### 2.3.5.2 Short-term Consequences of the Stabilization Operation

Experience from the stabilization operation (short-term aspect) suggests that one of the goals of the economic policy, namely diminishing of external imbalance (Table 9), will obviously be achieved. This goal is connected with an improvement of the domestic demand-GDP generation ratio, and/or of proportions between savings and investments (also see Tables 5, 6 and 7). There is some dispute concerning the price to be paid for the reestablishment of equilibrium, being some negative trends of other parameters such as unemployment, GDP growth rates, or inflation rates. Some economists (see Mikloš, 1999) consider a temporary worsening of some parameters as an unavoidable consequence of the previous development, and prefer establishing equilibrium and institutional changes warranting the growth of the economy at a higher quality level. The critics, so far without offering a comprehensive concept, require more pronounced and clearly defined developmental incentives on the part of the State.

There remain issues behind these disputes that have accompanied the transition process from its very beginning. The issues concern the acceptability and the extent of restrictions, the possible extent to which domestic demand can be reduced, preferences of more aggressive or milder methods, social, political and societal costs of stabilization, more or less extensive responsibility of the State.

TABLE 9. Some Impacts of Reestablishing Equilibrium

Positive Changes	Values	Negative Changes	Values
Reduction of External disbalance (measured here as the net share of exports on GDP, in %)	2 <sup>nd</sup> Q1999 -7.5 % 2 <sup>nd</sup> Q1998 -12.9 %	Reduced GDP Growth Rates	2 <sup>nd</sup> Q1999 2.9 % 2 <sup>nd</sup> Q1998 6.1 %
Improved GDP Structure (GDP growth exceeds that of domestic demand)	GDP Growth 2.9 % Domestic Demand Growth -1.7 % (constant prices, 2 <sup>nd</sup> Q99)	Growth of Unemployment Rates	2 <sup>nd</sup> Q1999 17.7 % 2 <sup>nd</sup> Q1998 13.5 %
Reversal in the Development of Parameters for Non- financial Organizations	Growth of Revenues / Growth of Expenditures 2 <sup>nd</sup> Q1999 1.13 2 <sup>nd</sup> Q1998 0.85	Expected Growth of Inflation Rates (in 2 <sup>nd</sup> Q1999)	ŠÚ SR Prognosis for 1999 11.8 % for 1998 6.7 %
Reduced Foreign Indebtedness (USD bn)	7/1999 10.1 7/1998 11.9	Reduced Growth Rates of Real Wages	2 <sup>nd</sup> Q1999 0.5 % 2 <sup>nd</sup> Q1998 2.8 %

Source: Data from ŠÚ SR (Slovak Statistical Office) and author's own calculations

### 2.3.6 Notes on the Expected Development

There have been attempts to take a new approach for macroeconomic regulation, including improved coordination of economic policy segments,

recovery of the business sector and banks, as well as the formation of perspective economic structures arising from the medium-term concept of the economic and social development of the Slovak Republic (1999).

The scope and the requirements associated with the tasks to stabilize and provide for further development of the economy will take more time. The risk of repeated failures requires speedy solutions as possible for all reform units. According to the macroeconomic scenario of the "Medium-term Concept", any postponement of reforms could lead the national economy to collapse. Hence, there is a need for parallel changes in economic policies, conditions for the operation of the banking and corporate sector, as well as changes in policies directed towards the support to structural changes, and improved competitiveness. A prologue of stabilization measures was taken in 1999, mainly aimed at consolidating public budgets, reducing domestic demand, and limiting trade balance deficit. It has to be followed quickly by the implementation of principal and comprehensive interventions into the whole, broadly conceived institutional framework of the economy.

To enable the macroeconomic developmental stage (increase in employment and of economic growth rates, and subsiding of the disbalance symptoms, see Chart 12 after 2000, the stabilization measures must satisfy certain economic conditions. They not only must be restrictive, but they have to also contain developmental stimuli that encourages the creation of both domestic and international developmental resources. The growth of domestic developmental resources requires the restriction of government spending and reducing public budget deficits, thus reducing the need for government loans and gradually enabling a relief of the tax burden. This step will provide the corporate sector with better access to funds.

A successful stabilization operation can improve the trustworthiness of Slovakia's economy and may make a contribution towards the acquisition of appropriate international resources in the form of direct foreign investments and advantageous credits. A stabilization policy, therefore, is not necessarily in contradiction to developmental policy. Holman (1991) has provided evidence that a rational restrictive policy need not act against growth. Although such a policy restricts the opportunities for short-term demand-side stimulation of economic growth, it develops its long-term pro-growth effects through the recovery of the supply side of the economy. Through reestablishing equilibrium and stability, a consistently and wisely implemented stabilization may create an environment for the normal operation of the economy associated with economic growth.

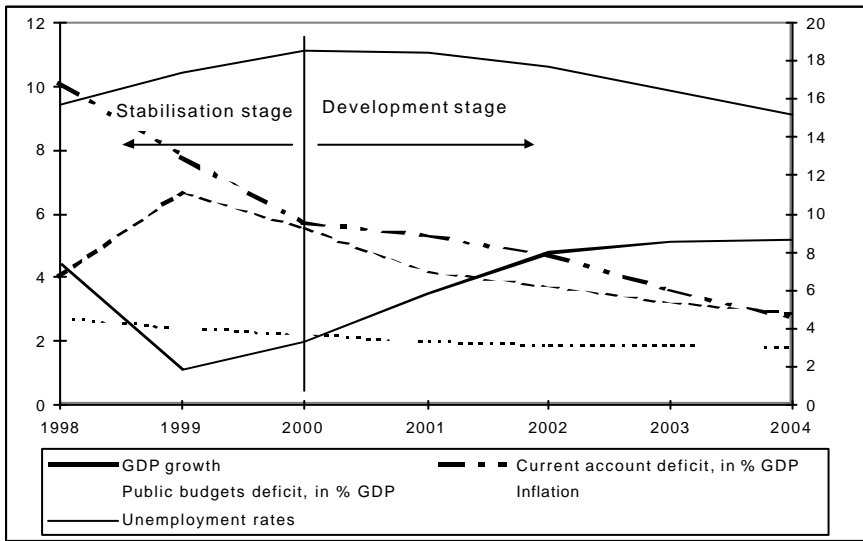
## 2.4 Conclusion

In our opinion, the macroeconomic development of Slovakia has reflected two factors that have been underestimated during the process of transition to date. The first factor was the underestimation of the institutional framework of a functioning market economy. The second factor was the underestimation of required coordination of macroeconomic policies during the restructuring of the economy.

Repeated destabilizations of the economy were the result of these factors having been neglected. Therefore, even after a decade since the initial transition steps, the economic policy makers have to frequently consider problems similar to those they were facing at the very beginning: how to stabilize the economy, how to restructure it, how to prevent the existence of soft budgetary constraints, how to draft functional rules for the behavior of economic entities under new conditions, etc.

Slovakia's example suggests that macroeconomic successes forced by the economic and political center through inadequate stimulation of financial policy tools will vanish, and will not be supported by a sufficiently viable corporate sector.

CHART 12. Expected Development of the Principal Macroeconomic Parameters – Medium Term Projections



Note: The right axis relates to unemployment rate and inflation rate, the left axis relates to all the other parameters. The values shown are average values of the intervals within which the expected parameter value should range. Source: Medium-term Concept of Economic and Social Development of Slovakia

(1999), part III. (Macroeconomic scenario developed by Institute of Slovak and World Economy, Slovak Academy of Sciences)

The fact that the imbalanced development has to be repeatedly remedied by packages of unpopular measures suggests the limited ability of the automatic economic regulators to operate, and the unreliability of the coordination mechanisms of the economy.

In view of the above, we consider it necessary that economic policy support the supply side of the economy. That type of support can improve economic performance through effects on formal and informal rules of behavior, elimination of allocation mechanism distortions, restructuring, support of human capital development, and innovations, etc. While supply side support is less direct and not as fast as demand-side support, supply side effects are long-term in nature. Higher quality economic growth and stability can be achieved by this approach. Going back to the economic stimulation of performance through domestic demand stimulation would likely result in a recurrence of the problems of economic imbalances.

A conceptual approach to completing the transition process is required. It must strive to improve the coordination of individual components of economic policy, provide links between macroeconomic policies and microeconomic restructuring, and eliminate distorted parts of the institutional framework. It can establish an environment that will not require more packages of rescue measures for survival under strains and uncertainty.

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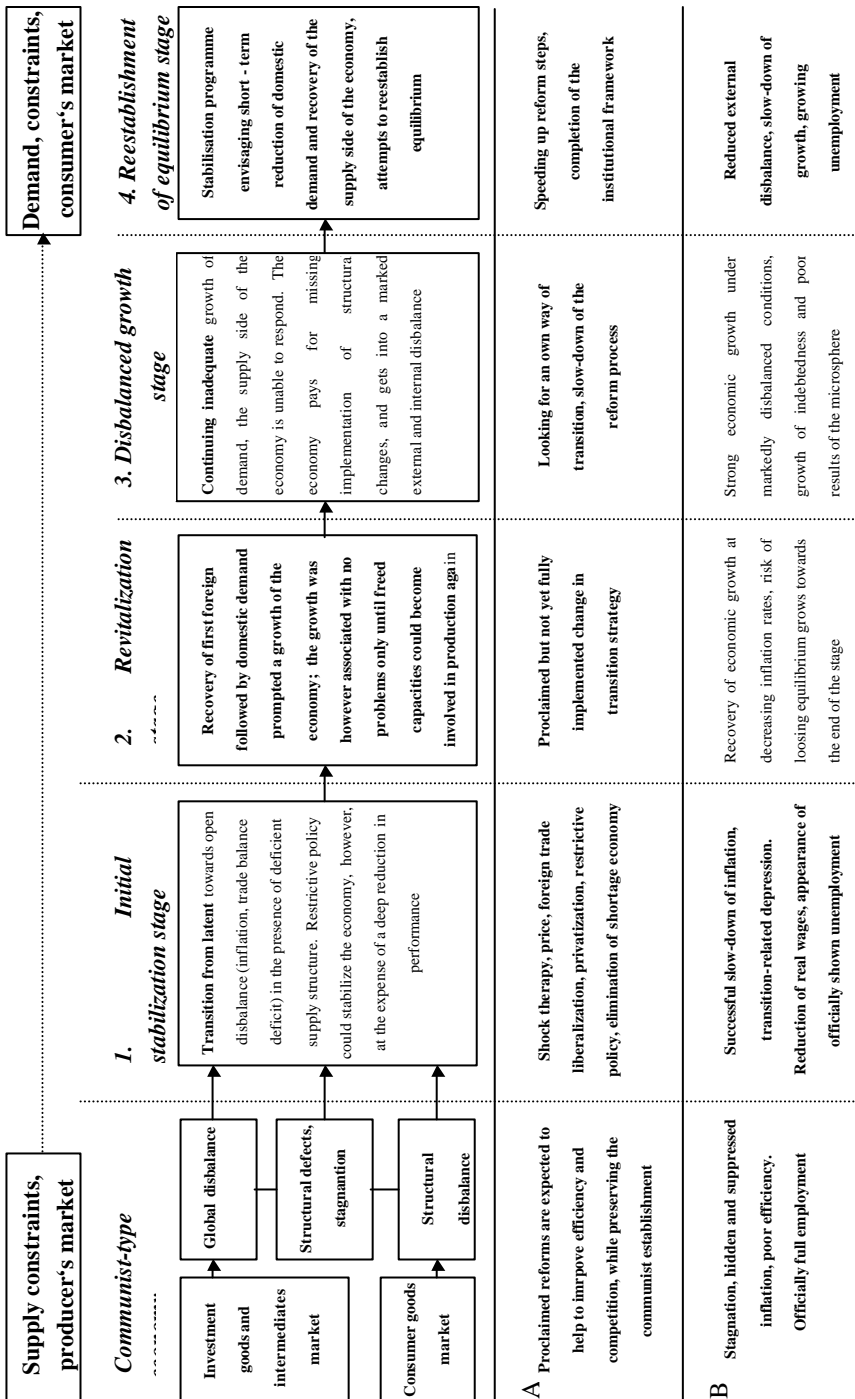
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**SCHEME 2. Stages of the transition process**



## 2.6 Annex

TABLE 10. 1990-99 Macroeconomic Parameters

Parameter	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP Growth <sup>i</sup>	-2.5	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.8
Unemployment <sup>ii</sup>	1.6	11.8	10.4	14.4	14.8	13.1	12.8	12.5	15.6	17.7
Inflation Rate <sup>iii</sup>	10.4	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	9.4
Net Exports <sup>iv</sup>	-9.0	-3.0	-4.0	-5.5	5.2	1.8	-12	-10.3	-11.2	-4.9

Data for 1999 are for quarters 1 through 3 except for „the first two quarters“<sup>i</sup>. Growth rates in %, constant prices. <sup>ii</sup> According to recorded unemployment rates, in %. <sup>iii</sup> Change as compared to preceding year, in %. Inflation has been calculated based on consumer price index. <sup>iv</sup> Balance of exports and imports of products and services expressed in terms of GDP %. Source: Slovak Statistical Office, National Bank of Slovakia, OECD (1999)

TABLE 11. Development of GDP and Its Components, 1990-99

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP, Sk bn, c.p.	278.1	319.8	329.8	369.1	440.5	516.8	575.7	653.9	717.4	579.2
GDP, % f.p.	-2.5	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.8
CH, Sk bn, c.p.	149.9	163.6	164.6	196.2	221.9	252.7	286.1	322.3	360.1	293.1
CH, Growth in % c.p.		-28.4	-6.4	-1.5	0.0	3.4	6.9	6.3	4.9	0.8
CH/GDP, %	53.9	51.2	49.9	53.2	50.4	48.9	49.7	49.3	50.2	50.6
G, Sk bn, c.p.	60.9	65.8	85.0	90.5	91.8	104.8	129.7	143.5	151.8	116.2
G, Growth in % f.p.		-17.8	9.9	-2.2	-11.6	2.1	21.9	0.0	0.2	0.6
G/GDP, %	21.9	20.6	25.8	24.5	20.8	20.3	22.5	21.9	21.2	20.1
FC, Sk bn c.p.	86.9	90.4	109.3	120.7	129.4	141.5	212.7	252.7	292.4	178.6
FC, Growth in % f.p.		-25.2	-3.3	-5.4	-4.6	5.3	39.8	14.5	11.0	-15.8
FC/GDP, %	31.2	28.3	33.1	32.7	29.4	27.4	36.9	38.6	40.8	30.8
C, Sk bn, c.p.	92.3	99.9	93.3	101.0	101.8	146.6	226.7	252.9	282.7	196.4
C, Growth in % f.p.		-21.1	-13.1	-9.2	-11.8	37.4	40.8	3.7	5.2	-11.4
C/GDP, %	33.2	31.2	28.3	27.4	23.1	28.4	39.4	38.7	39.4	33.9
DD, Sk bn, c.p.	303.1	329.3	342.9	389.5	417.6	507.4	644.9	721.4	797.5	607.7
DD, Growth ,in %f.p.		-24.3	-5.0	-3.7	-5.7	11.2	19.6	4.1	4.1	-3.4
DD/GP, %	109.0	103.0	104.0	105.5	94.8	98.2	112.0	110.3	111.2	104.9
X, Sk bn, c.p.	73.8	148.1	233.7	227.8	286.6	325.8	334.0	396.9	456.8	364.4
X, Growth in % f. p.		33.4	47.5	-0.5	14.2	3.1	-0.3	14.2	10.8	6.6
X/GDP, %	26.5	46.3	70.9	61.7	65.1	63.0	58.0	60.7	63.7	62.9
M, Sk bn c.p.	98.8	157.6	246.8	248.2	263.7	316.4	403.2	464.4	536.9	392.9
M, Growth, in % f.p.		-14.7	47.1	-0.8	-3.6	9.6	20.3	9.1	9.6	-1.6
M/GDP, %	35.5	49.3	74.9	67.2	59.9	61.2	70.0	71.0	74.8	67.8
NX, Sk bn c.p.	-25.0	-9.5	-13.1	-20.4	22.9	9.4	-69.2	-67.5	-80.1	-28.5
NX/GDP, %	-9.0	-3.0	-4.0	-5.5	5.2	1.8	-12.0	-10.3	-11.2	-4.9

Data for 1999 relate to quarters 1 through 3, c.p. – current prices, f. p. – fixed prices. GDP percentages have been calculated from current prices. CH End-consumption by households, G End-consumption by

State administration, FC Generation of gross fixed capital, C Generation of gross capital, i.e., FC+change in inventories, DD Domestic demand, i.e., CH+G+C, with immaterial deviations, if any, is given by not including non-for-profit organisations serving households, X Exports of products and services, M Imports of products and services, NX Net exports, i.e., X-M. Source: Slovak Statistical Office, OECD (1999) and author's own calculations based on these data

TABLE 12. Additional Parameters, 1993-99

Parameter	1993	1994	1995	1996	1997	1998	1999
Industrial Producer Prices, % <sup>i</sup>	17.2	10.0	9.0	4.1	4.5	3.3	2.7
Construction Work Prices, % <sup>i</sup>	24.1	11.0	12.0	15.0	9.7	8.9	10.8
Agric.Prod.Prices, % <sup>i</sup>	14.6	10.8	3.3	5.4	5.6	-0.3	-2.6
Deflator GDP, 1995=100	80.1	91.1	100.0	104.5	111.4	117.1	122.8 <sup>*</sup>
Unemployment Rates, %, VZPS <sup>ii</sup>	12.2	13.7	13.1	11.3	11.8	12.5	15.9
Average Monthly Wages, Sk	5 379	6 294	7 195	8 154	9 226	10 003	10 302
Growth of Real Wages, %	-3.6	3.2	4.0	7.1	6.6	2.7	-1.9
Growth of Productivity of Labor in f.p., % <sup>iii</sup>	-3.6	6.8	4.6	5.7	6.3	4.9	3.8
Constr.Industry Production Growth, %	-32.3	-6.8	2.9	4.4	9.2	-3.5	-28.0
Retail sales growth, c.p., %	9.8	1.7	2.0	7.0	4.6	8.2	7.0
Net Monthly Income per Household Member, Sk	2 820	3 196	3 476	4 067	4 716	4 986	5 125
Net Monthly Expenditures per Household Member, Sk	2 810	3 176	3 403	3 996	4 606	5 037	5 065
Growth of Deposits by Population, %	25.4	13.6	22.8	16.1	16.4	12.8	13.6
Nos. of Natural Persons Doing Business <sup>iv</sup>	282.9	287.0	275.1	258.2	277.2	295.8	299.7
Nos. of for Profit Organizations, in thous.	29.0	36.2	43.6	47.9	53.8	60.3	59.0
- in Public Sector, thous.	2.4	1.6	1.6	1.7	1.5	1.4	1.2
- Private, thous.	25.7	34.5	42.1	46.2	52.4	59.0	57.7
Private Sector's Share /GDP, %	37.3	53.3	62.6	76.8	82.6	82.4	84.5
State Budget Balance, Sk bn	-23.0	-22.9	-8.3	-25.6	-37.0		
- Using the New Method					-17.0	-19.2	-12.4

Unless stated differently, data for 1999 relate to Q. 1 through 3, except for „first two quarters“. <sup>i</sup> Year to year change, <sup>ii</sup> Sample survey of labor, <sup>iii</sup> Productivity of labor calculated based on GDP, <sup>iv</sup> Registered by Slovak Statistical Office, in thous.persons. Source: Slovak Statistical Office

### 3 Fiscal Policy

Ján TÓTH<sup>29</sup>

ING Barings

The following chapter focuses on one of the most important macroeconomic policies – fiscal policy. Slovak fiscal policy has undergone several different stages since 1989. After the collapse of communism, the priorities were the elimination of excessive taxation and the lowering of the gap between fiscal sources and public demands. Slovakia succeeded in decreasing public expenditures and implemented a modern taxation system. The fiscal policy between 1993 and 1995 was successful with regard to bringing the fiscal deficit down from 7.2 % of GDP in 1993, to a small *surplus* of 0.4 %, in 1995. Later, the fiscal prudence deteriorated markedly. The rapid worsening of the tax discipline was translated into huge external imbalances. Slovakia was running an average current account deficit of 10 % of GDP in 1996-1998, and when combined with minimal foreign direct investment, the country set out on an unsustainable borrowing spree. High real domestic interest rates destroyed the profitability of most Slovak corporates. To keep the fixed exchange rate regime, the central bank had to support the currency at the expense of monthly import coverage falling from 3.2 months to 2.2 months. Slovak external debt rating was cut from investment to noninvestment grade and the central bank was forced to float the currency.

Since 1999, the new government has started to address the issue of the rising public explicit and implicit liabilities. The following, more detailed discussion of revenues and expenditures shows that decreasing tax-to-GDP ratio does not allow a dramatic decrease in tax rates without the improvement of the tax discipline of taxpayers. Public expenditures are still very high, and it would be imperative to increase the effectiveness of the redistribution of public outlays.

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### 3.1 Introduction

Fiscal policy has immense consequences for the economy. It can ruin a country's rating by giving rise to external instability. It can destroy the profitability of private companies with little access to international markets through higher domestic real interest rates. It can rend monetary policy ineffective and break down the fixed exchange rate regime. It can triple the amount of public debt and contingent liabilities in the course of a few years. In addition, the policy can keep an economy running in high gears for some time and help win elections. Thus, fiscal policy plays a central role in determining overall economic developments of a country. Together with monetary policy, it influences short-run economic growth, balance of payments, debt levels, and rates of inflation. The policy forms the entrepreneurial environment and decides on the redistribution of income.

This chapter discusses in some detail the last ten years of fiscal stance in Slovakia, relying on IMF data. Slovak government data are either non-existent or not detailed enough. The Ministry of Finance is pre-occupied with only one part of the general government – the so-called state budget. However, recently, the state budget has produced only around *half* of the general government deficit. In addition, the state budget data are not time- and country-consistent.

This chapter separates the fiscal policy into four different periods. During the pre-1993 period, the policy was implemented in Czecho-Slovakia, and the policy execution was carried out without the benefit of a comprehensive tax reform. The “good times” period lasted from 1993 till 1995 when the general government balance turned into surplus from a deep deficit. The “bad times” period continued throughout 1998, and a new period, since 1999, is being written with a new government fighting the rising public debt needs.

This paper then discusses in more detail the revenue and expenditure side of the general government and comes to a conclusion that the decreasing tax-to-GDP ratio does not allow for a drastic reduction in taxes without improved financial discipline and that expenditures are unsustainably high and their allocation efficiency needs to be drastically improved.

### 3.2 Getting the Numbers Right

There are immense problems with getting reasonable data for a public sector deficit from the government. Anecdotal evidence suggests that it is probably a combination of both unfamiliarity and the intention of the Ministry of Finance (MinFin) that there have been no reasonably detailed data available for the general government.

One part of the general government deficit, the so called ‘state budget’ deficit has been reported on a monthly basis since 1993 by the MinFin. However, it was only in January 1998 that the government reported the state budget deficit in a reasonable way, i.e., excluding the repayments of principals as an expenditure item.<sup>30</sup> The monthly state budget deficit figures were not available before January 1998 using this methodology.<sup>31</sup> What is more important, a vast array of state funds outside the state budget was often created to improve state budget deficit numbers. The expenditures of the Road Fund, for example, are not fully included in the state budget. The Road Fund alone added around 1 % of GDP deficit to the general government in 1997-1998. In addition, none of the social security, nor the National Property Fund is a part of the state budget, too. In recent years, almost a *half* of the overall fiscal deficit has been created *outside* the state budget. Anecdotal evidence suggests the lack of realization on the side of Slovak policy makers reflecting that it does not really matter whether the deficit is being created in the state budget or off the budget.<sup>32</sup> Having received technical aid from the IMF, the MinFin is gradually moving to report overall fiscal deficit, however, on a quarterly basis only, not in a great detail, and not using the methodology of the Fund or EUROSTAT. Therefore, this chapter does not use official government statistics, but instead uses IMF data wherever possible in order to point out the very arbitrary nature of the state budget deficit that is not in addition consistent over time and across neighboring countries. Therefore, throughout this chapter the state budget is not discussed in any detail.

Table 1 shows the general government statistics reported in the IMF country reports on Slovakia. For analytical purposes, in order to best gauge the fiscal policy, it is useful to exclude net lending<sup>33</sup> since it usually represents one-off revenues or expenditures. When considering the impact of the government on the aggregate domestic demand, one should include the net increase in government guarantees since the fiscal policy was implemented in this way, too. Then the number should be cyclically adjusted.<sup>34</sup> The resulting number is arbitrarily called the Structural Quasi-Fiscal Deficit. This number best describes the fiscal stance. It

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<sup>30</sup> Reporting repayments of principal as an expenditure could be of an interest in countries in which the government is unable to raise money domestically or internationally, as this might have been the case in Russia just after the Russian crisis in 1998.

<sup>31</sup> However, even this methodology is not correct.

<sup>32</sup> The ministers have been asking the MinFin to obtain financing other than from the state budget for some of their expansionary plans. This is a consequence of the fact that the MinFin is under constraint by budgetary law to keep the state budget deficit target only.

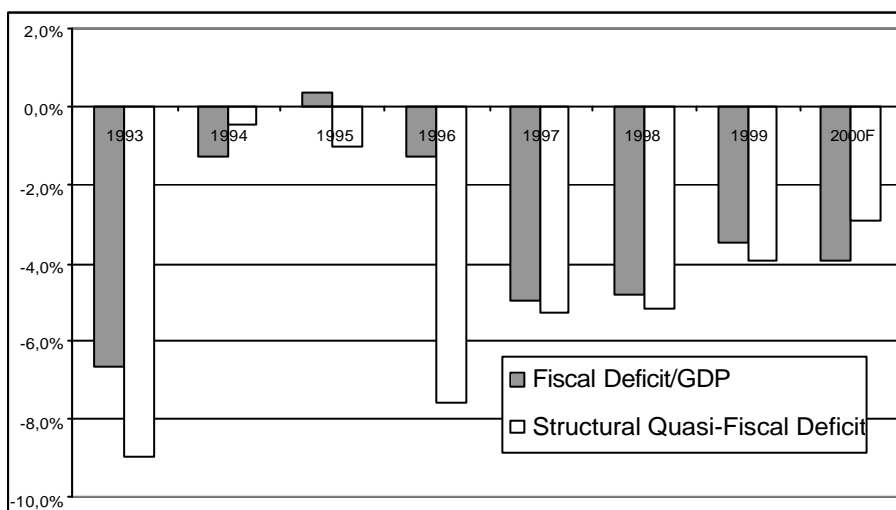
<sup>33</sup> Net Lending includes, e.g., privatization revenues and the recalled government guarantees.

<sup>34</sup> For more details see Part 1.4 and Appendix 1.

shows what would be the government-induced inelastic demand for resources should the economy operate near its potential.<sup>35</sup>

The 1992-1993 deficit was mainly due to the creation of an independent Slovakia as well as to the recession. Even once adjusted for the economic revival in 1994-1995, it seems that fiscal prudence dramatically improved during that period. In 1996, we saw the start of very expansionary government plans that were mainly realized, at first, through government guarantees.<sup>36</sup> During 1997-1998, a 5 % fiscal deficit was preserved. In 1999, a reversal of sorts has been indicated mainly due to the May 1999 fiscal austerity package. The structural quasi-fiscal deficit is estimated to reach around 4 % of GDP in 2000.

CHART 1. The Fiscal Stance – Structural Quasi-Fiscal Deficit



Source: Author, IMF, author's forecast

<sup>35</sup> The numbers are more for illustrative reasons and are subject to a great margin of error. For problems on estimations of a cyclical deficit, see part on Cyclical vs. Structural Government Deficit.

<sup>36</sup> Due to the lack of the detailed analysis of government guarantees, all government guarantees are assumed to be fiscally-expansionary in one way or another. In 1996, guarantees were used for power plant and dam constructions. In 1997, the guaranteed money supported Slovak Railways. Dam construction, railway, and highway construction received support from the government in the form of a guarantee in 1998. Slovak Railways and Vodohospodarska Vystavba (dam construction) restructured their short-run portfolio in 1999 and the additional guarantee support went into highway construction.

TABLE 1. The General Government

	1990	1991	1992	1993	1994	1995	1996	1997	1998	99e	00f
1 Revenues	400.2	489.4	149.2	159.3	200.8	251.7	274.5	293.5	304.1	312.2	321.8
2 Expenditures	401.5	510.6	191.5	188.0	207.5	250.5	282.8	322.7	336.9	338.1	353.7
3 Net Lending	3.8	6.2	-2.7	-2.7	-0.8	-0.7	-0.6	4.9	3.4	2.0	3.1
4 Net Interest and Recalled Guarantees			4.7	11.5	16.5	12.5	13.4	13.7	18.5	26.2	33.8
1-2-4 Basic Balance			-44.8	-39.3	-23.0	-8.9	-17.9	-38.7	-51.8	-43.8	-45.7
Basic Balance /GDP, %			-13.5	-10.6	-5.2	-1.7	-3.1	-5.9	-7.2	-5.5	-5.2
1-2 Revenues-Expenditures	-1.3	-21.2	-42.3	-28.7	-6.7	1.2	-8.3	-29.2	-37.6	-26.0	-31.9
(Revenues-Expenditures)/GDP, %	-0.2	-2.2	-12.7	-7.8	-1.5	0.2	-1.4	-4.5	-5.2	-3.3	-3.6
1-2-3 Fiscal Deficit	-5.1	-27.4	-39.6	-26.0	-5.9	1.9	-7.7	-34.1	-36.1	-28.0	-35.0
Fiscal Deficit /GDP, %	-0.6	-2.8	-11.9	-6.7	-1.3	0.3	-1.3	-5.0	-4.8	-3.5	-4.0
5 Net Increase in Government Guarantees (excl. state funds)			6.1	12.6	1.2	9.9	37.3	0.9	0.8	8.4	11.1
Net Increase in Government Guarantees /GDP, %			1.8	3.4	0.3	1.9	6.5	0.1	0.1	1.1	1.3
6 Recalled Guarantees (already in state budget)			1.1	0.5	0.1	1.2	1.9	2.1	2.1	4.2	10.0
1-2-3-5+6 Quasi-Fiscal Deficit			-44.6	-38.6	-6.9	-6.7	-43.0	-33.6	-41.4	-32.2	-36.1
Quasi-Fiscal Deficit /GDP, %			-13.4	-10.5	-1.6	-1.3	-7.5	-5.1	-5.8	-4.0	-4.1
1-2-5+6 Quasi-Fiscal Deficit (excl. Net Lending)			-47.3	-41.3	-7.7	-7.4	-43.6	-28.7	-36.6	-30.2	-33.0
Quasi-Fiscal Deficit /GDP (excl. Net Lending), %			-14.2	-11.2	-1.7	-1.4	-7.6	-4.4	-5.1	-3.8	-3.7
1-2-5+6+7 Structural Quasi-Fiscal Deficit (excl. Net Lending)			-51.6	-36.2	-2.1	-5.7	-45.8	-35.3	-38.1	-31.7	-26.7
Structural Quasi-Fiscal Deficit / Potential GDP (excl. Net Lending), %			-15.9	-9.0	0.4	-1.0	-7.6	-5.3	-5.2	-4.0	-2.9
<b>Memorandum Items</b>											
Nominal GDP*	811.3	977.8	332.3	369.1	440.5	516.8	575.7	653.9	717.4	797.5	883.1
Real GDP, %	-2.5	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.9	1.4
Newly Issued State Guarantees										29.3	44.6
Maturing State Guarantees	0.2	12.2	6.5	13.5	3.0	12.6	41.5	5.8	13.8		
7 Cyclical Fiscal Deficit (estimate)		0.0	0.3	0.9	1.8	2.7	4.2	4.9	10.6	9.6	25.4
				5.1	5.5	1.7	-2.2	-6.6	-6.6	-1.5	6.4

Skbn. \* The data are for Czecho-Slovakia before 1992. 1999 data abstract from the privatization revenues from CSOB bank sale. Source: IMF, MinFin, author, and author's forecasts

Since the MinFin was unable and probably not willing to provide the public with reasonable budget deficit data, the central bank has used their own monetary



survey data as a proxy for the fiscal deficit. The bank defines the fiscal deficit on a financing basis as the change in the net credit to the government and the state privatization body the National Property Fund (NPF). The analytical attractiveness of the data is that it is available on a monthly basis. However, the data is only an approximation; it does not include holdings of government debt by non-residents and non-banking entities.<sup>37</sup> In addition, the data is not fully consolidated. The average difference between the IMF and the central bank data was about 1 % of GDP in 1994-1998 period. The bank's data tend to *underestimate* the fiscal deficit.

### 3.3 Fiscal Policy Formation

This part discusses the possible forces that were behind the formation of the fiscal policy. It provides a feasible explanation as to why there has been a slowdown in reforms and the resulting fiscal policy slippage in 1996-1998 period.

Much of the traditional economic theory concerning the politics of economic reform is based on the assumption of a J-curve. A J-curve simply describes consumption pattern seen after the start of reforms – reforms drive aggregate consumption down in their early stages before future consumption reaches higher levels than was the initial level. The traditional theory assumes those short-term losers of the reforms such as unemployed, pensioners, and threatened state bureaucrats will take revenge against reforms at the very first opportunity and populist parties will gain power and halt the reforms. Therefore, in order to implement radical reforms, the state should be “isolated” from the pressures of these short-term losers until consumption reaches such high levels that it will create a majority of winners. This was the basis for the view that authoritarian governments had an advantage in implementing radical reforms; recent evidence from countries in Eastern and Central Europe conflicts with this conventional wisdom.

Hellman (1998) shows that early net *winners* might be at least the same influential than losers. The evidence suggests that it is precisely the most democratic countries (i.e., countries most vulnerable to short-term losers) that implemented the most radical reforms. Even though the early reform governments usually were voted out of the office, succeeding governments have not in general rejected reforms and in some cases even intensified them. Hellman argues that the most common obstacles to the progress of reforms came not from reform losers, but rather from early reform *winners* such as enterprise insiders, local officials, and

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<sup>37</sup> The central bank looks at balance sheets of domestic commercial banks and its own to determine the net credit to government and the National Property Fund. The new methodology to be used from 2000 on will include the debt of non-residents and non-bank entities.

managers of state banks, and state companies. ‘Crony capitalists’ bought companies dirt cheap only to then strip their assets; managers of state companies profited on full trade liberalization that was implemented. At the same time, when domestic prices were subsidized, local officials were bribed in order to prevent others from gaining market entry, and managers of state banks stripped deposits by giving credit to friendly counterparts. Early stages of reforms have created immense arbitrage opportunities that provided these short-term winners with concentrated rents. It was then in the very interest of these winners to block specific advances in the reform process since these would eliminate special advantages and market distortions upon which their own early reform gains were based.<sup>38</sup> Therefore, the winners strove to prolong the maintenance of partial reforms. The usual interests of these winners included:

- the prevention of foreign direct investment inflows into banks and industry;
- the imposition of trade barriers;
- maintenance of poorly defined property rights;
- inefficient law enforcement.

The data suggest that the highest social costs in terms of output declines<sup>39</sup> occurred in countries that implemented partial economic reforms as opposed to advanced reform countries or countries without any reforms.

Elections analyses have suggested that the voters supporting the government that was operating in 1996-1998 were the most populous in the group of basic education citizens (these people have suffered most from unemployment) and pensioners. Both of these groups suffer in early stages of reforms and therefore are early short-term losers. Traditional economic theory would suggest that the government should have favored these groups. Surprisingly, Slovakia offers a very poor replacement rate (the ratio of average pensions to average wages) and unemployment benefits are low in general.<sup>40</sup>

It is probably too early to discuss in great detail which forces were behind the formulation of the government's policy. One also needs to realize the great fiscal monitoring problems discussed earlier. Without proper monitoring, policy formulation cannot be conducted with a very clear vision.

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<sup>38</sup> Hellman (1998).

<sup>39</sup> The advanced reform countries and the countries that have not implemented almost any reforms fared best as far as their current output level is compared to the initial 1989 level. Intermediate reform countries have suffered most in terms of their output and their income inequality (when measured by Gini coefficient) changed most drastically. See Hellman (1998).

<sup>40</sup> For more details, see Part 1.8.3.3.

However, in view of the previous discussion, it is informative to consider short-term *winners* as the possible force behind the fiscal policy slippage in 1996-1998. Anecdotal evidence suggests that the possible winners could be among the new owners of privatized companies, building companies involved in highway, dam, and nuclear power constructions,<sup>41</sup> managers of state companies and monopolies, retail bankers,<sup>42</sup> and owners of inefficient domestic companies that are facing foreign competition.<sup>43</sup> The possibly high concentrated gains in the hands of these winners could have been one of the important reasons for the fiscal policy slippage during those years.

### 3.4 Twin Deficits in Small Open Economies

Too expansionary fiscal policy raises domestic demand and this could result in inflationary pressures and thus internal imbalance. Booming domestic demand could increase import growth and give rise to external imbalance. Eventually, these imbalances will affect the private sector's performance through higher interest rates or exchange rate losses. Therefore, very loose fiscal policy could institute unfavorable entrepreneurial environment and necessitate lower potential output growth.

The current account is defined as the difference between national investment and saving. An increase in budget deficit causes an increase in domestic demand, which under inelastic domestic supply usually translates into higher imports. Therefore, an increase in fiscal deficit *creates* an increase in current account deficit, hence the term twin deficits is used for both government and current (or trade) deficits. For example, when the Slovak government decided to start its extensive highway construction program - despite the political preference for domestic producers - Slovak firms were not able to supply the necessary equipment in the short-run and these then had to be imported. In addition, the Slovak government gave investment 'privatization tax' credit to the new domestic owners of Slovak companies. Fixed investment/GDP ratio reached an unsustainable 35 % average during 1996-98, and domestic savings could not cover all investment needs.

The rising budget deficit needs to be financed by an increase in foreign savings. Foreign savings flow could cause real exchange rate appreciation of the domestic currency. Numerous studies have shown that the overvalued domestic

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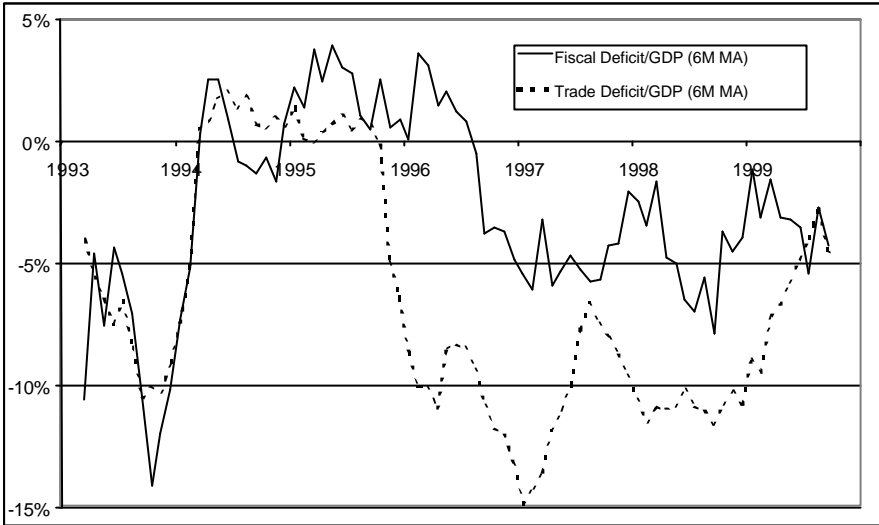
<sup>41</sup> Or in general, companies linked to the increased state expenditures.

<sup>42</sup> This is because of the lack of competition in the retail banking sector and the cases of the possible deposit-stripping in several Slovak banks.

<sup>43</sup> Because of the implementation of import certificates and tariffs.

currency is the best indicator of the future currency crisis.<sup>44</sup> Therefore, the rising real exchange rate of koruna in 1996-97 posed as the threat to the fixed exchange rate regime<sup>45</sup> and made the monetary situation more vulnerable.

CHART 2. Twin Deficits – Government Deficit Creates Trade Deficit



Source: Author

TABLE 2. Fiscal Deficit Using the Methodology of the Slovak Central Bank

	1993	1994	1995	1996	1997	1998	1999
Net Credit to Government and NPF (change)	-38.8	-2.5	10.5	-2.9	-29.5	-35.0	-21.1
Net Credit to Government and NPF (change) /GDP, %	-9.9	-0.5	1.9	-0.5	-4.3	-4.7	-2.6

1999 data is adjusted for the privatization sale of CSOB bank. Source: Slovak Central Bank, author

Since Slovakia was not fully open in its early years,<sup>46</sup> the central bank has decided to sustain the fixed exchange rate (for more details see the chapter on monetary policy); real domestic interest rates started to rise. The government-spending spree crowded out private investment through higher domestic real

<sup>44</sup> Kaminsky, Lizondo, Reinhard (1997).

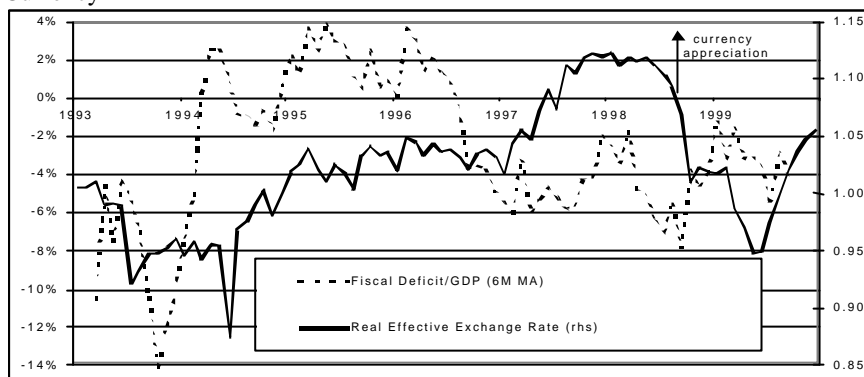
<sup>45</sup> Koruna was fixed to the basket of USD (40 %) and DEM (60 %), and before 1994 to the basket of 5 currencies.

<sup>46</sup> There were capital and current account restrictions, as well as the unavailability of sovereign and corporate ratings prevented companies to easily borrow from abroad.

interest rates. Moreover, the government entered international capital markets in 1998<sup>47</sup> and crowded out private investments even from these markets.<sup>48</sup>

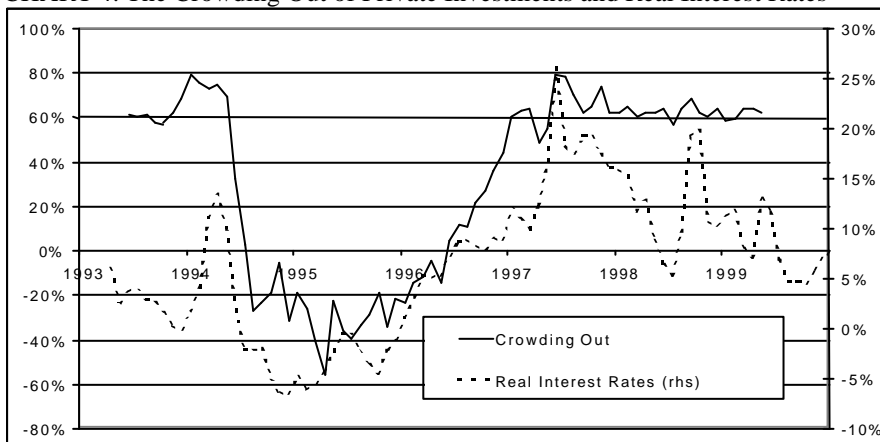
Very high real interest rates have negatively affected corporate results and forced smaller companies to rely exclusively on their working capital for financing. (Table 3).

CHART 3. Fiscal Deficit Could Cause Real Appreciation of the Domestic Currency



Source: Author

CHART 4. The Crowding Out of Private Investments and Real Interest Rates



Source: Author. Methodology: Domestic crowding out is defined as the ratio of the fiscal deficit to new domestic loans during the 12 months. A ratio of 100 % describes a complete crowding out of private

<sup>47</sup> The government borrowed USD 1 bn in Eurobonds in 1998 and another EUR 500 mn in 2000.

<sup>48</sup> Slovakia was facing rather thin international market once external indicators started to worsen and the crises in Asia and Russia caused worldwide flight to quality.

investments domestically, i.e., all new (net) domestic credits go to the government. Fiscal deficit is proxied by the change in net credit to the government and the National Property Fund.

With the smallest foreign direct investment inflows in the region, the expansionary government policy effectively hindered small and medium-sized enterprise growth, since the high monitoring costs prevented these companies to borrow from abroad. This worked against the increase in employment despite the high output growth since it is services and small entrepreneurs that are believed to create new jobs.

### 3.5 Cyclical vs. Structural Fiscal Deficit

Government deficit is defined as government revenues minus expenditures. Both are cyclically responsive, i.e., they change as the economy enters a different part of the economic cycle (a boom or a recession). In recession, incomes and profits *fall*, which drives tax revenues lower. In addition, expenditures *rise* since unemployment is increasing. Hence, government deficit increases even without a change in fiscal policy. An increase in the deficit increases domestic demand and short-term growth – hence, it functions as an *automatic stabilizer*. Therefore, it is of more interest to adjust the deficit for the cyclical stage of the economy and look at what is left – the so called structural government deficit.<sup>49</sup> In other words, it is much more dangerous to run a huge fiscal deficit at times when GDP growth is already high and by the same token, a bigger deficit might be of a less concern when GDP growth is low. If revenues are up only because the economy is operating in high gears, the revenue increase should be considered only temporary. An increase in expenditure in a deep recession ought to be viewed as short-lived.

TABLE 3. After-tax Profits of Slovak Corporates

	1994	1995	1996	1997	1998
Total Economy w/o Financial Services, Sk bn	29.9	42.8	33.6	32.3	6.6
Percentage of HDP, %	6.8	8.3	5.8	4.9	0.9

Note: Before 1996 the data are for companies with 25 and more employees, from 1997 on for companies with 20 and more employees. Source: Slovak Statistical Office, IMF.

TABLE 4. The Structural vs. Realized Fiscal Deficit

	1993	1994	1995	1996	1997	1998	1999	2000f
Structural Fiscal Deficit/GDP, %	-5.2	-0.1	0.6	-1.6	-6.1	-5.8	-3.7	-3.1
Fiscal Deficit/GDP, %	-6.7	-1.3	0.3	-1.3	-5.0	-4.8	-3.5	-4.0

Source: Author, IMF

<sup>49</sup> Structural, full-employment, or cyclically adjusted budget deficit is based on estimates of what the deficit would be should the economy be operating near its potential GDP.

The biggest improvement in the structural fiscal deficit (see the methodology note in Appendix 1) was recorded in 1993-94 and in 1999. In line with the warning of the IMF,<sup>50</sup> the structural budget deficit worsened in 1996-1998. When adjusted for the favorable cyclical stage, the fiscal deterioration was even more pronounced than the official data suggest. The structural deficit worsened by 2.3 % (of GDP) in 1996 and 4.5 % in 1997. In 1998, the fiscal slippage was less pronounced, due to the limited access for external funds since the country was downgraded to noninvestment grade.

### 3.6 Fiscal Policy before 1993<sup>51</sup>

Czecho-Slovakia experienced transformation recession comparable to other Central European countries at the start of the reforms. However, the macroeconomic imbalances were far less evident in communist Czecho-Slovakia than in Hungary or Poland. Even though in the 1980s consumption was increasing at the cost of lower investment and thus a growing obsolescence of capital stock, communist Czecho-Slovakia had a relatively prudent fiscal and monetary policy “partly attributable to the greater importance attached to financial developments by the central planners in Czechoslovakia than in most other planned economies”.<sup>52</sup> Realizing the disparity between available sources and wants, the communist government introduced some measures in 1988-1989.<sup>53</sup> However, the reform legislation adopted in 1990 abandoned the continuation of these gradual reforms and sought a massive reduction in the role of the state in the economy.

TABLE 5. Czecho-Slovakia: Federal Government Budget Balance (Kcs bn)

	1988	1989	1990	1991
Total Revenues	359.9	431.2	400.2	489.4
Total Expenditures	376.1	446.6	401.5	510.6
Net Lending	x	13.4	3.8	6.2
(Revenues-Expenditures)/GDP, %	-2.2	-2.0	-0.2	-2.2
Fiscal Deficit	-16.2	-28.8	-5.1	-27.4
Fiscal Deficit/GDP, %	-2.2	-3.8	-0.6	-2.8

Source: IMF's International Financial Statistics Yearbook

<sup>50</sup> IMF (1997).

<sup>51</sup> This part relies on IMF's Transition to Market, Studies in Fiscal Reform, Chapter 3: The Czech and Slovak Federal Republic: Government Finances in a Period of Transition, Jim Prust, Vito Tanzi, 1993 and CEPR Discussion Paper #1151, Tax and Benefit Reform in the Czech and Slovak Republics, Christopher Heady, Stephen Smith, March 1995. Unless stated otherwise, the data in this part refer to the Czecho-Slovak Federation, not Slovakia.

<sup>52</sup> Prust, Tanzi (1993)

<sup>53</sup> The measures included the simplification of bureaucracy, a breakup of a number of large enterprises into smaller units, a possibility of a joint-venture, and preparations for the establishment of the usual two-tier banking system.

TABLE 6. Consolidated Tax Revenues of All Federal and Local Governments, 1989

	Kcs bn	% Share
Profit Tax	83	21
Payroll Tax (employer's contribution to social security)	95	24
Turnover Tax (positive)	135	33
Wage Tax and Other Income Taxes	53	13
Other Taxes (on agricultural land, trade taxes, etc.)	37	9
Total Tax Revenues	403	100
Total Tax Revenues /GDP, %		53

Note: Presented taking negative turnover tax as a subsidy (i.e., part of expenditures, not revenues). Negative turnover taxes on food were abolished in July 1990 and on non-food items later. Source: Czechoslovak Federal Ministry of Finance; Heady, Smith (1995)

The main tax revenues came from taxes on 'enterprise surpluses' (profit taxes),<sup>54</sup> payroll,<sup>55</sup> and turnover. The tax on individual incomes was less significant.<sup>56</sup> Incentives in the tax system were not intended to play any role, taxes were often not predetermined ex-ante (e.g., profit taxes). Elimination of the scope for discretionary reduction in taxation for less profitable enterprises is a key step towards eliminating the 'soft budget constraints'.<sup>57</sup> Payroll taxes were simple and flat. There were no redistribution concerns since wage was already determined through an administrative process. A shift from the total tax burden from enterprise to indirect and personal income taxes was needed. In 1990, after three sharp administered devaluations, the government provided transfers to the banking sector to cover the devaluation losses on the net foreign liabilities.<sup>58</sup> In 1991, the ambition was to significantly cut the revenues and expenditures in real terms. The reduction in profit tax and in turnover and foreign trade<sup>59</sup> taxes decreased the share of revenues in GDP by 10 % to 53 %.<sup>60</sup> On the expenditure side, (budgetary) subsidies were sharply cut from 13 % to 7 % of GDP.<sup>61</sup> Retail subsidies were

<sup>54</sup> The profits tax was cut from 75-85 % to 55 %.

<sup>55</sup> Payroll taxes represented the employer's contribution to social security and were paid by enterprises. The rate was 20 % before 1989 and then it was increased to 50 %.

<sup>56</sup> The tax rates ranged from 5 to 20 % for most incomes. The highest marginal tax rate was 33 % in 1992.

<sup>57</sup> Kornai (1986).

<sup>58</sup> Prust, Tanzi (1993).

<sup>59</sup> Czechoslovakia experienced the collapse of trade with its most significant trading partners organized by CMEA (Council for Mutual Economic Assistance – a trading block of communist countries). Czechoslovakia relied heavily on intra-CMEA trade for both cheap raw material supplies and the undemanding markets for its goods. A 20 % import surcharge was imposed in 1991 and later reduced to 10 % in two stages.

<sup>60</sup> Excluding some exceptional items. Prust, Tanzi (1993).

<sup>61</sup> Budgetary subsidies were equivalent to 16 % of GDP in 1989 excluding cross-



removed in May 1991.<sup>62</sup> Subsidies to agricultural producers were cut by one-third.<sup>63</sup> To sum up, real government consumption collapsed by 18 %, the highest drop in the last 20 years.<sup>64</sup> The budget balance was in a strong surplus of 5 % in the first half of 1991 partly due to the boost in profits tax revenue from price liberalization; however, it ended up in a deficit of 2 % for the year as a whole.<sup>65</sup> The reform accomplished its goal of a substantial decrease in the government's role in the economy to a more reasonable level. However, with the new government arising from the elections in June 1992 and the foundation of an independent Slovakia, government expenditures reached this low level for a short-time only in 1995-1996, before the government set off on a public spree again.

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subsidization. This was a relatively small level than seen in other communist countries. Prices for energy and most primarily materials were low to the large extent due to sub-market prices offered by CMEA, thus 60 % of the subsidies applied to agricultural producers and retail subsidies on food (in the form of negative turnover tax). The negative turnover tax on foodstuffs was equivalent to almost a 25 % of the value of retail sales of such items in 1989. In July 1990, the retail subsidies on food were eliminated causing a 25 % rise in food prices. The remaining subsidies were offered to housing and other high-cost producers. The average monthly rent was equivalent to less than 5 % of average monthly earnings. Prust, Tanzi (1993).

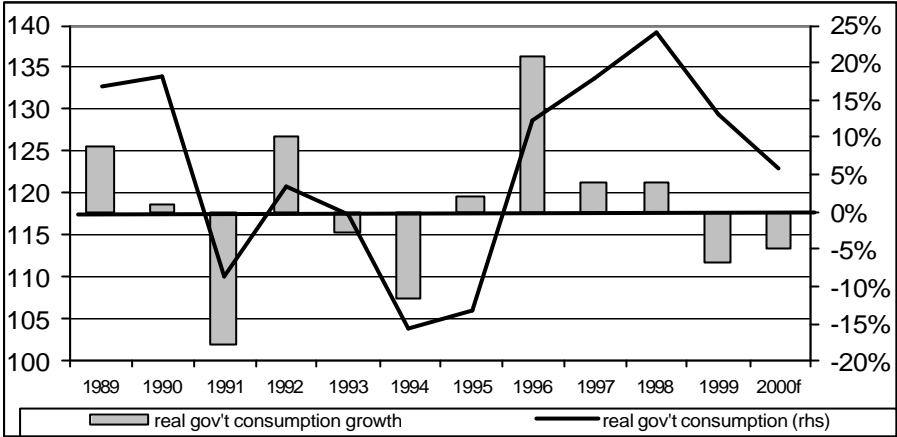
<sup>62</sup> The Slovak public seems to be very nostalgic about the low level of basic food prices even 10 years after the Velvet Revolution, not fully realizing that the almost free and heavily subsidized goods were largely paid by the public anyway in the form of low salaries (because of heavy taxes and other levies imposed on the enterprise sector) as documented by the bigger wage disparity than GDP per capita disparity between Western Europe and Czecho-Slovakia.

<sup>63</sup> Prust, Tanzi (1993).

<sup>64</sup> The structural collapse in expenditures was probably even greater since real GDP growth decreased by 14.6 % in 91. The data refers to Slovakia.

<sup>65</sup> Prust, Tanzi (1993).

CHART 5. Government Consumption (growth and the level) since 1988, Sk bn



Source: Slovak Statistics Office, author

### 3.7 Two Phases – The Good Times followed by The Bad Times<sup>66</sup>

Slovakia has, what the IMF report called, a “modern tax system with few exemptions.” The IMF suggests that the tax-to-GDP ratio<sup>67</sup> has been one of the highest in the region and much higher than in other economies with a similar GDP per capita level. In addition, it has been higher than in more developed OECD countries. Tax-to-GDP ratio is expected to decline in 2000 as a consequence of personal income tax bracket creep, the decrease of import surcharge, and the tax holidays for foreign direct investment (FDI) investors.

The „Good Times” (1993-1995) were characterized by the healthy reduction of expenditures while preserving very high tax- and revenue-to-GDP ratios. On the other hand, the ”Bad Times” (1996-1998) reflected the significant deterioration of tax revenue collection as well as a public spending rampage on health, public administration and major public investment projects such as highways and power plants.

<sup>66</sup> This part relies heavily on two recent IMF reports on Slovakia: Slovak Republic: Recent Economic Developments, June 98 and Slovak Republic: Selected Issues and Statistical Appendix, September 1999.

<sup>67</sup> The IMF reflects that cross-country comparisons of tax revenue are more reliable than comparisons of total revenue since the treatment of non-tax proceeds is different.

TABLE 7. Fiscal Balance

	1993	1994	1995	1996	1997	1998	1999	2000f
State Budget	-25.3	-4.6	-2.4	-11.1	-17.1	-16.4	-14.1	-17.1
% GDP	-6.5	-1.0	-0.4	-1.8	-2.5	-2.2	-1.8	-1.9
Local Authorities	0.3	-1.0	0.8	0.9	0.5	-1.6	-1.4	0.0
% GDP	0.1	-0.2	0.1	0.1	0.1	-0.2	-0.2	0.0
Social Security System (social and health insurance)		2.9	4.1	5.0	-5.1	-3.1	-7.8	-7.1
% GDP		0.6	0.8	0.8	-0.7	-0.4	-1.0	-0.8
Extra-budgetary funds ('state funds')	0.3	-1.0	0.2	-3.7	-11.8	-8.8	-3.7	-4.5
% GDP	0.1	-0.2	0.0	-0.6	-1.7	-1.2	-0.5	-0.5
Extra-budgetary projects (incl. Nat. Property Fund)	-1.7	-2.0	-0.7	1.3	-1.3	-6.2	-1.0	-6.3
% GDP	-0.4	-0.4	-0.1	0.2	-0.2	-0.8	-0.1	-0.7
Fiscal Deficit	-26.5	-5.8	2.0	-7.6	-34.8	-36.1	-28.0	-35.0
Fiscal Deficit/GDP	-6.8	-1.2	0.4	-1.3	-5.1	-4.8	-3.5	-4.0

Note: State budget balance as recorded using the methodology of the IMF. Source: IMF, author's forecast

TABLE 8. Tax-to-GDP Ratios, %

	1993	1994	1995	1996	1997	1998	1999f	2000f
Slovakia	34.4	36.7	39.8	39.0	36.6	35.4	34.5	32.5
Czech Republic	41.2	40.5	40.0	39.0	37.9	36.8		
Poland	39.1	39.3	38.9	38.3				
Hungary	42.4	39.7	37.2	36.1	38.4	40.7		
OECD	37.0	38.4	37.0					

"Good Times" 1993-95, "Bad Times" 1996-98. Source: IMF, author's forecasts"

The upcoming Phase Three (1999-) focuses on keeping the tax revenue in, public wage restraints, price deregulation, while showing the lack of political will for the structural reforms on the expenditure side. Yet, the fiscal adjustments that rely on spending cuts in transfers and the government wage bill have a better chance of longer-term success of lowering budget deficit (and may even turn out to be expansionary over time) rather than fiscal adjustments that rely on tax increases.<sup>68</sup> These tend to last shortly and may even decrease long-term growth potential.<sup>69</sup>

<sup>68</sup> Alesina, Perotti (1997), Perotti (1996, 1999).

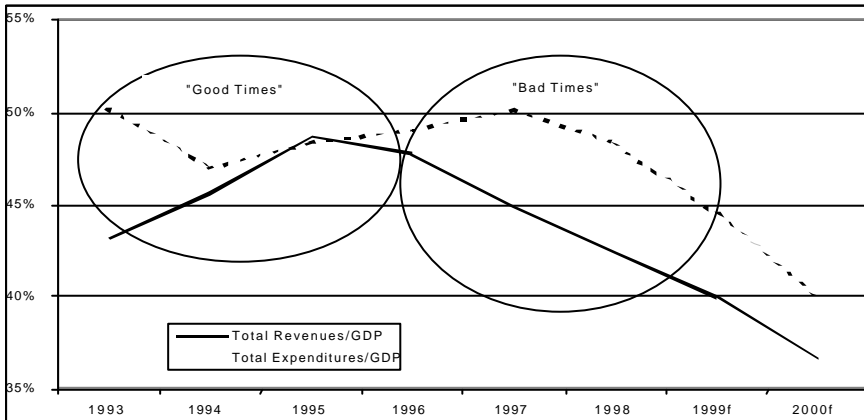
<sup>69</sup> Musgrave (1959), Feldstein (1994), Fullerton, Walker, Long (1994), Anderson (1997).

### 3.7.1 Phase One: The Good Times

A comprehensive tax reform took place in 1992 when the parliament approved new legislature on income and value-added tax (VAT).<sup>70</sup> Hence, Slovakia started to have a tax legislature similar to those of developed countries. Despite the fiscally expansive rhetoric of the government in 1992-1994, the government was basically following all the routes in fiscal policy that were laid down during the Czecho-Slovak Federation. From 1993 to 1995, the fiscal deficit was driven from huge (cyclically unadjusted) fiscal deficit/GDP of 7.2 %<sup>71</sup> to a *surplus* of 0.4 %. This was achieved by both an increase in total revenue and a significant decrease in total expenditures (of course, economic recovery helped tremendously as GDP growth recovered from -3.7 % in 1993 to 6.7 % in 1995).

The revenue received a boost from indirect taxes (especially VAT), direct taxes (both personal and corporate profit tax) and social security contributions (the balance of social security/GDP remained *positive* 0.8 % in 1995).

CHART 6. “Good Times” vs. “Bad Times” – Two Different Fiscal Policies 1993-98



Source: IMF, author's forecasts

<sup>70</sup> Before 1993, turnover tax rates were rationalized to a basic structure of four rates: 0, 12, 22, and 32 percent (higher rates were intended to function as excises). In January, the standard VAT rate was set at 25 % in Slovakia (at 23 % in the Czech Republic) and the lower rate was set at 6 % in Slovakia (5 % in the Czech Republic). Heady, Smith (1995). Excises were set for alcohol, tobacco, and gasoline.

<sup>71</sup> The deficit was partially 'justified' by the break-up of the Czecho-Slovak Federation. Slovakia had to create new institutions that were needed for the existence of independent state.

### 3.7.2 Phase Two: The Bad Times

In 1996, the government started to foster investment through highway construction and dam and nuclear plant constructions. Highway construction was artificially hastened so that the first signs should have been visible before the general elections in September 1998. In addition, the government tried to minimize the purchasing costs of the new owners by giving them tax investment credit. There was also a revitalization attempt, which was supposed to involve direct bailouts of the indebted companies by the state. This further worsened the corporate governance that probably reached an all time low in 1997-98 when asset stripping was pervasive.<sup>72</sup> Corporate profit tax took a huge dive, decreasing from 6.8 % of GDP in 1995 to 3 % in 1999.<sup>73</sup> Inefficiencies in social security and higher unemployment changed the social security/GDP surplus of 0.8 % to the *deficit* of -1 % in 1999.

TABLE 9. Direct and Indirect Taxes, % of GDP

	1993	1994	1995	1996	1997	1998	1999f	2000f
<b>Direct Taxes</b>								
Slovakia	9.3	10.7	10.7	10.7	8.9	9.1	8.7	7.8
Czech Republic	10.1	10.4	10.2	9.4		8.9		
Poland	13.2	13.2	12.8	12.3				
Hungary	8.3	7.5	7.1	7.8		8.7		
<b>Indirect Taxes</b>								
Slovakia	12.0	12.5	13.2	11.6	11.2	10.4	10.5	10.2
Czech Republic	12.0	13.1	12.6	12.5		10.3		
Poland	11.4	11.5	11.4	12.1				
Hungary				11.0		12.3		

Note: Direct taxes represent corporate and personal income taxes. Indirect taxes represent value-added and excise taxes. Source: IMF, author's forecast

## 3.8 Revenues

### 3.8.1 Direct Taxes

#### 3.8.1.1 Corporate Profit Income Tax

Slovakia has had the highest corporate profit tax in the region. The new government agreed in December 1999 to lower the corporate tax from 40 % to 29 % effective in 2000 to decrease the benefit of tax avoidance, to make Slovakia

<sup>72</sup> Since the new owners of companies did not command expertise, sometimes it was in their own interest to exhibit 'rent-seeking' behavior instead of 'profit-seeking' one.

<sup>73</sup> The decrease is not cyclical since the corporate tax/GDP has been steadily decreasing even in 1996-1997 with GDP growth reaching 6.6 % and 6.5 %, respectively. However, part of the drop from 1996 to 1997 is attributed to the removal of paper profits at the state banks.

more competitive in this area, and to decrease direct taxation at the cost of the indirect one.

**Box 1: 1999 Discussion about Corporate Taxes in Slovakia**

The MinFin proposed cutting corporate tax from 40 % to 35 % and later settled for 29 %. The EconMin was fighting for a 20 % corporate tax rate citing the Hungarian scenario where the Hungarian corporate tax rate was cut from 36 % to 18 %, and it allegedly prompted an increase in tax collection of 36 %. The government offered no detailed analysis of the impact on the 2001 budget.

*Czech Republic:* The current corporate income tax rate is 35 % in 1999, unchanged from the previous year but down from the 45 % in 1992. A new law, adopted at the end of June 1999, lowers the corporate income tax rate to 32 % in 2000.

*Poland:* The Polish parliament is debating the plan approved by government which calls for the corporate income tax rate to drop to 30 % in 2000, from the current 34 %, and then to decrease by an additional 2 % annually until it reaches level of 22 % in 2004. However, most tax deductions are to be cut, while amortization rules will become more favorable. The corporate income tax has been lowered gradually from 38 % in 1997, to 36 % in 1998, and then to 34 % in 1999.

*Hungary:* Its ability to attract the lion share of Eastern European FDI can be in part contributed to its corporate income tax rate, which was cut in January 1995 from 36 % to 18 %, by far the lowest number in the region. The 23 % tax on dividends was introduced. Hungary's decentralized taxation system grants municipalities power to add generous incentives for investors. (e.g., in the city of Szekesfehar, most investors pay no corporate income tax until 2000, then they will pay 7.5 % until 2005).

**Corporate Profit Income Tax Rate in Central Europe and Expectations**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	'02	'03	'04
SK	45	40	40	40	40	40	40	29	29	29	29	29
HU			36	18	18	18	18	18	18	18	18	18
PL					38	36	34	30	28	26	24	22
CR	45	42	41	41	39	35	35	32	32	32	32	32

In percent. Source: Reuters, ING Barings

During Phase One, the Slovak legislature did not offer many tax exemptions<sup>74</sup> and corporate tax/GDP had been reaching a hard-to-believe 6-7 % of GDP. High

<sup>74</sup> Even though substantial tax incentives to foreigners and backward regions existed, the lack of sizeable FDI till 1999 caused that the incentives were not used in any major way. They were removed at the beginning of 1996 and enacted again by the new government in April 1999. Further discussions need to take place on how to make Slovakia more competitive with other countries in its struggle for FDI.

paper profits of state banks were part of the reason of such a high number till 1996. In Phase Two, the tax income has *halved* as a consequence of declining fiscal discipline and corporate governance, asset-stripping by the new owners originating from the political privatizations in 1994-98, and tax exemptions for investments. Tax evasion has become widespread. In 1998, despite the deep recession in the Czech Republic and higher corporate profit tax rate, the Czech government was able to collect more corporate taxes/GDP than Slovakia. In 1999, Slovakia was able to lure only 32 % more taxes (of GDP) despite having a 120 % higher tax rate<sup>75</sup> than Hungary. Revenue is now dropping even below the average in the OECD and EU countries.

A simple exercise offers the answer as to whether the huge drop in corporate profit tax revenue was mainly due to the removal of paper profits at state banks, lower profits of state monopolies, or lower economic growth.

Table 10 suggests that when adjusted for the aforementioned, the drop in the corporate revenues is still very evident. If Slovakia were able to sustain the same corporate tax revenue/GDP in 1998 as in 1995 (for private companies), this could have decreased the fiscal deficit by huge 2.3 % of GDP in 1998

### 3.8.1.2 Personal Income Tax

Personal income tax (PIT) is a more successful story. The Slovak Republic has continually increased its personal income tax revenue/GDP during both Phases, starting from 4 % of GDP in 1993 to 5.9 % of GDP in 1998. In 1997, PIT brought more tax revenues to the government than corporate tax for the first time. This was a hot political issue, but looking at other countries' experiences, PIT brings more money to the government budget in all neighboring countries. A pick-up in PIT partially offset the shortfall of corporate taxes causing direct taxes to decrease from 10-11.5 % on GDP to 9.5 % in 1998, roughly in line with other countries' experiences in the region. However, direct taxes would probably reach the minimum in the region in 1999-2000 at 7.6 %. As such, PIT rate is relatively modest in Slovakia. In 1997, the average wage was taxed at 12 % average tax rate (as it was in the Czech Republic), but in Hungary and Poland the average tax rate was substantially higher (19 %, 18 % respectively). In addition, the Slovak tax code has fewer exemptions and marginal tax rates have been relatively low.<sup>76</sup> However, neither tax brackets, nor a personal exemption was indexed for inflation; therefore, Slovak tax authorities were imposing an increasing real tax burden on its

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<sup>75</sup> However, the Slovak tax system has much more tax deductible items compared to the corporate tax regime in Hungary.

<sup>76</sup> In 1997, the marginal tax rate for a 300 % average wage was 32 % in Slovakia and the Czech Republic, while the rate was substantially higher in Hungary and Poland (42 %, 44 %, respectively). Slovak Republic, IMF (1999).

citizens (which explains an ever-higher share of PIT on GDP). Cumulatively, consumer prices doubled in 1993-1999.<sup>77</sup> Average wage was taxed at 15 % in 1993 and at already 17.2 % in 1999. In 2000, tax brackets will be moved up. The lower income groups will even enjoy lower average taxation than it was in 1993; higher income groups will get only a partial indexation.

TABLE 10. Corporate Profit Income Tax

	1994	1995	1996	1997	1998
Corporate Profit Income Tax	31.9	35.2	34.8	24.4	26.0
Corporate Profit Income Tax /GDP, %	6.8	6.4	5.7	3.6	3.5
Out of which state companies (monopolies and banks)	13.2	12.6	11.3	10.3	12.3
Private companies	18.7	22.6	23.5	14.1	13.7
Private companies /GDP, %	4.0	4.1	3.9	2.1	1.8
Private companies (structural revenues)	19.9	23.1	23.0	13.3	13.0
Private companies (structural revenues) /Potential GDP, %	4.2	4.2	3.8	2.0	1.8

Note: See Appendix 1 for more details on structural vs. cyclical adjustment. The corporate income tax revenue of state companies was rather crudely approximated by the taxes of natural monopolies and banks using the available data in M.E.S.A. 10 (1999).

TABLE 11. Average Personal Income Taxation in 1997

	Slovakia	Czech R.	Hungary	Poland
75 % of average wage	7	7	19	18
Average wage	12	7	25	18
300 % of average wage	24	24	31	23

Note: The calculation assumes that the taxpayer claims exemption for spouse, or 1.3 children on average. In percent. Source: IMF (1998)

TABLE 12. Average Personal Income Tax Rate in Slovakia

	1993	1994	1995	1996	1997	1998	1999	2000
75 % of average wage	15.0	15.0	15.4	15.9	16.4	16.7	16.9	13.2
Average wage	15.0	15.0	15.4	16.1	16.7	17.0	17.2	13.0
300 % of average wage	17.3	18.7	19.9	21.7	23.3	24.2	24.9	20.1

Note: The calculation assumes the general personal exemption as the only tax deduction. In percent. Source: Author

## 3.8.2 Indirect Taxes

### 3.8.2.1 Value-added Tax (VAT)

Slovakia's VAT is high at 23 % compared with EU and OECD averages of 19 % and 17 %, respectively. It is the second highest after Hungary's one of 25 %.<sup>78</sup>

<sup>77</sup> CPI increased by 102.3 % in 1993-1999.

<sup>78</sup> The reader should realize that since corporate profit tax rate in Hungary is only 18 %, to some extent, Hungary is taxing more at other different tax rates (such as VAT) and therefore



In contrast, Slovak's lower VAT rate (covering basic food and services) was very low at only 6 % (compared with 12 % in Hungary and 7/12 % for Poland). In May 1999, the lower rate was increased to 10 % as one of the measures implemented in the austerity package of the new government. The two different rates are causing distortions and could be used for tax-evasion purposes, e.g., in construction activities.<sup>79</sup> In the future, Slovakia should be increasing the lower VAT (which is a cause of political concern among leftist parties) and lowering the standard 23 % VAT.

### **3.8.3 Excise Taxes**

Slovakia's excise taxes on alcohol, tobacco, and gas seem to be behind those of EU and even behind the ones imposed by neighboring countries. Whereas Slovakia will collect only 3 % of GDP in excise taxes in 2000, the average tax ratio is 4 % for Central European countries. The shortfall in revenues from these taxes is partially offset by buoyant VAT revenues causing indirect taxes to bring 10 % of GDP revenues in 2000.

### **3.8.4 Other Taxes**

#### **3.8.4.1 Import Taxes**

Slovakia is an extremely small open economy. Trade turnover is 120 % of GDP, almost three times larger than household consumption. Slovakia is set to benefit from labor specialization and comparative advantages and should, to the maximum possible extent, try to stay open to all the markets in the world. In contrast, recently, it has become a popular political issue to fight imports and boost tax revenues through import certificates and import surcharge. The widespread unfamiliarity with basic economic laws among politicians and per consequence a political will to impose trade barriers might be one of the most damaging maneuvers Slovak politicians could do to its long-run GDP growth potential. Luckily, Slovakia has had low barriers imposed to free trade mainly as a consequence of demands from IMF, World Bank, OECD, and WTO. Even though the average statutory duty rate is about 8 %, many trade agreements have effectively exempted most imports. The IMF suggests that the effective taxation of imports was only 2.5 % in Slovakia compared with 9-10 % taxation in Poland and Hungary (the Czech Republic had a low 2.1 % taxation of imports).<sup>80</sup>

In 1997, Slovakia imposed import certificates and later substituted a 7 % import surcharge in the summer of 1997. The surcharge was removed in October

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might not be a good example.

<sup>79</sup> Slovak Republic, IMF (1999).

<sup>80</sup> Slovakia, IMF (1998).

1998<sup>81</sup> only later to be introduced again as one of the measures of the May 1999 austerity package. Fortunately (for Slovakia), the same international organizations urge Slovakia to remove the surcharge by January 2001.

### 3.8.4.2 Social Security Tax

Slovak social security taxes (SST) are by far the highest in the region with the combined tax rate of 50 % compared with 47 % in the Czech Republic and 41 % and 35.4-43.1 % for Hungary and Poland, respectively. SST are also well above those in the EU (36.5 %) and the OECD (24.8 %).<sup>82</sup> The very high employer's contribution of 38 % might be effectively deterring employment.

Despite these enormous taxes, the Social Security system has been turning from almost 1 % surplus (of GDP) in 1994-1996 into a very deep deficit of 2 % in 2000. The state used to be the biggest debtor, not fulfilling its tax obligations for the unemployed and students. There are great inefficiencies in the Slovak social security system, ranging from inefficient operations of health care insurance houses to employed people taking home unemployment benefits. Assuming that the half of the 65,000 "shadow unemployed" people receive unemployment benefits, the benefits would cost Sk1.9bn or 0.24 % of GDP.

## 3.9 Expenditures

The Slovak government still has too large of a role in the economy; its level of public expenditures is the highest in the region. This part discusses the expenditure profile in more detail.

TABLE 13. Effective Import Surcharge

%	91	92	3/94	7/96	1/97	7/97	1/98	4/98	10/98	6/99	1/00	7/00	1/01
Import Surcharge	20	10	10	7,5	0	7	5	3	0	7	5	3	0
Effective Import Surcharge			x	2.5	0.0	5.3	3.8	2.3	0.0	5.0	3.8	3.0	0.0

Note: Effective import surcharge is defined as the product of import surcharge rate and the portion of imports that the surcharge applies to. Source: MinFin, author

<sup>81</sup> It was lowered to 5 % in January 98 and 3 % in April at the request of WTO.

<sup>82</sup> Slovakia, IMF (1999).

TABLE 14. Social Contribution Rates in Selected Countries ( % of wage)

	Employer's Contribution	Employee's Contribution	Total
Slovakia	38.0	12.0	50.0
Health	10.0	3.7	13.7
Sickness	3.4	1.4	4.8
Pensions	21.6	5.9	27.5
Unemployment	3.0	1.0	4.0
Czech Republic	35.0	12.5	47.5
Health	9.0	4.5	13.5
Sickness	3.3	1.1	4.4
Pensions	19.5	6.5	26.0
Unemployment	3.2	0.4	3.6
Hungary	33.0	8.0	41.0
Health	11.0	3.0	14.0
Sickness	n/a	n/a	n/a
Pensions	22.0	5.0	27.0
Unemployment	n/a	n/a	n/a
Poland	16.7-24.4	18.7	35.4-43.1
Health	0	2.5	2.5
Sickness	6.5	6.5	13.0
Pensions	9.8	9.8	19.5
Unemployment	0.4-8.1	0.0	0.4-8.1
European Union (1)	23.6	12.9	36.5
Western Europe (2)	22.1	11.7	33.8
OECD (3)	16.2	8.6	24.8

(1) unweighted average of the European Union countries (excluding Denmark). (2) unweighted average of European Union countries (excluding Denmark) and Iceland, Norway and Switzerland. (3) unweighted average of OECD member countries. Source: World Bank, IMF

TABLE 15. Total Expenditures to GDP Ratio

	1993	1994	1995	1996	1997	1998
Slovakia	47.4	44.3	45.8	46.5	47.7	45.3
Czech Republic		46.0	45.7	43.9	42.8	42.9
Poland	50.5	48.9	47.9	47.5		
Hungary	58.3	55.5	49.6			47.2

Source: IMF

## 3.9.1 Consumption

### 3.9.1.1 General Government Administration – Very Expensive

The 1994-1998 government implemented an administrative reform that divided Slovakia into regional districts and opened regional offices as an intermediary between state and local government. This was done mainly for political reasons. Realizing the upcoming elections in 1998, the government was very generous in offering nominal wage increases to state bureaucrats. In fact, the

bureaucrats enjoyed an ever-higher margin over the average salary, starting from 15 % in 1993, and reaching 25 % in 1998. Despite the high average level of public wages, the public sector does not offer competitive wages for highly skilled civil servants. In addition, teachers were receiving an ever-lower margin over the average salary; in 1993, teachers received only 87.5 % of average salary, and in 1998 teachers took home only 82.4 % of the average salary. The health sector was in similar shape.

Labor costs are not the only reason why the government administration is so costly in Slovakia. The purchased goods and services (as a proportion to GDP) are expected to come down to more reasonable levels only in 2000.

### **3.9.2 Subsidies to Enterprises**

Only recently, Slovakia set itself on the path to decrease state subsidies. Around 1/3 of all subsidies are subsidies for agriculture (while agriculture produces only 4 % of GDP in Slovakia). The allocation of subsidies in agriculture indirectly supports inefficient producers, and the mechanism is known for its great inefficiency and non-transparency. On the other hand, only 1 % of all subsidies goes to industry. Heating subsidies decreased as a consequence of on-going price deregulation.

### **3.9.3 Capital Expenditures**

#### **3.9.3.1 Extrabudgetary State Funds – Easy Way to Spend Money**

Off-the-budget state funds are not constrained by the state budget deficit target (set by the law). As argued previously, many expansionary (and inefficient) plans of the ministries and the government are being implemented outside the state budget via state funds. Yet, the state funds can borrow money at only higher rates.<sup>83</sup> A popular example to see the diminishing information value of state budget deficit data is the Road Fund. In 1994, transfers from the state budget covered most of the total expenditures; therefore, the Road Fund as such did not add anything to the general government deficit. However, the transfers did not go hand in hand with an increase in expenditures and the Road Fund produced 1 % fiscal deficit/GDP (i.e., above the transfers from the state budget) in 1997-99.

#### **3.9.3.2 Government Guarantees – How to Manipulate Fiscal Deficit Figures**

Another favorite way of excessive spending and investments concerns the usage of government guarantees. Government guarantees do not enter fiscal data

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<sup>83</sup> Sometimes the rates are substantially higher. The Road Fund borrowed EUR120m in late September 1999 at 4.7 % spread. Slovakia EUR eurobond paper was trading 1.5 % lower at 3.2 % spread.

and can even be repaid by issuing another government guarantee.<sup>84</sup> Therefore, it seems that despite the enormous costs involved in financing through government guarantees, the government decided to take these steps to limit the state budget deficit, which was never a credible macroeconomic indicator to start with. Market participants suggest that there is hardly a country in the world with such a wide premium of government guaranteed debt over sovereign issue.

TABLE 16. Road Fund

	1994	1995	1996	1997	1998
Total Expenditures, Sk bn	2.066	3.581	4.588	15.122	16.432
Road Fund Deficit, Sk bn	0.113	1.468	2.966	10.858	8.838
Road Fund Deficit / GDP	0.0	0.3	0.5	1.6	1.2

Source: IMF, author

TABLE 17. State Guarantees and the Net Cost to the State Budget

Sk bn	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99f	'00f
Newly issued guarantees	0.2	12.2	6.5	13.5	3.0	12.6	41.5	5.8	13.8	29.3	44.6
Maturing guarantees		0.0	0.3	0.9	1.8	2.7	4.2	4.9	10.6	9.6	25.4
Net increase in gov't guarantees	0.2	12.2	6.1	12.6	1.2	9.9	37.3	0.9	3.2	19.6	19.1
Net increase/GDP, %	0.1	3.8	1.8	3.2	0.3	1.8	6.2	0.1	0.4	2.5	2.2
Net cost to state budget				0.48	0.11	1.21	1.89	2.06	2.14	4.2	10.5
Net cost/GDP, %				0.1	0.0	0.2	0.3	0.3	0.3	0.5	1.2

Source: MinFin, author

It is only now that the government needs to face the fiscal burden with government guarantees expected to be called upon at 1.2 % of GDP in 2000.

### 3.9.3.3 Social Security Funds

Social security expenses in Slovakia are the highest in the region. Whilst these expenses in 1998 amounted to 21.5 % of GDP in Slovakia, they totaled only 9.2 % of GDP in Hungary, 19 % in the Czech Republic, and 21.1 % in Poland. Pensions took a 40 % share, and health expenses reached a 30 % share.<sup>85</sup> Sickness expenses are twice as high in Slovakia than the OECD average.<sup>86</sup>

*Health Insurance.* Four health funds and six health insurance companies supposedly competing for customers carry out health spending and insurance.

<sup>84</sup> In the 2000 state budget draft, the MinFin officers suggested that “due to the lack of revenues in the state budget the direct financing of development projects from the state budget would lead to an unacceptably high level of state budget deficit and therefore, momentarily, the government would need to use government guaranteed loans ...”.

<sup>85</sup> IMF (1999).

<sup>86</sup> They amount to 1.3 % of GDP in Slovakia and 0.7 % of GDP in OECD. OECD (1999).

However, competition is only illusory since services do not differ. Health insurance companies are believed to have high wage and overhead bills. As much as 96 % of the contributions to the health care system comes from public sources compared with an average of 78 % for EU.<sup>87</sup> Health spending seems to be inefficient especially as far as medication expenses are concerned. Thirty-five percent of total spending covers medication as opposed to 15 % in EU. Slovakia also has too many hospitals per capita.

*Pensions.* Slovakia has a pay-as-you-go pension system, which is now a topic of discussion. The government plans to implement a three-pillar pension system gradually and increase the retirement age. Pension expenditure/GDP has been relatively modest, reaching 7.9 % in 1998 (compared with 9.4 % for the Czech Republic). This is primarily due to the low ratio of average pensions to the average wage – the so-called replacement rate. In contrast, Slovakia spends too much on disability and early retirement.<sup>88</sup>

TABLE 18. Social Security Funds

	1994	1995	1996	1997	1998
Social Insurance	3.7	1.9	4.5	0.9	-0.2
Sickness Fund	3.3	1.8	-0.2	0.9	0.6
Pension Fund	0.4	0.1	4.7	0.0	-0.8
Health Fund	-1.5	1.2	0.0	-5.7	-7.7
Employment Fund	0.7	1.0	0.5	-0.3	0.0
Total	2.9	4.1	5.0	-5.1	-7.9
Total/GDP, %	0.6	0.8	0.9	-0.8	-1.1

Note: Social security was included in the state budget in 1993. Source: IMF

### 3.10 Debt Sustainability

Slovakia was born with a very small level of public debt and total liabilities. The level has increased by 10 % (of GDP) and now, assuming bank-restructuring costs, the level is slightly below 50 %. However, the debt rapidly started to increase from the end of 1997.

Expansionary fiscal policy under a fixed exchange rate regime prompted the central bank to tighten its monetary policy resulting in extremely high domestic real interest rates. High interest rates in turn did not allow for the debt to be decreased as a percentage of GDP in 1997-98.

<sup>87</sup> Slovak Republic, IMF (1999).

<sup>88</sup> OECD (1999).

TABLE 19. Central Government Debt and Contingent State Liabilities

Skbn	1992	1993	1994	1995	1996	1997	1998	'99f	'00f	'01f
Domestic Debt	51.6	71.6	87.1	100.6	86.4	104.2	112.0	116.5	123.5	161.1
Foreign Debt	44.5	51.6	43.4	34.3	32.0	30.8	65.7	86.7	118.4	126.6
- Bank Restructuring									18.2	26.4
Public Debt	96.1	123.2	130.4	134.9	118.4	135.0	177.7	203.2	241.9	271.9
Public Debt /GDP, %	28.9	33.4	29.6	26.1	20.6	20.6	24.8	25.4	26.8	27.1
State Guarantees	18.5	31.1	32.3	42.2	79.5	80.4	83.6	103.3	122.4	107.6
Other Bank Restructuring Liabilities									77.8	42.8
Total Liabilities	114.6	154.3	162.8	177.1	197.9	215.4	261.3	306.5	442.1	454.7
T. Liabilities /GDP %	34.5	41.8	37.0	34.3	34.4	32.9	36.4	38.3	49.1	45.4

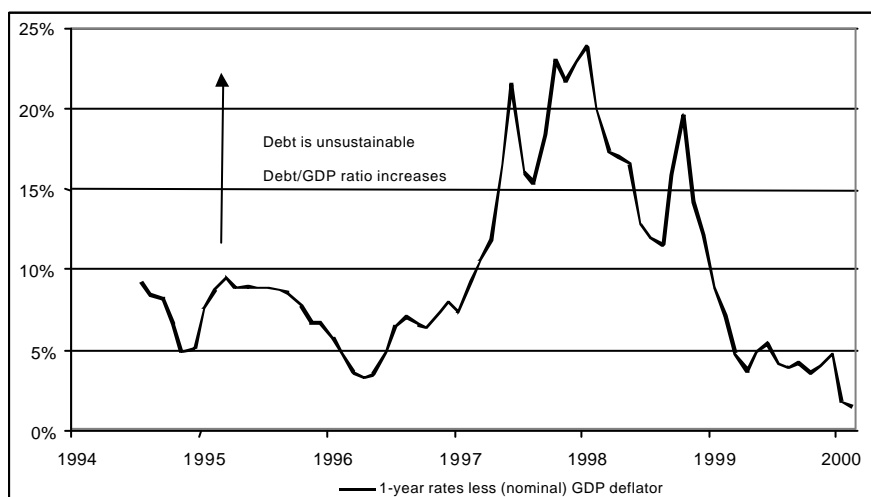
Note: Public debt is defined as the sum of state budget deficits. The table assumes the sale of IRB bank for Sk7bn in 2000 and the sale of VUB and Slovak savings bank for a total of Sk35bn in 2001. These numbers should be regarded with a great caution and are for illustrative purposes only. Source: MinFin, author, and author's forecasts

TABLE 20. Public Liabilities Costs

	1992	1993	1994	1995	1996	1997	1998	1999f	2000f
Net Interest and Recalled Guarantees	4.7	12.1	17.3	13.4	14.6	14.4	19.6	25.0	34.4
% of GDP	1.4	3.3	3.9	2.6	2.5	2.2	2.7	3.1	3.8

Source: IMF, author, and author's forecasts

CHART 7. Debt Sustainability– the Difference between Interest Rates and GDP Deflator



Source: Author

Slovakia's more prudent fiscal policy in 1999 together with its improved international profile helped substantially reduce real interest rates to sustainable levels.

### 3.11 Conclusion

Fiscal policy has had different aspects since 1989. After the change of the communist regime, the priority of the fiscal policy between 1990 and 1992 was to eliminate the discretionary aspect of the taxation under communism, minimize the disparity between available resources and wants mainly through the reduction of subsidies and price deregulation. The goal was accomplished as far as the substantial decrease of the role of the government in the economy is concerned. Together with the foundation of an independent Slovakia, the government introduced a modern tax system. Fiscal policy between 1993 and 1995 could be characterized as successful, the fiscal deficit/GDP was brought down from 7.2 % in 1993 to a small surplus of 0.4 % in 1995. Enterprise insiders, managers of state companies and banks, and local officials could be tempted to exert pressure on the government between 1996 and 1998 in order to implement much more expansionary policy. The fiscal stance rapidly worsened causing huge external imbalances. Current account deficit averaged over 10 % between 1996 and 1998; due to minimal foreign direct investment inflows, foreign indebtedness rapidly shot up. High real interest rates negatively effected corporate results, and the maintenance of the fixed exchange rate regime cost a decrease of monthly cover from 3.3 months to 2.2 months. The country was downgraded from the investment grade to noninvestment one, and the central bank had to float the currency.

The new government needs to address the rising public debt levels and decreasing tax-to-GDP ratio. Privatization helps only temporarily, sooner or later the government would need to give serious concern to decrease expenditures. During this process the government should 'insulate' itself more from the early reform winners, since they could exert pressure on the government to slow down reforms. The most inefficient expenditures seem to be the likes of general government administration, social transfers, agricultural subsidies, health expenditures, and government guarantees. The reform of schooling, health system, and pension reform should be high on the agenda. Theory and evidence suggests that the fiscal adjustments that rely on spending cuts in transfers and the public wage bill have a better chance of longer-term success of lowering budget deficit and may even turn out to be expansionary over time. On the other hand, fiscal adjustments based on tax increases tend to be only of a temporary nature and might even decrease the long-term growth potential.

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### 3.13 Appendix 1: Structural vs. Cyclical Deficit, Methodology

In order to compute a structural budget balance, potential output data are needed. Due to Slovak data limitation, the following assumptions have been made. Potential output should represent an average growth. Unemployment should be close to its natural rate, which is proxied here by the long-run average.<sup>89</sup> Potential (real) GDP growth is assumed at 4.5 %.<sup>90</sup> Last but not least, it is assumed that the Slovak economy was operating below its potential in 1999-2000. These three arguments lead to a rather crude approach that assumes that the economy was operating very close to its equilibrium between 1995 and 1996.<sup>91</sup>

Applying the methodology used previously in an IMF report on Slovakia<sup>92</sup> the structural value of the tax revenue (TS) is then calculated as:

$$TS = T(1-eGAP),$$

where GAP is defined as (Actual Output - Potential Output)/Potential Output in nominal terms and e is the tax elasticity to the current output gap. Tax elasticities are assumed the same as they were in the Fund report:

TABLE 21. Tax Elasticities

	Tax Elasticity		Tax Elasticity
Corporate Profit Tax	2.4	Social Security Contributions	0.7
Personal Income Tax	1.2	Other Taxes	1
Indirect Tax	1		

Note: Due to the data limitations, tax elasticities presented in the table are averages for small industrial countries. Source: IMF (1997), OECD (1994)

<sup>89</sup> The average unemployment rate between 1990-2000 is close to 12 %. The relatively high rate is due to the lack of FDI-led company restructuring and high social security tax rate. IMF (arbitrarily) assumed 9.5 % natural rate of unemployment.

<sup>90</sup> The IMF in its report assumed 5.0 % growth citing the study by Fisher, Sahay, Vegh (1996). Lower growth of 4.5 % is assumed here due to the market distortions introduced by the government in 1996-1998.

<sup>91</sup> The base year is set such that the sum of output gaps in 1995 and 1996 is equal to zero. The choice of the base year is somewhat arbitrary. The last condition dictates that the base year needs to be later than 1995. Therefore, 1995-1996 is assumed as a base year despite the signs of huge external imbalances in second half of 1996.

<sup>92</sup> IMF (1997).

The structural value of unemployment benefits (UNS) is assumed to be proportional to the ratio of natural rate of unemployment to actual rate and is given by:

$$UNS = UN(US/U),$$

where US represents the natural rate and U denotes the actual rate.

TABLE 22. Structural Deficit

Sk bn	1993	1994	1995	1996	1997	1998	1999	2000f
Total Revenue (structural)	164.3	206.6	253.7	272.2	286.9	298.3	313.5	332.0
Total Revenue	159.3	200.8	251.7	274.5	293.5	304.1	312.2	321.8
Total Revenue (structural)/ Potential GDP, %	40.7	43.0	46.1	45.3	42.8	40.6	39.1	36.3
Total Revenue /GDP, %	40.8	43.1	46.1	45.3	42.8	40.5	39.1	36.4
Total Expenditures and Net Lending (structural)	185.3	206.9	250.2	281.9	327.6	341.1	343.0	360.7
Total Expenditures and Net Lending	185.3	206.7	249.8	282.1	327.6	340.2	340.2	356.8
Total Expenditures and Net Lending (structural)/ GDP, %	45.9	43.1	45.4	46.9	48.9	46.4	42.8	39.4
Total Expenditures and Net Lending /GDP %	47.4	44.3	45.8	46.5	47.7	45.3	42.7	40.4
Structural Fiscal Deficit	-21.0	-0.3	3.5	-9.8	-40.7	-42.7	-29.5	-28.6
Actual Fiscal Deficit	-26.5	-5.8	2.0	-7.6	-34.8	-36.1	-28.0	-35.0
Structural Fiscal Deficit / Potential GDP, %	-5.2	-0.1	0.6	-1.6	-6.1	-5.8	-3.7	-3.1
Actual Fiscal Deficit /GDP, %	-6.8	-1.2	0.4	-1.3	-5.1	-4.8	-3.5	-4.0
Improvement over previous year (structural deficit), %	9.9	5.1	0.7	-2.3	-4.5	0.3	2.1	0.6
Improvement over previous year (actual deficit), %	5.1	5.5	1.6	-1.6	-3.8	0.3	1.3	-0.5
Memorandum Items								
Nominal GDP	390.6	466.2	546.0	606.1	686.1	750.8	797.5	883.1
Potential Nominal GDP	403.8	480.0	550.5	601.2	669.6	735.7	801.3	914.4
Nominal GDP GAP, %	-3.3	-2.9	-0.8	0.8	2.5	2.1	-0.5	-3.4

Note: Potential GDP growth assumed at 4.5 %. 1995-1996 is presumed to be the base year for potential GDP. Source: Author

### 3.14 Appendix 2: Detailed Fiscal Data

TABLE 25. General Government Fiscal Deficit

	'92	'93	'94	'95	'96	'97	'98	'99e	'00P
1 State budget (IMF methodology)		-25.3	-4.6	-2.4	-11.1	-17.1	-16.4	-14.1	-17.1
2 Local authorities		0.3	-1.0	0.8	0.9	0.5	-1.6	-1.4	0.0
3 Social security system		0.0	2.9	4.1	5.0	-5.1	-3.1	-7.8	-7.1
3.1 Social insurance			3.3	1.8	-0.2	0.9	0.6	n/a	n/a
3.1.1 Sickness fund			0.4	0.1	4.7	0.0	-0.8	n/a	n/a
3.1.2 Pension fund			0.4	0.1	4.7	0.0	-0.8		
3.2 Health fund			-1.5	1.2	0.0	-5.7	-2.9	n/a	n/a
3.3 Employment fund			0.7	1.0	0.5	-0.3	0.0	n/a	n/a
4 Extrabudgetary funds ('state funds')		0.3	-1.0	0.2	-3.7	-11.8	-8.8	-3.7	-4.5
5 Extrabudgetary projects (incl. NPF)		-1.7	-2.0	-0.7	1.3	-1.3	-6.2	-1.0	-6.3
1+2+3+4+5 Fiscal deficit	-26.5	-26.5	-5.8	2.0	-7.6	-34.8	-36.1	-28.0	-35.0
Fiscal deficit/GDP. %	-11.9	-6.8	-1.2	0.4	-1.3	-5.1	-4.8	-3.5	-4.0
A+B Total Revenue	149.2	159.3	200.8	251.7	274.5	293.5	304.1	312.2	321.8
A Tax Revenue	130.8	134.5	170.9	217.1	236.3	251.4	266.1	275.0	286.7
A.1 Direct taxes	54.3	36.4	50.0	58.5	64.9	61.0	68.5	69.3	69.3
A.1.1 Corporate income tax	31.2	22.0	31.9	35.2	34.8	24.4	26.0	23.2	25.7
A.1.2 Personal income tax	23.1	14.4	18.1	23.2	30.1	36.6	42.5	46.1	43.7
A.1.2.1 Entrepreneurial income	1.9	3.2	3.5	3.6	4.7	5.3	5.4	n/a	n/a
A.1.2.2 Wage income	21.3	10.7	11.7	15.7	20.3	25.6	29.6	n/a	n/a
A.1.2.3 Capital income	0.0	0.6	3.0	3.9	5.1	5.7	7.6	n/a	n/a
A.2 Indirect taxes	40.3	47.0	58.2	72.3	70.3	76.8	78.3	84.1	90.4
A.2.1 VAT	n.a.	27.5	37.1	52.3	48.7	54.9	55.3	58.9	63.3
A.2.2 Excise taxes	n.a.	19.5	21.1	20.0	21.6	21.9	23.1	25.2	27.1
A.3 Import duties and surcharge	5.3	4.5	7.2	8.8	9.7	12.8	11.7	12.5	12.0
A.4 Road tax	0.0	1.6	1.4	1.5	1.5	2.5	2.6	3.1	3.6
A.5 Other taxes	0.8	2.1	2.6	4.2	4.8	4.2	4.5	4.6	4.4
A.6 Social security contributions	30.1	42.9	51.4	71.9	85.0	94.0	100.5	101.3	107.0
B Nontax revenues	18.4	24.8	29.9	34.6	38.1	42.1	38.0	37.2	35.1
B.1 Budgetary and subsidized organ's	5.6	6.3	6.5	11.9	1.8	2.2	5.3	n/a	n/a
B.2 Interest revenues	0.0	0.6	0.8	0.9	1.2	0.7	1.2	n/a	n/a
B.3 Central bank profit contribution	0.0	4.0	6.7	1.4	2.4	1.1	1.0	n/a	n/a
B.4 Fees and fines	6.5	3.8	2.2	3.9	7.1	5.6	5.1	n/a	n/a
B.5 Other	6.3	7.3	8.3	9.3	10.3	11.3	12.3	n/a	n/a
1+2 Total expenditures	191.5	188.0	207.5	250.5	282.8	322.7	336.9	338.1	353.7

and net lending									
1 Total expenditures	188.8	185.3	206.7	249.8	282.1	327.6	340.2	340.2	356.8
1.1 Consumption	90.2	79.4	86.5	112.9	120.4	144.9	141.8	142.8	145.4
1.1.1 Gross wages	15.4	15.9	16.7	28.7	33.2	50.7	56.5	55.4	58.4
1.1.2 Health care	15.3	15.8	22.9	27.5	36.7	45.9	44.7	43.6	44.0
1.1.3 Other goods and services	59.5	47.7	46.9	56.7	50.5	48.3	40.6	43.7	43.0
1.1.3.1 Education (w/o wages)	8.0	8.0	7.6	7.7	1.9	2.2	1.5	n/a	n/a
1.1.3.2 Other	51.5	39.7	39.3	49.0	48.6	46.1	41.5	n/a	n/a
1.2 Subsidies to enterprises	16.2	17.2	18.5	19.4	24.0	26.1	26.1	26.2	29.5
1.2.1 Agriculture	8.2	8.7	7.6	7.4	6.0	7.0	6.8	n/a	n/a
1.2.2 Industry	1.1	0.6	0.3	0.4	0.3	0.3	0.3	n/a	n/a
1.2.3 Transportation	1.7	2.6	2.8	3.0	2.9	2.2	2.2	n/a	n/a
1.2.4 Heating	2.0	2.5	3.0	3.5	4.3	4.2	3.4	n/a	n/a
1.2.5 Other (incl. state funds)	3.2	2.9	4.8	5.2	10.5	12.3	13.6	n/a	n/a
1.3 Interest expenses	3.6	11.6	17.2	12.2	12.7	12.3	17.5	23.3	25.1
1.4 Social expenditures	56.7	58.6	65.3	80.7	90.8	93.5	107.5	117.0	122.9
1.5 Pensions	28.0	32.7	39.3	43.3	46.1	51.0	56.9	n/a	n/a
1.5.1 Labor policies	5.8	3.0	3.6	5.5	7.4	7.1	7.8	n/a	n/a
1.5.1.1 Unemployment benefits	2.0	1.9	1.7	5.5	7.4	4.0	5.5	n/a	n/a
1.5.1.2 Active policies	3.8	1.1	1.9	0.0	0.0	3.1	2.3	n/a	n/a
1.5.2 Sickness benefits	5.9	5.2	5.2	5.7	7.4	8.1	9.0	n/a	n/a
1.5.3 Social assistance	2.4	3.1	5.2	11.3	13.7	11.0	16.4	n/a	n/a
1.5.4 General income support	7.2	4.3	2.5	0.0	0.0	0.0	0.0	n/a	n/a
1.5.5 Other state benefits	7.4	10.3	9.5	14.9	16.3	16.3	17.5	n/a	n/a
1.1+1.2+1.3+1.4+1.5	166.7	166.8	187.6	225.3	247.9	276.8	292.9	309.3	322.9
Current expenditures									
1.6 Investment expenditures	24.8	21.2	19.9	25.2	34.9	45.9	44.0	28.9	30.8
1.6.1 Budgetary and subsidized organ's	12.2	12.5	14.0	19.2	29.0	25.9	n/a	n/a	n/a
1.6.2 Transfers to enterprises	3.0	6.9	3.9	4.8	5.2	5.3	n/a	n/a	n/a
1.6.3 Extrabudgetary projects	9.6	1.8	2.0	0.8	6.8	6.8	n/a	n/a	n/a
2=2.1-2.2 Net lending	-2.7	-2.7	-0.8	-0.7	-0.6	4.9	3.4	2.0	3.1
2.1 Lending (e.g., recalled guarantees)	1.1	1.5	3.0	3.0	2.0	6.3	n/a	n/a	n/a
2.2 Repayments (goes w/ (-) such as privatization proceeds)	3.8	4.2	3.8	3.7	2.6	1.4	n/a	n/a	n/a

Source: IMF, author's forecasts

## 4 Monetary Policy

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This chapter deals with monetary policy in Slovakia during the years 1990-1999. First, it looks at two aspects of the common monetary policy of Czechoslovakia in the years 1990-1992. The first aspect is the institutional framework for monetary policy management from the viewpoint of Slovak interests where we arrive at the conclusion that it was a system comparable to other “federal” monetary policies. The second aspect is whether Czechoslovakia represented an optimum currency area or whether, in view of much higher unemployment, Slovakia required its own monetary policy from a short-term or long-term perspective. Our answer is that the problem was not one of monetary policy and that the costs of a common monetary policy were not high.

Next, we turn to an analysis of the independent monetary policy of the National Bank of Slovakia in the years 1993-1998. The conduct of monetary policy in those years can be viewed as successful due to low inflation, a stable exchange rate, and rising levels of liberalization of the foreign currency market and the money market. The monetary policy can be criticized in some respects, particularly in the years 1997 and 1998 when it maintained a fixed exchange rate for too long in the face of an expanded fiscal policy and an overheated economy.

The last section deals with the current and future challenges for NBS’s monetary policy. At the end of 1998 and in early 1999, the central bank switched to a new monetary policy approach characterized by a floating exchange rate and the use of inflation targeting. The year 1999 was one of provisional inflation targeting with several problematic aspects. A new, formally defined mechanism of inflation targeting put in place on January 1, 2000, has eliminated most of these problems. The European Union accession is expected around 2005-2007 and the European Monetary Union accession is expected a few years later. In view of this we looked at the suitability of participation in the common currency. The eurozone should generally represent an optimum currency area for Slovakia. With regard to the monetary policy during the interim period, we recommend that inflation targeting be preserved as long as possible and that a fixed exchange rate to the euro be used for only a few years before the actual entry into the monetary union.

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<sup>93</sup> The author would like to thank NBS Vice-governor Elena Kohútiková for her valuable comments on the first draft of this chapter.

## 4.1 Introduction

The purpose of this chapter is to provide the reader with information on the development of monetary policy in the Slovak Republic dating from when the political regime changed in 1989 to the year 1999. It consists of two parts. The first part briefly summarizes narrative information – it describes the development of key macroeconomic indicators related to monetary policy (inflation and the exchange rate) and their relationship with the monetary policy implemented by the central bank. The second, much broader, part focuses on analysis of monetary policy conducted in the years 1990 to 1999. Although the analysis is mostly carried out chronologically, it is not our aim to describe in detail all aspects of monetary policy in chronological order. This task would require much more space. Instead, the analysis attempts to seek answers to questions that can be viewed as key:

- What was the institutional framework for monetary policy in Czechoslovakia from the perspective of Slovak interests?
- Did the existence of a common currency pose significant disadvantages for Slovakia – did Czechoslovakia constitute an optimum currency area?
- What is the institutional framework for the National Bank of Slovakia in terms of its independence according to central bank theory?
- To what degree did monetary policy contribute to the successful stabilization and revival of the Slovak economy in the years 1993 to 1995?
- Did the NBS respond correctly to expansive fiscal policy and macroeconomic imbalances in the years 1996-1998? Should the NBS have abandoned the crown's fixed exchange rate earlier?
- What can be said about the provisional inflation-targeting regime conducted by the NBS after abandoning the fixed exchange rate for the crown in October 1998?

## 4.2 Monetary Policy Results in the 1990s

In the last decade, the central bank's aim has been, according to the law on the State Bank of Czechoslovakia and later the law on the National Bank of Slovakia, to ensure stability of the currency. This stability consists of two basic elements – internal and external. Internal stability is the stability of domestic prices. External stability should be understood as the stability of the exchange rate. As this chapter will show, Slovakia's monetary policy can be seen as successful in comparison with other transition economies, since it has maintained one of the lowest inflation levels and one of the most stable exchange rates.

Inflation developments in Slovakia in the 90s are dealt with in greater narrative detail and, in part, analytically in the chapter on overall macroeconomic developments. To avoid repetition, let us only restate a few essential facts:

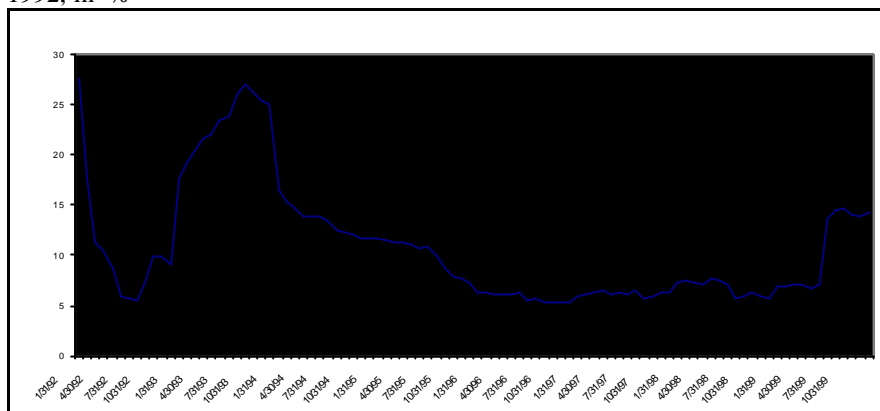
- Before January 1, 1991, the vast majority of prices were regulated by the state and official inflation in the years 1970-1989 oscillated slightly above 1 % annually (IMF, 1990, p. 12). According to estimates of Czechoslovak authorities, real inflation - including hidden and suppressed inflation that appeared in the economy with regulated prices - was about 2.5 % annually (*ibid.*).
- Some 85 % of consumer and producer prices were liberalized as of January 1, 1991, as a part of a shock therapy economic reform (Svejnar, 1993, p. 29). From then on, official inflation data can be considered relatively reliable, although a fairly sizable portion of the consumer basket (about 20 %) remained regulated. This allowed the state to increase or reduce the rate of price increases through the use of deregulation as a political and economic instrument. At the time of this writing, 17.8 % of the consumer basket remained regulated (NBS, 1999a). Chart 1 depicts year-on-year changes in the price level from January 1, 1992 and Chart 2 shows month-on-month price increases since January 1, 1991.

These charts clearly demonstrate several facts. First, the price level has increased during the course of the decade by a factor of about 3.5 from the origin. This is a very high level of inflation compared with the same period in developed countries; however, such a comparison would be misleading. At the inception of the transition, the economy had to correct distorted prices through a one-time price jump as well as cope with several additional leaps caused by the introduction of a new tax system or price deregulation (as demonstrated by Wozniak (1997). One – time deregulation leaps have an accelerating effect on overall inflation beyond their contribution to the increase of consumer prices. All of these effects can be viewed as a transition tax. Repeated devaluation of the Czechoslovak crown at the end of 1990, devaluation of the Slovak crown in July 1993 and the floating of the crown in October 1998 were the only “standard” influences on inflation. Both charts illustrate, with the exception of the initial devaluation in 1990, that these external devaluations of the crown had minimal or no effect on inflation.

The relative success of monetary policy in achieving the task of internal monetary stability can be seen when economic results are compared to those of the neighboring countries. As shown in Table 3 in the text, the Slovak Republic and Czech Republic had the lowest levels of inflation in the 90s. On the other hand, this fact was partially a consequence of better initial macroeconomic conditions than were available in most post-communist countries.

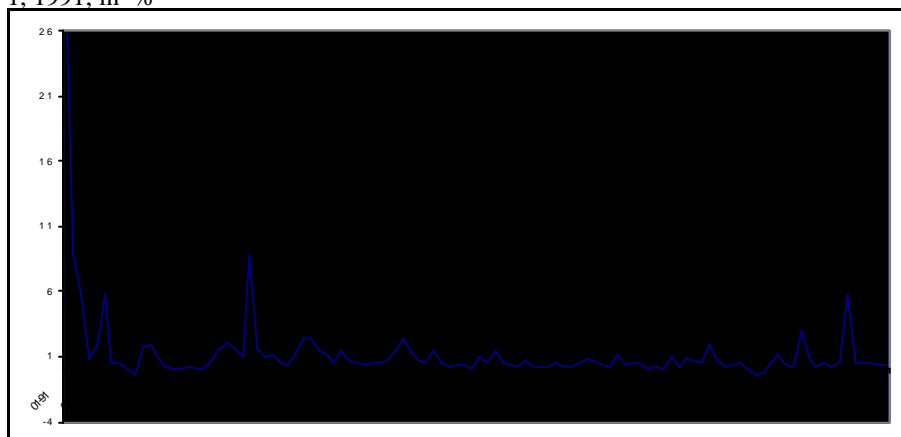


CHART 1. Year-on-year Change in the Price Level in Slovakia from January 1, 1992, in %



Source: NBS (1999a)

CHART 2. Month-on-month Change in the Price Level in Slovakia from January 1, 1991, in %



Source: NBS (1999a)

The exchange rate was subject to more dramatic developments, although in contrast with other transition economies, the rate evolved in a calm and stable manner. The Czechoslovak crown was devalued several times in the second half of 1990 in order to reduce the differential between the official and the parallel black market exchange rate, and to create the requisite conditions for the introduction of internal convertibility of the crown on January 1, 1991 (Svejnar, 1993, p. 33). The introduction of internal convertibility meant unrestricted access

to foreign currency for all domestic legal entities for commercial purposes and, to a limited degree, also for individuals.

The exchange rate of the crown was fixed against the following basket of five currencies: USD 49.06 %, DEM 36.16 %, ATS 8.07 %, CHF 3.79 %, and FRF 2.92 %. On July 10, 1993, the currency was devalued by 10 % against the basket. The basket was simplified on July 14, 1994, when it was narrowed to only include two currencies – 60 % the German mark and 40 % the U.S. dollar. The exchange rate was set in this way until October 2, 1998, when the fixed exchange rate for the crown was abandoned. Since then, the Slovak crown floats freely based on trading on the foreign exchange market. Since January 1, 1999, the National Bank of Slovakia has been using the euro as the reference currency for internal purposes, although this does not affect the crown's free float.

The exchange rate regime has been gradually liberalized through the abandonment of administrative restrictions. This action preceded the introduction of full current account convertibility on October 1, 1995. The capital account also has undergone gradual liberalization, although some restrictions still remain in place. At the time of this writing, Slovakia basically met the foreign exchange liberalization criteria required for joining the Organization for Economic Cooperation and Development (OECD).

A description of the monetary policy in a market economy should include detailed data on the development of interest rates. However, due to the legacy of the centrally planned economy, interest rates have long failed to play the role of a basic monetary policy instrument in Slovakia. Until the mid-90s, the central bank had extensively employed administrative instruments for monetary policy management. A transition to the dominant use of interest rates by the central bank has occurred only recently and mainly in connection with the evolution of the interbank market. In spite of this, we provide some basic data on interest rate developments in the 90s. The discount rate has been the basic indicative interest rate used throughout this period. Table 1 shows its development.

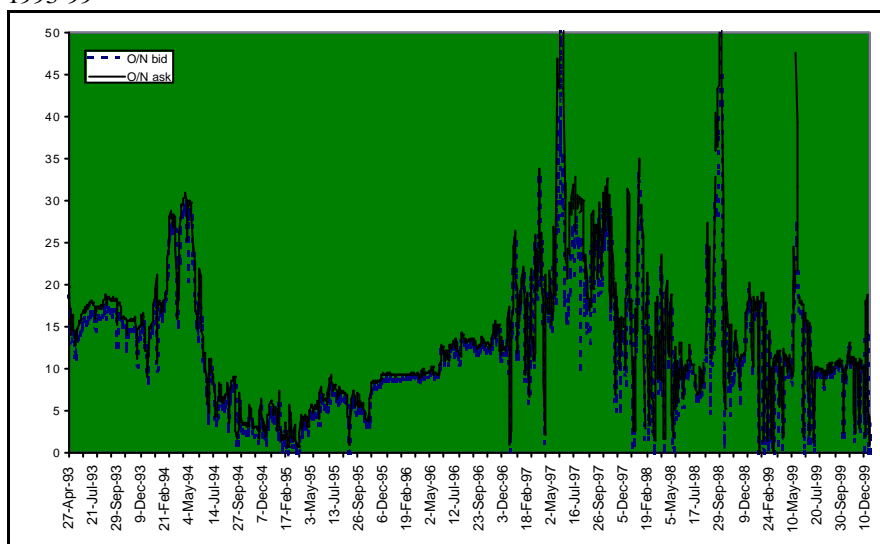
However, the discount rate *de facto* lost its indicative value mainly in the second half of the decade, due to the fact that the NBS failed to modify it despite a significant move towards restrictive monetary policy. We, therefore, supplement the data with a graph depicting the development of one-day (overnight) rates on the interbank market since April 1993 (from when these data are available) – see chart 3.

TABLE 1. Discount Rate in Czechoslovakia and in Slovakia, 1990-99

From	To	Discount rate, %
January 1, 1990	April 1990	4.0
April 1990	October 1990	5.0
October 1990	November 1990	7.0
November 1990	January 1, 1991	8.5
January 1, 1991	September 8, 1991	10.0
September 8, 1991	March 25, 1992	9.5
March 25, 1992	April 1, 1992	9.0
August 26, 1992	December 30, 1992	8.0
December 30, 1992	December 19, 1993	9.5
December 20, 1993	March 16, 1995	12.0
March 17, 1995	October 5, 1995	11.0
October 6, 1995	January 12, 1996	9.75
January 13, 1996		8.8

Source: SBCS, NBS

CHART 3. Development of Overnight Rates on the Interbank Market in the Years 1993-99



Source: ING Barings

In the case of a small open economy such as Slovakia, internal and external stability are very closely connected although short-term divergence can occur. In Slovakia's case, monetary policy in the 90s achieved a relatively high degree of external and internal stability, which has to be viewed favorably. This was accomplished mostly through a monetary policy ranging from highly restrictive to neutral in character. Only occasionally (1994-1995) was it accommodating to expansion. In this respect, we again refer to the chapter on overall macroeconomic

developments. It is there that the monetary policy can be seen in relation to other macroeconomic policies.

### **4.3 Monetary Policy within Czechoslovakia**

The success of the monetary policy since the year 1993 can be evaluated on the basis of economic development in Slovakia providing we keep in mind its limited influence on the real economy. It is far more complicated to analyze its role in the 1990-1992 period, since the policy was carried out to serve the interest of a federative state with 15 million inhabitants, of which Slovakia only constituted a third. It is therefore not entirely fair to evaluate federal monetary policy only through the prism of Slovakia. On the other hand, it is appropriate to ask to what degree this policy affected the Slovak economy and whether a separate or different monetary policy would have better served the economy.

#### **4.3.1 The Institutional Framework – The State Bank of Czechoslovakia**

Before 1989, the State Bank of Czechoslovakia (SBCS) was a so-called monobank, combining the functions of a central bank (for instance issuing currency) with the tasks of a commercial bank for enterprises (for example maintaining accounts for and providing loans to enterprises). Commercial banks did not exist, with the exception of banks dealing with foreign trade and savings banks for individuals. The SBCS itself did not carry out real monetary policy tasks, but rather the state plan utilized it as a transmission tool to allocate finances to enterprises. This system was typical for socialist countries in Eastern Europe. The system, began to gradually change as a result of socialist economic reforms and even in socialist countries, central banks were split into one central and several commercial banks (a so-called two-tier system). In Hungary, for example, this transition took place in 1987. Czechoslovakia decided on its introduction even before the November 1989 revolution by adopting Law no. 130/1989 Coll. and the reform was put into practice on January 1, 1990. From this point, we can view the SBCS as a real central bank. On the other hand, this was a law adopted under socialism and after the political system changed, further amendment was needed. In the latter part of 1991, a new law amended the SBCS. The law remained in validity, not only until the end of the federation, but *de facto* afterwards. Both laws on central banks in Czechoslovakia's successor states (the law on the CNB and the law on the NBS, 566/1992 Coll.) are based on it and have instituted only small changes (all three laws are in turn significantly influenced by the law on the German Bundesbank). Since we deal with the institutional standing of the NBS in greater detail later, we will not analyze the almost identical law on the SBCS here in greater detail. The one exception is that we will look at how the existence of the federative state affected the conduct of monetary policy from the institutional

perspective. From the Slovak viewpoint, we can best look at the functioning of the SBCS from the institutional perspective by comparing it with other “federative” central banks – the German Bundesbank and the European Central Bank, which administers the eurozone’s monetary policy.

The bank board was the SBCS’s highest body. It consisted of seven members; one of them - the governor - appointed at the federal government’s proposal by the Czechoslovak president. The remaining members were proposed by the governor and approved by the president after consulting the federal government (two members), the Czech government (two members), and the Slovak government (two members). With the exception of the governor, Czecho-Slovak parity was established by law – three members had to be from the Czech Republic and three from the Slovak Republic.

This system can hardly be considered institutionally biased against Slovakia. In the case of a Slovak governor, it even gave one-third of the federation a majority in deciding monetary policy. In addition, the Slovak government was always able to block the appointment of two members if it did not consider them suitable defenders of Slovak interests. Slovak political representatives were also able to do the same in the negotiations on a Slovak vice governor in the federal government and on the government nomination for the key post of the governor. Slovakia’s political representation thus had firm *blocking* rights on the make-up of the whole bank board, although its power to force through their *own* candidate was significantly weaker.

This notion is confirmed by a comparison with the Bundesbank and the ECB. In the Bundesbank, the federal government nominates 10 out of the 21 members of the directorate, while the German states propose the remaining 11 members. As in the case of the former Czechoslovakia, they are appointed by the federal president (Forder, 1999, pp. 59-60). On the board that steers monetary policy within the European Central Bank, every country has one vote – cast by the governor of the respective central bank. It is therefore based on a similar principle as the SBCS. In contrast to the ECB, members of the bank board of the SBCS were not expressly forbidden to promote their country’s interests, which gave them far more leeway to represent the Slovak Republic. In addition, the ECB board also contains six members who represent the eurozone as a whole rather than any single country. This further strengthens the ECB’s centralized form.

### **4.3.2 Was Czechoslovakia an Optimum Currency Area?**

During the existence of Czechoslovakia, debates raged from many perspectives as to whether or not it made sense for Slovakia to remain a part of Czechoslovakia. One of them was the monetary issue – did the common monetary policy have negative consequences for Slovakia? The question can also be asked in

another way. Did the advantages of a joint currency for Slovakia dominate over the disadvantages? Before turning any analysis, we must warn that it deals exclusively with the issue of the common currency. The analysis does not address whether the existence of Czechoslovakia was optimal for Slovakia from other angles and it must not be interpreted as an opinion either in favor or against the existence of an independent Slovak Republic. It will be shown that the existence of an independent Slovakia did not have major long-term consequences in comparison with the existence of the Czechoslovak Federative Republic.

In economic theory there exists extensive theoretical and empirical treatment concerning the suitability of a common currency for two or more economies. In the European context, it has evolved in relation to the planned shift to a common European currency. It is based on the so-called optimum currency area theory proposed by Mundell (1961). We want to point out that most of this section will deal with the costs of the common Czechoslovak currency and examine whether these costs were high. We will deal with the advantages of a common currency only marginally, since the relevant theories and their application to the Czechoslovak situation are fairly uncontroversial. With the exception of Krugman (1991), there is a consensus that the advantages of a common currency (reduction of transaction costs, reduction of entrepreneurial and exchange rate uncertainty) are directly related to the level of economic integration of member regions (states), especially to the level of trade integration (see EC, 1990 and Gros and Thygesen, 1992). In this context, we can see significant advantages in former Czechoslovakia's case due to high levels of mutual exchange in the area of trade, capital and labor.

Let us turn to the costs. The theory of optimum currency areas is based on the short-term stabilizing role of monetary policy. If a negative economic shock occurs, relaxation of monetary policy may reduce the impact on the real economy. Conversely, if the economy is overheating due to positive economic shocks, a more restrictive policy can prevent inflation from accelerating and prevent other negative consequences. If two economies have a common monetary policy, the usefulness of this instrument is reduced, particularly if there are cyclical or structural differences between them.<sup>94</sup>

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<sup>94</sup> If two economies are very similar and have a synchronized economic cycle, a shared monetary policy is not a problem for them. The following two examples illustrate when it can be a problem. The first example concerns economies with a similar structure but at a different point in the economic cycle. If one of them is in recession and the other is experiencing economic recovery, a common monetary policy is not suitable for them. Economies with significant structural differences represent the other possibility, since identical shocks affect them differently. In a simplified example, if one economy specializes in producing automobiles and the other on agriculture, then the entry of Japanese car manufacturers into the market has a markedly varied effect on them. Such a shock – if it has

The question of optimality of a common currency area can be answered from two angles – short- and long-term. The first concerns the specific reform path chosen at the beginning of the 90s. Did Slovakia at that time need a different monetary policy than that of the Czech Republic? A more long-term analysis deals with the overall structural changes in the Slovak and Czech GDP and their economic cycle in the 1990-1999 period. Based on the theory of optimum currency areas, another question can be asked. Was the common currency sustainable in the long-term for the Czech and Slovak economy?

Let us begin with the early 90s. Table 2 shows the overall decline in GDP between 1989 and 1992 and the unemployment level in 1992 in selected eastern European countries. We can see that the decline of GDP in Slovakia was almost identical to that in Czech Republic and in line with the average in other transition countries, particularly in comparison with the closest neighbors – Poland and Hungary. Czechoslovak monetary policy can hardly be seen as excessively tight. Similarly, there is little evidence that the monetary policy had a negative effect on Slovak output, since cumulative decline in GDP in Slovakia was comparable to that in the Czech Republic. On the other hand, unemployment took a radically different course in the two countries, as shown by the second column of the table. In a normal market economy, changes in unemployment and the GDP should be closely related but this was clearly not the case. Monetary policy has a direct (short-term) effect only on the level of production in the economy and affects employment indirectly through changes in the levels of production. We can see that the effect of monetary policy and of other policies on the Czech Republic and on the Slovak Republic was not too dissimilar, but the outcomes in terms of unemployment were significantly different. This indicates that other policies (fiscal, industrial, labor market policy) or structural labor market differences in Czech Republic and Slovakia (see Svejnar and Ham, 1993 and Svejnar and Terrell, 1998) are more responsible than monetary policy for the significantly different results in the area of unemployment.

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a different effect on the two economies – is called an asymmetric shock and its likelihood and effect is considered to be one of the key indicators as to the suitability of a common currency area. If the likelihood of asymmetric shocks is low then a monetary union is more suitable for the economy and vice versa. It is a result of different degree of importance of the stabilizing role of monetary policy.

TABLE 2. GDP Change, 1989-1992 and Unemployment in 1992

Country	GDP, cumulative change, %	Unemployment, 1992, %
Bulgaria	-29	13.9
Czech Republic	-21	2.6
Slovakia	-19	10.4
Hungary	-18	10.7
Former GDR	-40	-
Poland	-17	12.7
Romania	-29	8.4
Slovenia	-18	13.8
Ukraine (1989-1991)	-15	0.3

Source: Godfrey (1995), pp. 6 and 8

We can say that in the long-term, the costs of a common currency rise if one of the following conditions is met:

- Do the above-mentioned asymmetric shocks occur?
- Do the countries have different preferences with regard to the short-term tradeoff between inflation and unemployment (in this case, more between inflation and output)?
- Do the countries have different levels of economic growth?
- Do the countries have significantly different fiscal system levels and consequent needs to finance fiscal expenditure with revenues from printing money (so-called seigniorage)?

The more frequently the answer to these four questions is a yes, the more likely it is for a common currency not to be the most suitable solution (although we must stress that these are only indicators).

Asymmetric shocks are reflected by the unequal effect of external shocks on the domestic economic situation. They can be measured by the level of correlation with the economic cycle. Fidrmuc et al. (1999) attempted an analysis of the optimality of the Czechoslovak currency area based on data from 1948-1990. The conclusion was that Czechoslovakia, under socialism, represented an equally optimal currency area as the core countries of the European Monetary Union, but less optimal than the core states of Germany or regions of the United States. We must note that this analysis suffers from a fundamental problem – the overall unreliability of statistics from the given period and the fact that the macroeconomic indicator used to represent the overall level of output (net material product) cannot be automatically treated as a proxy for GDP, particularly in estimating the potential optimality of a common monetary policy. The distorted allocating mechanism and distorted prices in the socialist era command economy led to a permanent macroeconomic imbalance. It is not advisable to measure the optimality of the currency area using a methodology developed for the purposes of a normal, open market economy.



The second question – whether Slovakia and Czech Republic had significantly different preferences regarding the short-term trade-off between inflation and GDP performance – can be satisfactorily answered in the negative. This answer is based on developments in the years 1993-1998, when each of the countries conducted its own monetary policy. Both countries achieved very close inflation levels, some of the lowest among transition countries (see table 3). It is an unlikely assumption that they would have significantly different preferences regarding inflation and its relationship to the GDP.

**TABLE 3. Average Year-on-year Inflation in Selected Countries, 1993-98**

Country	Inflation, %	Country	Inflation, %
1. Slovakia	10.6	5. Poland	23.6
2. Czech Republic	11.3	6. Romania	123.7
3. Slovenia	15.6	7. Russia	244.3
4. Hungary	20.9	8. Bulgaria	282.1

Source: ILO Yearbook of Statistics 1998 and others

The other two questions can also be answered in the negative. As we have already shown, Slovakia and the Czech Republic suffered approximately identical economic decline during the transformational recession period and conversely, macroeconomic indicators evolved very similarly in both countries from after recovery until 1997. It is difficult to claim that they had radically different potential growth levels. The tax burden and the effectiveness of the tax system are also very similar and therefore we cannot speak of different fiscal system levels (see IMF, 1998).

It is hard to find any stronger arguments within the theory of optimum currency areas to prove that Slovakia paid a high price for the common currency. The assembled data appear to indicate that Slovakia's problems stemmed from different aspects of common economic policies on which monetary policy had little effect. This is confirmed by a study by Artis, Kohler and Méltiz (1998) that tried to identify optimum currency areas throughout the world. Based on a methodology similar to that used in this work, it came to the conclusion that an optimum currency area for Slovakia could exist mainly with Czech Republic or possibly with Hungary (Artis, Kohler and Méltiz, 1998, p. 34).

## 4.4 Monetary Policy in Slovakia

### 4.4.1 The Institutional Framework and Central Bank Independence

#### 4.4.1.1 Central Bank Independence and Monetary Policy

The relationship between the state/government and the central bank is one of the most important factors influencing monetary policy. There is a basic consensus among monetary economists that central bank independence from the government has, *ceteris paribus*, positive effects – lower inflation can be achieved without negative consequences such as lower levels of economic growth. On the other hand, we must admit that there is a minority school that contests the validity of this theory.

On the basis of several theoretical models, it can be said that if the government has direct control over monetary policy, the outcome is - again *ceteris paribus* - sustained higher inflation without any long-term benefits. This is the so-called time - inconsistency problem or in Nordhaus, the so-called political economic cycle. Several theoretical solutions exist to this problem; in the last two decades, increased central bank independence from the government has become the most popular one. Furthermore, extensive empirical research started in the mid-80s was aimed at either confirming or disproving the relationship between central bank independence and inflation. Extensive literature exists in this area. We refer the reader to the most highly respected analyses, which include Grilli, Masciandaro, and Tabellini (1991), Cukierman (1992), Alesina and Summers (1993) and Eijffinger and Schaling (1993).

The key results of empirical research may be summarized as follows:

- there indeed exists a statistically significant empirical relationship between high central bank independence and low inflation;
- on the other hand, there is no evidence of a relationship between GDP growth and central bank independence.

These conclusions have been unanimously arrived at by virtually all studies, and they confirm the theoretical conclusions of the so-called dynamic inconsistencies school. Additionally, there are results without consensus; however, we will not deal with them here. There are also works that reject the whole theory of central bank independence and empirical research in the area, although they represent a significant minority (for example, Forder, 1996, Mangano, 1998). This work will try to incorporate some aspects of these criticisms in its analysis of the situation in Slovakia.

#### 4.4.1.2 Independence of the National Bank of Slovakia

In this section, we will look at the independence of the NBS from two perspectives. Traditional central bank independence (hereinafter CBI) analysis represents the first angle. It analyzes, according to set rules, legislation treating the status of the given central bank and assigns points in various categories. The resulting CBI index is arrived at as a sum of points in the individual categories and is comparable internationally. Most economists, who do detailed work in this area, have constructed their own index with its own rules. These indices are determined based on analyses of legislation on the central bank and other relevant legislation. In this work, we will use two “classics” – the first comes from three Italian economists Grilli et al. (1991, hereinafter GMT) and the second from Cukierman (1992).

The second angle for looking at CBI responds to criticisms of traditional CBI analyses from economists like Forder (1996), (1998) and Mangano (1998). Instead of constructing quantitative indices, this approach attempts to look in depth at the individual central banks - see for example Berger and de Haan (1999). Due to the constraints of space, this approach will be used here only to a limited degree.

The GMT index consists of two parts – political and economic independence. Political independence is evaluated primarily on the basis of the procedures for appointing members of the central bank’s governing body, the relationship of this body to the government, and on the formally defined tasks of the central bank. Economic independence is measured by how much the government can borrow from the central bank and according to the character of the monetary instruments at the central bank’s disposal (Grilli et al., 1991, pp. 366-8). Cukierman (1992) has an index based on similar criteria, but more precisely determined criteria that can be combined into one index (Cukierman, 1992, p. 372). Higher scores are assigned in all categories if in the given area; the central bank is independent from the executive or sets its own rules. Conversely, the greater the government’s influence, the lower the CBI.

Both indices suffer from the problem of the so-called interpretation spread. This was pointed out by Mangano (1988, p. 477). This research showed that different scores could be assigned in various categories due to imprecisely defined criteria. Specifically, in the case of NBS independence, the interpretation spread for political independence reaches 2.3, with the possible values ranging from 4 to 6.3 (maximum value is 8). The criteria for economic independence of the NBS are straightforward and the index reaches the value 5 (maximum value is 7). Using Cukierman’s criteria, the independence index of the NBS reaches 0.71 – 0.83 (maximum is 1). We have determined these values in earlier research and, due to constraints of space, we do not provide detailed analysis of the research process. We refer readers to Beblavý (1999a). Table 4 provides a detailed comparison of

NBS's independence with a selected sample of developed countries, as provided by the authors of the indices.

We can see that the National Bank of Slovakia has a very high degree of independence, one of the highest among the banks under consideration. In this regard, we need to point out one important difference. The other countries were evaluated over a long post-war period and therefore their indices do not necessarily reflect the present situation. This is particularly important in view of the fact that a significant shift in favor of greater central bank independence took place in developed countries in the late 80s and the 90s. For example, Cobham et al. (1999) have calculated that due to changes in central banks' standing, the independence of the Banque de France calculated, using Cukierman's index, increased to 0.87, for Banca d'Italia to 0.74 and for the Bank of England to 0.66 (Cobham et al. (1999, p. 39)). Nonetheless, we can conclude that the NBS has a strong position and a high degree of independence in terms of independence measured by traditional indices.

TABLE 4. Comparison of NBS's Independence with a Sample of Developed Countries

Country	Central Bank Independence Indices Grilli et al.		Cukierman Overall
	Political	Economic	
Czech Republic	5-8	5	0.71-0.83
Slovakia	4-6.3	5	0.71-0.83
Germany	6	7	0.66
Netherlands	6	4	0.42
Switzerland	5	7	0.68
USA	5	7	0.51
Canada	4	7	0.46
Australia	3	6	0.31
Austria	3	6	0.58
Denmark	3	5	0.47
Ireland	3	4	0.39
Great Britain	1	5	0.31

Source: Grilli et al. (1991), Cukierman (1992), author's calculations based on Beblavý (1999a)

The following section will deal with one type of criticism of these indices that we consider to be substantiated. This is Forder's criticism of the determination of central bank independence on the basis of surveying legislation regarding the central bank. One of his key arguments is that the possibility of a change in the laws has an equal influence on the central bankers' behavior as the diction of the law itself. If the leaders of a central bank are aware that in the event of "disobedience," the law can easily change and independence can be taken away, they are less confident about their position and will behave differently. Therefore,

our in-depth analysis of NBS independence will take into account the possibility of a change in the law on the NBS.

The first point that deserves mention is constitutional protection of NBS independence. The constitution is the basic law of the state. Since a higher quorum is required to amend it, the independence of the central bank is better protected if it is written into the constitution rather than established by an ordinary law. But the Constitution of the Slovak Republic only contains the following clause: “*The Slovak Republic establishes an issuing bank. Details will be determined by a law.*” (Article 56, Constitution of the Slovak Republic) It differs from the Czech constitution, which explicitly establishes the independence of the CNB and states its basic aims – stability of the currency (see article 98 of the Constitution of the Czech Republic). We can thus conclude that in this sense, the independence of the NBS is less strongly protected because it can be eliminated or diminished through the change of an ordinary law.

On the other hand, this analysis does not attend to the true content of Forder’s criticism. Criticism that addresses the political and economic climate in the society and asks to what degree it would be permissible, politically and socially in various countries, to withdraw the central bank’s independence. For example, in Germany the Bundesbank has gradually achieved a position where any attempt to reduce the level of its independence would amount to political suicide. This is also related to a bank’s ability to achieve such prestige and standing that would guarantee it public support.

In our specific Slovak circumstances, not enough time has elapsed since the NBS’s creation to allow for a serious analysis of its position and public support. But there has been an instance in history of a serious but failed attempt to de facto eliminate the bank’s independence. The analysis of this event can reveal what truly protects the NBS’s independence. In 1997, Vladimír Mečiar’s government put forward an official parliamentary proposal to amend the law on the NBS. This proposal contained three serious changes.

First, the number of members of the NBS would rise from eight to ten and the government would be able to appoint and recall half of them (until then, the government had the right to appoint three out of the eight members *at the governor’s proposal*). Furthermore, the amount that the NBS can lend to the state (through a technical issue of state treasury bills) would have increased from 5 to 10 % of state budget revenues in the previous year. Thirdly, parliament, rather than the bank’s board, would approve the NBS’s budget – according to then Governor Masár, a vast majority of the bank’s budget serves purposes related to the conduct of monetary policy, so the National Council of the Slovak Republic would have been able to *de facto* dictate to the NBS its policy (Financial Times, October 23,

1997). Taken together, these proposals would have basically meant the abolishment of the NBS's independent status.

In the end, the proposal did not pass in parliament. This was one of the rare cases when Vladimír Mečiar's government gave up on its original intentions to reduce an institution's independence or to replace its leadership. No reliable analysis has been carried out as to the reasons for this move, but we would like to point out one factor: the National Bank of Slovakia was seen abroad as one of the essential guarantors of the relatively reasonable macroeconomic policies in the 1994 – 1998 period (for example, see OECD, 1999, p. 63). Due to low inflows of foreign direct investment, Vladimír Mečiar's government was economically dependent on foreign sources of credit both directly and for financing infrastructure projects and the like. The loss of credibility for the Slovak Republic, had the NBS's independence been abolished, would have made these funds significantly more expensive if not impossible to get. Losses (both political and economic) from this move could have far exceeded gains. Another factor was that it would have also damaged domestic credibility and probably made domestic funding more expensive. Slovakia's gross foreign debt rose by 22.7 % in one year. In September 1997, the government adopted the proposal and in the following election year, the debt rose from \$9.7 billion to \$11.9 billion. \$1 billion of that amount was a government Eurobond issue and state-guaranteed loans represented a further unspecified amount (NBS, 1998, Appendices). In the same period, net domestic credit to the government rose by 32.4 %, from 89.2 billion crowns to 118.1 billion crowns. Preserving both the credibility of the monetary policy and low inflationary expectations was in the government's long-term interest, as well as in the short-term interest. This can partly explain why it gave up on its effort to strip the NBS of its independence.

#### **4.4.2 Monetary Policy in the Years 1993-1995: From Zero to Convertibility**

On January 1, 1993, the independent Slovak Republic was formed. Five weeks later, on February 8, 1993, the Czecho-Slovak monetary union split and the NBS began implementing a fully independent monetary policy. Within it, the NBS had to struggle with the following problems: low foreign exchange reserves, continued economic recession, relatively high inflation caused by the introduction of a new tax system (mainly a value-added tax), low credibility of the new state abroad and zero credibility of monetary policy stemming from the existence of a new central bank. Less than three years from its formation, the independent Slovak Republic had one of the lowest levels of inflation among transition economies, one of the highest levels of economic growth, satisfactory foreign exchange reserves

and full current account convertibility. The NBS achieved fairly high credibility (see OECD, 1996 and OECD, 1999).

In this section, we will attempt to identify the key elements of the National Bank of Slovakia's success during this period. In our view, these are:

- institutional independence of the NBS (see the section devoted to central bank independence);
- the use of a fixed exchange rate as a nominal anchor and the ability to stabilize inflationary expectations;
- an appropriate mix of market and administrative measures and a well chosen timetable for a shift from indirect to direct instruments of monetary policy management. On the other hand, there were certain problems in this area that we will discuss later.

At its inception, the central bank adopted two tasks for the first year – to maintain internal convertibility and to minimize price level increases (NBS, 1994, p. 1). It clearly met the first aim. With regard to the second aim, the insufficient specificity of this criterion rules out a simple answer. We claim, however, that the NBS was indeed successful, since given the three main economic shocks – a new tax system introduced on January 1, 1993, a ten percent devaluation in July 1993, and a relaxed fiscal environment – the rise in the price level was really minimal. To compare: the year-on-year change in consumer prices in Czech Republic between December 1992 and 1993 reached 18.8 %, while in Slovakia it was 25.1 %. However, the Czech crown did not devalue and Czech Republic had a budget surplus in 1993, while the state budget deficit in Slovakia reached 6.8 % of GDP (NBS, 1994, p. 29). In the following two years inflation declined into the single digits and the success of the NBS's monetary policy was reaffirmed.

We have to keep in mind the dilemma faced by the NBS in the first years of existence of the independent Slovak Republic. High inflation, low credibility of both fiscal and monetary policy of the new state, low foreign exchange reserves, relaxed fiscal policy, and the consequent deficit of the current account of the balance of payments (-17.2 billion SKK in 1993) triggered pressures for further internal and external depreciation of the currency. Given the price liberalization and the underdeveloped financial market, the NBS had the following instruments at its disposal: the exchange rate, administrative tools for setting the foreign exchange regime (access to foreign currency funds, etc.) and administrative tools towards banks. (As the money and credit markets gradually evolved, the situation changed. This was demonstrated towards the end of 1995, when administrative instruments towards banks were becoming ineffective. The NBS's response to this lagged somewhat.)

Soon it became apparent that due to high expectations of devaluation early in 1993 and low foreign exchange reserves, the exchange rate of the crown was

unsustainable given the prevalent degree liberalization of the foreign exchange market and transactions. The NBS responded with a series of administrative measures, mainly involving limits to banks' access to foreign currency funds (NBS, 1994, p. 47) and delaying payments for imports. (Credit limits for larger banks were a further administrative tool used towards banks.) This approach alone could not achieve success, because it could not raise confidence in the Slovak crown. As we have already stated, the low levels of credibility and foreign exchange reserves were not the only problems: the fiscal deficit and external deficits were also an issue. The aforementioned administrative measures amounted to de facto restrictions on internal convertibility, which could only temporarily moderate the effects of these problems, not resolve them. A purely administrative solution would have led to a further deepening of the real imbalance and a gradual backsliding on foreign exchange regime liberalization.

On the other hand, a pure "market" solution – a drastic devaluation to the tune of 20 to 40 % – presented some major risks. Due to the one-time character of the price level increase in January 1993, inflation was expected to stabilize at the level reached in 1992 – around 10 % – relatively rapidly as long as the exchange rate remained unchanged. A major devaluation would have probably resulted in a sharp increase in inflation due to the openness of the Slovak economy. This would have piled a more significant inflation impulse on top of the one-time impulse from the beginning of the year. The result would have probably have been a sharp rise in medium-term inflationary expectations with subsequent problems for economic policy along with erosion of gains from the sharp devaluation. Besides, in a country with such undeveloped financial markets and low foreign investment inflows, increased monetary risk posed a threat of sharp foreign exchange and financial market volatility.

Therefore, the combination of instruments chosen in 1993 by the National Bank of Slovakia – administrative tools combined with a 10 % devaluation – can be considered a suitable choice, as evidenced by the fact that the crown's exchange rate was sustained and some administrative measures were eliminated as early as in December 1993. When the inward administrative measures used towards the banking sector are also considered, it can be concluded (see Mathieson and Haas, 1995) that in banking systems with limited competition, large extent of state ownership and a high share of bad loans, a rapid shift to strictly market instruments can have negative consequences.

The end of 1993 marked a turning point in Slovakia's economic situation that was marked by rapid improvement. In 1994 and 1995, the economy saw high levels of growth relative to the rest of the region. During this period, the NBS did not focus on aggressive disinflation, but instead accommodatingly allowed the economy to grow, concentrated on eliminating some administrative barriers, and



raised foreign exchange reserves. If we compare the inflation in 1992 with the inflation in the years 1994 and 1995, we can see that after the effect of the aforementioned changes in 1993 subsided, inflation gradually returned to 1992 levels (especially if the inflation is cleansed of volatile food prices, which are to a large extent determined by the supply).

In the external monetary policy area, it is hard to object to the NBS's actions, since they led to a gradual liberalization of the foreign exchange regime along with a concurrent rise in foreign exchange reserves. This liberalization led to the stabilization of the level of dollarization. This was reflected in the economy of 1994 and followed by a gradual decline in the following years (see Beblavý, 1999b).

It is more difficult to assess the inward monetary policy, particularly in 1995. Understandably, after several years of a transitional recession, the NBS saw as one of its targets "a growth-promoting monetary policy set within the frame of anti-inflationary intentions." (NBS, 1996, p. 14) On the outside, the target was successfully met in 1994 and 1995 when simultaneously with rapid GDP growth, the inflation declined. But monetary policy affects inflation with a one-year and in some countries even a two-year lag. This raises the question of whether the NBS, through its pro-growth policy in 1995, did not sow the seeds of future internal and external imbalances, which had to be dealt with through heavily restrictive policies in the years 1996-1998? The question is also raised by an analysis of real interest rates in Slovakia in 1995 and overall monetary policy in Slovakia during this period. In 1995, inflation in Slovakia was already at fairly low levels, but throughout the year, real interest rates remained negative (the only such period between 1993-1999). This implies an even larger decline of nominal rates. This event was of great importance in this period due to the open character of the Slovak economy and a fixed exchange rate. We can thus speak of a significantly expansive monetary policy.

The answer to the question of whether or not the NBS's pro-growth policy, particularly in 1995, set the foundations for future internal and external imbalance. This imbalance had to be dealt with through strong restrictive policy in the years 1996-1998. The answer has three parts. First, fiscal policy in 1994 and 1995 was monetarily neutral (NBS, 1996, p. 14), and to a degree even restrictive. The ratio of credit to government on total credit, as well as the actual value of net credit to government, either declined or stagnated and the budget deficit was stabilized. Due to the absence of a medium-term fiscal outlook, and government changes, the NBS did not have at its disposal an overview of the future direction of fiscal policy. In 1996, particularly in the second half, the fiscal policy became sharply expansive (see for example Mikloš and Žitnanský, 1997 and NBS, 1997). If we consider the monetary policy in 1995 excessively accommodating in the

view of future fiscal policy developments, it must be clearly said that the NBS did not have this information at its disposal *ex ante* and its performance can therefore hardly be criticized in this respect.

Secondly, the perceived risks of investing in Slovakia declined, mainly due to the improving economic situation. The fixed exchange rate and a sizeable interest rate differential created room for short-term capital inflows and consequent currency volatility. The NBS responded to this phenomenon not only by introducing a fluctuation band and some administrative measures, but also by issuing NBS treasury bills and by other restrictive instruments sterilizing funds from the financial markets. The NBS gradually began to introduce monetary restriction, albeit very mildly, already during the year 1995.

In spite of this, the National Bank of Slovakia failed at one important stage of the shift from administrative and quantitative monetary policy management to a policy based to a greater extent on a qualitative, market approach. In 1995, the NBS still used the administrative tool of credit limits for the largest banks (with loan activities in excess of 20 billion crowns in 1995 (NBS, 1996, p. 46)). This method was abandoned in 1996. Using this instrument enabled the central bank to limit excessively rapid credit expansion. This was utilized in state-controlled banks where there was a greater threat of moral hazard. In 1993 and 1994, these limits were often not filled. The largest banks were a part of the driving force behind credit expansion and these limits were an effective monetary policy tool (see NBS, 1994, p. 40, NBS, 1995, p. 48). In 1995, the credit limits were significantly exceeded – by 20.6 billion crowns (NBS, 1996, p. 46) and this excess was one of the key reasons behind the excessive credit expansion, particularly in the second half of 1995. The excess was caused by significant credit expansion in the smaller banks that were unaffected by credit limits. In simple terms, the central bank excessively relied on an administrative instrument as an efficient tool to secure its monetary goals and subsequently failed to adequately employ indirect restrictive instruments. After realizing that this administrative instrument was becoming progressively less effective and more distortive, the NBS ceased to apply it in 1996.

#### **4.4.3 The Years 1996-1998: Conflict between Monetary and Fiscal Policy**

The years 1996 to 1998 in Slovakia saw a textbook example of a conflict or lack of coordination between monetary and fiscal policy. The state's budgetary policy was heavily expansionary and accompanied by a high fiscal deficit (and deficit in the current account of the balance of payments). Monetary policy, in contrast, turned from the second half of 1996 towards a policy of relative restriction. This was seen as a way to prevent to prevent the imbalances from

having negative consequences on the real economy. In this section, we will analyze the NBS's role within this conflict between monetary and fiscal policy and examine possible solutions for this situation.

The National Bank of Slovakia significantly modified its monetary policy in mid-1996 by moving towards restriction; however this shift was not accompanied by a change in the indicative discount rate. The change can, however, be observed from an analysis of one-month interbank rates (BRIBOR) – see chart 4, and also from a composite look at the internal and external monetary policy using the monetary conditions indicator (MCI)<sup>95</sup> – see chart 5.

Although up until the year 1998 this policy successfully prevented the imbalances from turning into a full-fledged economic and financial crisis, it failed to resolve them – many of them actually deepened as a result. It could be argued that monetary policy has only limited instruments at its disposal unless it is coordinated with fiscal policy. In spite of this, it can be argued that the NBS could have and should have taken the step that it took when forced by events in October 1998 – the abolishment of the fixed exchange rate. A shift to a floating exchange rate was the only really potent weapon at the central bank's disposal. Furthermore, such a shift would have been optimal for the economy even in the absence of a conflict between monetary and fiscal policy. In our view, the change in the exchange rate regime should have been made in fall 1997 or at the very latest, after the May currency crisis had been dispelled. If the abandonment of a fixed exchange rate would have been a politically unacceptable action during “peaceful” times, the NBS could have exploited the May crisis as an opportunity to move to a floating exchange rate.

The NBS could have theoretically used an even more restrictive policy to resolve the imbalance, prevent an overheating of the economy and the deepening of internal and external imbalances. But real interest rates were already extremely high – for instance, at the beginning of April 1997, ex post real interest rates in Slovakia reached 13.1 %, while in Czech Republic in the same period they were 5.3 % and in Hungary 1.5 % (calculated on the basis of year-on-year inflation to the end of March 1997 and the six-month interbank interest rate). A further rate increase would have particularly affected the credit position of the state, which during the 1996 to 1998 period had drained away most domestic savings. But the state displayed low levels of interest rate elasticity of demand even in the following period and it was unlikely that an interest rate increase would have altered its behavior.

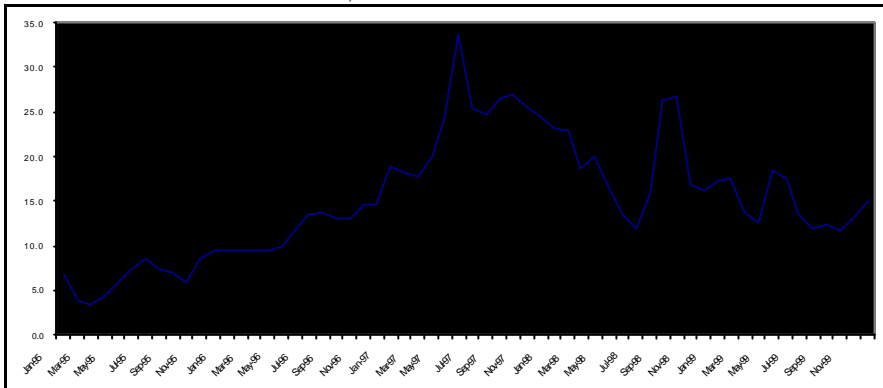
High interest rates were already causing distortions in the economy through the general phenomenon of adverse selection, when rising interest rates attract

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<sup>95</sup>  $MCI = 0.35 * \text{the currency's overvaluation above its arbitrarily determined equilibrium level} + 0.65 * (\text{real interest rates} - \text{real GDP growth})$ .

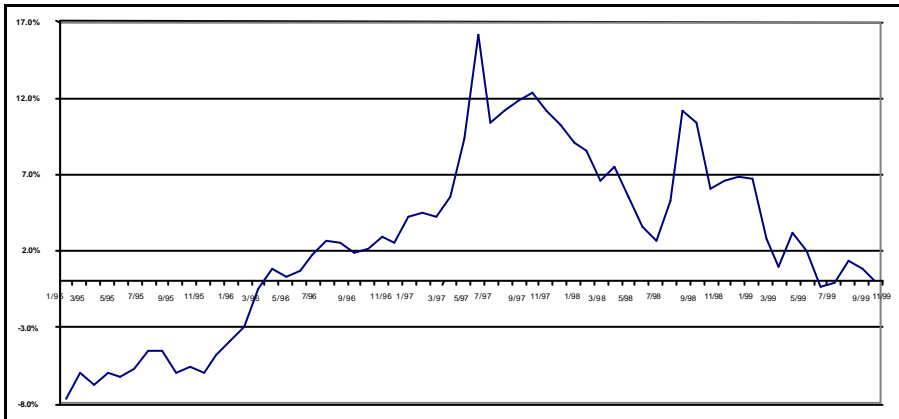
applicants with higher-risk or rent-seeking projects. In addition, the unevenly distributed access of economic entities to foreign currency credit posed an even more significant distortion. These loans were available primarily to larger entities and to ones with a government guarantee. We have already analyzed this phenomenon in the chapter on industrial policy and in other chapters. A stricter monetary policy would have exacerbated this imbalance.

CHART 4. BRIBOR 1995-1999, %



Source: ING Barings

CHART 5. MCI 1995-1999



Source: ING Barings

In this context, we need to address one question. Should Slovakia have abandoned the fixed exchange rate earlier? There are several serious arguments suggesting that it should have. A fixed exchange rate can be very useful in the initial phases of transition when the need for a nominal anchor prevails over the

drawbacks of a fixed exchange rate. In Slovakia's case, three basic arguments support this assertion:

- a fixed exchange rate is an unambiguous demonstration of the government's determination to keep inflation down;
- a fixed exchange rate helps economic entities by serving as a nominal anchor for setting prices and wages, especially in an economy with such high degree of openness as Slovakia's;
- fixed exchange rate as a monetary policy target is transparent, popular and easy to check for the public.

According to Sachs (1996), transition countries that have adopted a fixed exchange rate policy have experienced significantly lower inflation without noticeable output losses when compared with other post-communist states. He and several other authors reject long-term fixed exchange rate policies though, not only for economies in transition, but also for small open economies in general. The following paragraphs review the basic arguments against a long-term fixed exchange rate and try to establish to what degree they apply to Slovakia. Our conclusion is that they apply to a great extent.

According to Mishkin (1999), the drawback of a fixed exchange rate is that it *“removes the signal that, with a floating exchange rate, the foreign exchange market gives every day on monetary policy.”* (p. 582) The government can conduct excessively expansive fiscal policy or the central bank can evoke excessively expansive monetary policy without any short-term effect on the exchange rate, until the situation becomes unsustainable and a currency crisis breaks out. In this context, we can contrast the situation in the foreign exchange market under Meciar's (1994-1998) and under Dzurinda's (1998-) government. The fixed exchange rate made possible the first three years of significantly expansive fiscal policy that led to a crisis, a significant devaluation of the currency and a slowdown in economic growth. In contrast, the floating exchange rate gave a signal very fast that Dzurinda's cabinet's reforms were progressing too slowly through the crown's dip in May 1999 – after a series of economic measures, it recovered very fast. In general, more recent works in the area of relationship between fiscal, monetary and foreign exchange policy emphasize the importance of a moderate fiscal policy for the monetary regime especially in the case of a fixed exchange rate. Canzoneri and Diba (1996) and Canzoneri, Cumby and Diba (1998) also explain theoretically why even an independent central bank cannot maintain low inflation and a fixed exchange rate if the government is not restricted in the size of the public finance deficit.

We can quote Mishkin with regard to economic developments:

*“Exchange-rate targeting in emerging market countries is likely to promote financial fragility and possibly a full-fledged financial crisis that can be highly destructive to the economy.*

*Because of uncertainty about the future value of the domestic currency, many nonfinancial firms, banks and governments in emerging market countries find it much easier to issue debt if the debt is denominated in foreign currencies. This tendency can be further encouraged by an exchange-rate targeting regime which may encourage domestic firms and financial institutions to issue foreign denominated debt. The substantial issuance of foreign denominated debt was a prominent feature of the institutional structure in the Chilean financial markets before the financial crisis in 1982, in Mexico before its financial crisis in 1994 and in East Asian countries before their recent crisis.*

*With an exchange-rate target regime, depreciation of the currency when it occurs is a highly nonlinear event because it involves a devaluation. In most developed countries a devaluation has little direct effects on the balance sheets of households, firms and banks because their debts are denominated in domestic currency. This is not true, however, in emerging market countries with their very different institutional structure. With debt contracts denominated in foreign currency as in emerging market countries, when there is a devaluation of the domestic currency, the debt burden of domestic firms increases. On the other hand, since assets are typically denominated in domestic currency, there is no simultaneous increase in the value of firms' assets. The result is that a devaluation leads to a substantial deterioration in balance sheets and a decline in net worth, both for nonfinancial firms and financial firms,”* this in turn leads to reduced credit activity, investment and economic slowdown (Mishkin, 1999, pp. 584-5).

This scenario took place in Slovakia during the years 1996-1998, especially in connection with foreign currency loans to large firms such as Slovnaft and VSŽ, and as well as by direct and indirect foreign currency loans granted to the state (government eurobonds, government-guaranteed loans for state-controlled enterprises) – see for example MH SR (1999). It is not coincidental that the relative economic contraction in Slovakia in 1999 was led by the state, a state that was suffering from a growing debt burden.

Sachs (1996) emphasizes that in order to maintain a fixed exchange rate in the long term, the economy must have a high structural, price and wage flexibility. Transition economies generally do not have such flexibility. With a few exceptions, long-term use of a fixed exchange rate is, in his view, not suitable for transition economies. (Sachs, 1996, pp. 150-1) NBS representatives argued that they had hoped for a change in fiscal policy both before and after the elections. But even a significantly stricter fiscal policy would not have sustained the fixed exchange rate in the long term. First, as we have already stated, up to the point of

devaluation, a fixed exchange rate does not exert pressure on the government to reduce the deficit or the expansiveness of public finances.

Fixed exchange rate carries another disadvantage in terms of its complicated relationship to the equilibrium exchange rate for the currency. As Halpern and Wyplosz (1997), among others, show, the equilibrium exchange rate shifts significantly in the course of transition due to radical structural changes in the economy. A floating exchange rate allows the foreign exchange market to seek an equilibrium value, although, it can not be said that the market is at all times close to this exchange rate. But with the exchange rate fixed, real currency appreciation of the currency can easily occur (based on higher inflation than in the countries of the reference basket currencies). This can be accompanied by significant deviations from the (unknown) equilibrium value and subsequent loss of foreign trade competitiveness resulting in a foreign trade deficit problem and macroeconomic imbalance. During 1999, the exchange rate of the freely floating Slovak crown oscillated in the interval between 42.3 SKK/euro to 47.3 SKK/euro. This approximately corresponds to a 10 %-23 % deviation from the former central parity (we are providing only an approximation, since the original parity was against a basket composed of the DEM (euro) and the USD). We have pointed out that it is extremely difficult to determine the currency's equilibrium exchange rate under such rapidly changing and transitive conditions. Tóth (1999) made an attempt to calculate it, working under the assumption that the real exchange rate was at an equilibrium at the beginning of 1995 and that no significant changes in the micro economy justifying a change in the equilibrium exchange rate occurred in the years 1995-1999. If we accept these assumptions, it appears that in 1997 and 1998 (before the fixed exchange rate was abandoned) a significant real overvaluation of the crown took place. Jointly, these indicators show that the equilibrium level for the Slovak crown was lower than the fixed exchange rate already in 1998. NBS interventions validated this. The bank intervened in December 1999 (for the first time in history) against the crown, approximately at the 42.3 SKK/euro level, or about 10 % above the former central parity, thus confirming, that even the bank considered ex post that the former central parity was unsustainable.

#### **4.4.4 Monetary Policy after the Abolishment of the Fixed Exchange Rate**

The National Bank of Slovakia cancelled the crown's fixed band and moved to inflation targeting from December 1998. Although it was only a provisional regime throughout 1999, this action could hardly be labeled as true inflation targeting. The NBS switched to actual inflation targeting in January 2000. We will

analyze this regime in the final section. This section will examine the NBS's monetary policy in the interim period.

The National Bank divided the currency basket into three parts – food (26.8 %), goods and services with regulated prices (17.8 %) and other (55.4 %). It decided to only target price changes in the latter group. It is understandable that regulated prices were left out – they change on the basis of administrative measures, often politically motivated ones, and unrelated to inflationary pressures in the economy, which the NBS's focus. Food represents a more complex issue with that we will deal later. In general, however, prices in this group display high volatility mainly due to the influence of supply-side factors. The impact of a poor harvest or, conversely, a surplus can cause these prices to oscillate far more sharply than the rest of the consumer basket. If the central bank takes these prices into account, it risks reacting to the high volatility rather than reacting to real inflationary pressures. This could result in changing policy too hastily. The NBS primarily looks at changes in prices in the limited currency basket. This represents slightly more than a half of the overall basket.

In our analysis of monetary policy during the interim period, we will deal with the following issues: transparency and intelligibility of the NBS's policy, suitability of the NBS's overall inflation strategy for the interim period and practicality of this policy.

In regard to transparency and intelligibility of monetary policy, we will quote the 1999 Monetary Program: “In view of price deregulation, as well as the package of measures to reduce macroeconomic imbalances, the NBS will target net inflation at the level of 5 – 7 %, while anticipating a primary effect on the overall consumer price index of about 2 percentage points for every average 10 % increase in regulated prices. The NBS will only influence secondary effects of price deregulation, in the sense of acting against “price contagion.” Net inflation concerns 55 % of goods and services in the consumer basket and includes the increase or decline in prices caused by changes in the exchange rate, administrative measures in foreign trade (e.g., the import surcharge), changes in consumption taxes and value-added tax, secondary effects of price regulations in the other sectors, secondary effects of accelerated food price increases in the other sectors, changes in the population's purchasing power, propensity to consume, seasonality of purchases, changes in producer prices, developments in the relationship between labor productivity and wages, etc.” (Biatec 1/99, p. 2)

This quote served as the basis for a misunderstanding between the central bank and the financial markets (see the daily SME, June 19, 1999, p. 9). Inflation targeting usually uses abridged price indices, although 55 % is one of the narrowest – if not the narrowest – reduced basket (we will return to this issue). Core or net inflation is usually calculated as the year-on-year change in prices in such a basket.



But the NBS defined net inflation as the change in these prices multiplied by their share on the overall basket, i.e., using a factor of 0.554 for 1999. In other words, if the prices in this basket rose by 10 %, net inflation, according to the NBS, would go up by only 5.5 %. Since this represents a unique approach, it was the NBS's duty in the interest of intelligibility to repeatedly warn that its indicator deviates from the standard approach. But the NBS actually defined the whole issue in its monetary program very vaguely, and although it stated its definition in the monetary reviews, it never specifically pointed out its principle. The misunderstanding was clarified only when it published the updated monetary program in June 1999. Until this occurred, the financial markets had understood the proclaimed 5-7 % net inflation target as a 5-7 % change in prices in the reduced basket. In reality, the NBS meant their change by 9-12.6 %.<sup>96</sup> The Statistical Office of the Slovak Republic, which began publishing official net inflation data in January 2000, shows that this was a confusing approach. It provides under net inflation figures according to the standard definition, not according to the original NBS definition.

The exclusion of food from the net inflation basket poses another problem. It is questionable for two reasons. First, given the high share that food represents in the basket and the exclusion of regulated prices, there is a risk that net inflation will be irrelevant in the formation of inflationary expectations for most economic agents. This will particularly affect the consumers, because the net inflation basket as defined in this manner contains only a half of their consumer basket. Secondly, volatile items can be left out of an inflation basket only if their long-term path is consistent with the rest of the basket. It would be hard to find such consistency in the Slovak case. Since 1995, food prices have consistently grown slower than the remaining unregulated portion of the basket. Overall, in evaluating NBS's monetary policy in 1999, we can point to a vaguely defined target and to problems with the definition of the consumer basket.

#### **4.4.5 The Monetary Regime after January 1, 2000**

In January 1, 2000, the National Bank of Slovakia moved from the previously described provisional arrangements to a real system of inflation targeting (NBS, 1999a). Simultaneously, a shift took place from quantitative to limited qualitative monetary policy based on a single indicative NBS interest rate. The new inflation targeting mechanism represents a significantly improved model compared with the previous provisional arrangement – most criticisms from the

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<sup>96</sup> The NBS revised this target to 6-7.5 % in June 1999, effectively implying a year-on-year change in these prices by 10.9-13.6 %. The NBS simultaneously published its overall inflation target, which was supposed to reach 13.5-15.5 % year-on-year in December.

previous section do not apply to it anymore (the following part is based on NBS, 1999b). Nevertheless, it does have at least one significant problem.

The NBS targets clearly defined core inflation. It will be calculated and published by the Statistical Office of the Slovak Republic. This will ensure not only transparency of monetary policy results, but also independence from the NBS's calculation. The core inflation consumer basket will contain not only the basket used for the net inflation, but also food. As we explained earlier, despite the volatility of food prices, this is an improvement. Their development diverges from the basic basket and food represents a high share of the overall consumer basket. Core inflation will be stripped of changes in indirect taxes and subsidies that directly affect consumer prices (except for the import surcharge). Core inflation will thus capture – assuming unchanged indirect taxes – 82 % of changes in the consumer basket and will be very similar to “net inflation” currently used in Czech Republic.

Another problem for the transparency and credibility of monetary policy is that *“the NBS comments on developments of the overall consumer price index only in the form of a forecast while core inflation will gradually become the NBS's target.”* (NBS, 1999b, p. 3) Although this distinction is clear for the more sophisticated economic actors and means that only meeting the core inflation target matters in evaluating the success and credibility of monetary policy, there is a major risk that the other economic actors will not understand the distinction between a prediction and a binding target. The overall consumer price basket is a natural anchor for economic actors' inflationary expectations due to its clarity and the importance of the changes in it. If the central bank issues its prediction along with the core inflation target, it will be natural for the less sophisticated actors to focus on the overall inflation figure and view it as a monetary policy target. If this prediction is not met due to circumstances beyond the central bank's control, the credibility of monetary policy will be damaged even if the core inflation target is met. Besides, the wording that core inflation will become the NBS's target, without specifying a clear timetable, also challenges the credibility of the new monetary policy framework.

Along with this change, the central bank is moving to the use of an indicative interest rate. The central bank will employ this to influence the situation in the money market and that will become its basic operative monetary policy instrument. It goes into effect on February 1, initially as a one-day (overnight) repo rate, but with the perspective of a gradual lengthening to two weeks (see NBS, 1999b). Banking entities will be able to borrow relatively unlimited funds from the central bank. Up until this point, the NBS had always limited the volumes of money provided through repurchase loans. This represents a significant change. Overall, the year 2000 can be viewed as the year of the most significant qualitative

changes in monetary policy. The introduction of a new monetary policy target and a new operative instrument creates room for a gradual convergence of Slovak monetary policy to the policy of the ECB.

#### **4.4.6 Monetary Policy in Slovakia and the European Central Bank**

The goal of all Slovak governments has been Slovakia's membership in the European Union. Since the formation of the European Monetary Union on January 1, 1999, we need to also keep in mind the possibility of Slovakia's membership in the EMU. This is especially significant if new members do not receive an exemption from the Maastricht Treaty – in other words, if they have to join the EMU. Temprano-Arroyo and Feldman (1998) warn that EMU membership will become a part of the *acquis communautaire* that new members will have to adopt. On the other hand, even the European Commission does not expect post-communist countries to join the EMU right after joining the EU (The daily SME, October 14, 1999). In spite of this, in the medium term we need to consider two issues:

- Can entry into the monetary union cause serious economic problems for Slovakia?
- What strategy should be chosen for the interim period of Slovakia's approximation and accession to the EU?

The first case brings us back to a theme analyzed in connection with the existence of Czechoslovakia – optimum currency areas. In other words, will the EU represent an optimum currency area for Slovakia? Very few studies have been devoted to this issue, with the exception of De Graw and Lavac's (1999) book. An econometric study by De Graw and Aksoy in the book comes to the conclusion that economic shocks in Central Europe are correlated with shocks in the EU countries and that the economic cycle is synchronized. Boone and Maurel (1999) come to a similar conclusion. Synchronization and integration can be expected to increase due to intensifying trade and capital ties (see Boone and Maurel, 1999). We can make the preliminary conclusion that participation in the EMU should not pose any greater problems related to optimum currency areas than those experienced by current EMU members.

The second question, which has so far received little attention, is that of strategy during the interim period prior to EMU entry. The interim period is likely to last 8-10 years and the question of the optimum monetary regime is therefore crucial. There are two basic monetary regime options for this period – a fixed exchange rate to the euro and inflation targeting. Both present certain problems in terms of functionality and the Maastricht criteria.

A fixed exchange rate to the euro brings all the problems discussed in the section devoted to the 1996-1998 period. These problems were related to fiscal and

monetary policy and to speculative attacks. Therefore, the fixed rate exchange can only be recommended for the final period prior to EMU entry (one of the Maastricht criteria states that the exchange rate has to be fixed to the euro at least two years before accession). Additionally, the Maastricht criteria includes inflation of no more than 1.5 % above the average of the three EMU countries with the lowest inflation and interest rates meeting the same condition with a 2 % boundary. With a fixed exchange rate, Slovakia may find it difficult to meet these conditions. The Balassa-Samuelson model addresses the issue of developing countries efforts to catch up with the developed world. The model shows that for a rapidly growing country “*the stability of the overall price level is possible only if the exchange rate appreciates in proportion to the multiple of the share of non-tradable goods on the price index and the difference between productivity growth in the tradable goods sector and the non-tradable goods sector.*” (Masson, 1999, p. 16) There is a problem that can occur with the fixed exchange rate in a country in the process of catching up for instance with EU countries. With high labor productivity growth and GDP growth, the process can lead to inflation. This inflation can be several percentages higher than in the EU countries.

On the other hand, inflation targeting also has its risks (we refer those interested in inflation targeting particularly to Bernanke et al., 1999). Two of the risks are especially relevant for Slovakia. It is well known in monetary economics that the measured inflation in most countries (including developed countries) is somewhat higher than actual price growth. This is due to several factors – for example, the inability to measure qualitative changes and the time lapse between the revisions of the basket used for calculating inflation. In developed countries, the overvaluation is usually estimated at 1-2 %. Therefore, central banks targeting price stability usually have an inflation target of about 1-2 %. According to Škrebo (1998), this difference can be much higher in transition economies. This makes it hard to target price stability without knowing what measured inflation level corresponds with it.

The ambiguous relationship between various monetary indicators and inflation represents the second risk for inflation targeting in Slovakia. No clear relationship has been demonstrated in Slovakia between any of the other indicators and subsequent inflation. Since the effect of monetary policy on inflation is subject to a delay, inflation targeting requires the use of an intermediate target in the interest of monetary policy transparency and in order to prevent dynamic inconsistencies. The tool increasingly used in inflation targeting around the world – inflation forecast targeting – is unlikely to be of much use in Slovakia in the next few years. This is due to a lack of solid and proven structural models for the Slovak economy.

In spite of this, for the next few years inflation targeting should be the optimal solution for Slovakia. A fixed exchange rate is completely out of the question in the short term due to the accelerated inflation caused by price deregulation, tax changes and currency depreciation. Other factors relevant to the issue are the low foreign exchange reserve coupled with a higher degree of capital account liberalization. In the next 2-4 years, monetary policy should focus on stabilizing inflation and reducing it to the 5-6 % level. This goal is served perfectly by credible inflation targeting. This policy could succeed because Slovakia has already experienced a few years of low inflation and it should be possible to quickly bring inflationary expectations back to these levels. The lack of an intermediate target and a solid structural model to serve as the basis for forecasting should not be a great problem due to relatively high credibility of the NBS. The National Bank of Slovakia's inflation targets could, as long as the bank's credibility is preserved, be accepted by economic actors even under conditions that are not completely transparent.

On the other hand, after joining the EU around 2005-2007, Slovakia should prepare for EMU membership by gradually moving to a fixed exchange rate. The European Exchange Rate Mechanism 2 (CERM 2) appears to be the optimal in-between step. The system should be put in place for EU members who are not also members of the EMU (Masson, 1999, p. 11). The mechanism fixes the exchange rates of member currencies to the euro, but still allows them to fluctuate within fairly broad, 15 % bands around the central parities.

## **4.5 Conclusion**

The nineties in Slovakia were a decade of radical changes in terms of economic policy and monetary policy. In spite of this, monetary policy represented one of the most stable elements of economic policy, not only through its conduct, but also through the results (relatively low inflation and a relatively stable exchange rate). Our analysis focused on the causes of this stability, as well as on the key issues of Slovakia's monetary policy.

We have arrived at the following conclusions:

Monetary policy within Czechoslovakia did not constitute a real problem from the institutional perspective or the perspective of the optimum currency area theory. The institutional framework for Slovakia's representation in monetary policy conduct was similar to the frameworks used in other federal central banks in Western Europe. The basic tests used to identify optimum currency areas have shown that there were no major divergences between Slovakia and Czech Republic and that the two countries probably constituted such an area. The explanation for divergent unemployment rates should probably be sought by examining other aspects of economic policy.

The National Bank of Slovakia represents an independent institution even by international standards. Based on research indicating a relationship between central bank independence and low inflation, we can observe one of the reasons for the successful curbing of inflation in the 90s.

Monetary policy conduct in the years 1993-1998 can be viewed as successful, especially from the viewpoint of the appropriate pace of liberalization, the appropriate mix of market and the administrative monetary policy instruments. The results were low inflation, a stable exchange rate and an increasing degree of liberalization of the foreign exchange and money markets. However, certain problems cannot be overlooked. Most notably, the NBS responded inadequately to new developments in 1996 in relation to expansive fiscal policy and an overheating of the economy. Although the central bank applied monetary restriction, it failed to adopt the only measure that could have reversed these developments. This measure was necessary for several reasons – the shift from a fixed to a floating exchange rate. This was one of the reasons why the five-year period of exchange rate stability led to a monetary crisis in September 1998 which subsequently resulted in the floatation of the crown on October 2, 1998.

In October 1998, the central bank adopted a new approach on monetary policy characterized by a floating exchange rate and the use of inflation targeting. The year 1999 was one of provisional inflation targeting and it had several problematic aspects. However, as of January 1, 2000, a new, formally defined inflation targeting system has been put into use. This system should resolve most of the aforementioned problems. Simultaneously, the central bank moved to qualitative monetary policy management using one interest rate as the main monetary policy instrument.

We have examined some of the basic issues that Slovak policy will have to cope with in connection with European Union accession. This accession is expected around the years 2005-2007 and the European Monetary Union entry is expected a few years later. Although very little research has been conducted in this area, existing works suggest that the so-called eurozone should represent an optimum currency area for Slovakia. The entry into the EMU in about 10 years should not be a significant problem strictly from a monetary policy perspective. In regard to monetary policy during the interim period, we recommend that inflation targeting be maintained as long as it is deemed feasible and that steps to begin fixing the crown to the euro should be taken only a few years before joining the monetary union.

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# 5 World Economy

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## 5.1 Introduction

Although Slovak (and Czechoslovak) markets have lacked the close ties that connect most of the world's industrialized countries into a global economy at this point, several features of other economies have had a large impact on Slovakia's economic well-being. Due to its extensive and growing openness and an economic structure based mainly on exports of products with lower value added, Slovakia has been greatly influenced by the economic cycle of its main trading partners. Hence, this chapter emphasizes the economic growth in Western Europe as well as other East European countries, former trading partners within Comecon arrangements. The United States economy, the largest in the world, to a great degree determines the fate of its trade partners and is thus also dealt with in detail.

Several other emerging economies that seemingly have little connection to the Slovak economy are mentioned in this chapter. Developments in countries like Mexico or some emerging markets in Asia, at times, have had a profound influence on other distant economies undergoing transition. That influence is due to their effect on the general sentiment about emerging markets. Moreover, some developments in emerging markets hold invaluable clues to understanding similar features of Slovakia's situation. When foreign investors burned their fingers in Mexico and Russia, other emerging markets suffered severe repercussions in the form of lower investment inflows. Another side effect of developments in far away emerging markets was in the attitudes of international financial institutions whose programs, some of which pertained to Slovakia, were affected in scale or form to reflect new insights gained.

## 5.2 The End of the 80s – Cold War Ends

At the end of the 1980s, the world's industrialized nations were nearing the end of a long stretch of successful economic growth. The world economy had been growing steadily since 1982. Although limited slowdown was expected by economic forecasters for 1989, the gradual thawing of Cold War global tensions gave rise to optimism that there would be benefits of improved trade relations and reduced armament expenditures.

The key concern among world economic leaders for the new decade was the fear of a rise in protectionist pressures. This fear followed the breakdown of talks on eliminating barriers to world trade within the General Agreement on Trade and Tariffs (GATT) framework. Another major concern was the continued growth of the U.S. balance of payments deficit. There was also a concern about massive failures of savings and loans institutions, which called for substantial bailouts by the state, creating further budgetary pressures.

Meanwhile, countries of the former Eastern Bloc pursued a path of economic transition from planned economies to market economies. The transition of economies toward free market was widely expected to be costly for Western loan providers and especially for these countries' own people who would carry the burden of declining industrial production, rising deregulated prices, and the previously unknown problems of unemployment. The end of the 1980s already showed serious slow-downs in economic growth of the Soviet Union and most of its East European satellites, despite more or less half-hearted efforts tied to various Perestroika programs.

### **5.3 1990 – Western Europe in Recession, German Re-Unification**

The actual slowdown in economic growth seen in 1990 led to a recession that lasted through 1993 in Western Europe. It came as a surprise. Economists and policy-makers could not foresee one major event that took place during 1990 – Iraq's invasion of the oil-rich state of Kuwait. The subsequent doubling of world oil prices had implications similar to the of oil shocks in the 1970s, a global credit crunch and a shortage of loan funding, which negatively affected growth. The credit crunch was first a result of a greater need for outside financing in developing countries that did not have their own crude oil reserves. Rising oil import costs in developing and developed countries alike increased the need for credit to finance oil purchases.

German re-unification was already in its early stages and expected to significantly affect the entire European economy, mainly due to the strain on the budget of Germany, Europe's largest economy. Although no clear figure can be given for the total cost of the process, it is estimated at trillions of German marks. Annual budgetary transfers from former West Germany to the five new states in the early years of reunification were over 170 billion marks. The high fiscal costs were translated into higher government borrowing, which in effect raised interest rates and resulted in an economic slowdown. The existence of a nascent European Monetary System (EMS), tying most European currencies together, provided for the transmittal of slowing German growth to other already struggling European countries. The EMS also complicated efforts at economic stimulation. It made rate

cuts in individual countries cause a divergence in interest rates between members and exerted pressure on the stability of the exchange rate mechanism.

Germany and the United States in particular attempted to set their own economies, and indirectly the world economy, back on a growth track through a series of interest rate cuts. But underlying cyclical recessionary pressures proved too hard to tackle in this manner. Growth in the U.S. remained positive, albeit unsteady, throughout most of this period. But Western Europe experienced a full-blown recession with economic decline and soaring unemployment.

## **5.4 1991 – Russian Coup, Economic Slump Continues**

The situation in Eastern Europe and Russia also deteriorated in this period. It did so more because of economic reform effects than through transferred effects of economic difficulties elsewhere. Russia failed to achieve one key component of economic reform – political stability. Fears of a return to Communist rule were suppressed by the election of Boris Yeltsin, arguably a pro-market reformist, to Russia's presidency and a failed 1991 coup. Yet domestic politics remained marred by social tensions and fighting among the president, Russia's parliament, and powerful pressure groups in various areas of Russian industry.

Other Eastern European countries fared better than Russia, due to a more solid structural foundation. But, they experienced a period of high inflation as a result of price deregulation, the dissolving of a monetary overhang, and the stock of excess currency held by households resulting from the unavailability of consumer goods in the Communist-era shortage economy. Every country that pursued economic reforms also experienced sharp contractions in output as industries fell apart, hard hit by the collapse of Comecon trade links, and were unable to compete in the world market due to inefficiency and obsolescence.

Some analysts called this period the worst since the 1930s Great Depression. With the exception of a few Asian countries, the economies of most countries slumped. Repeatedly in 1992 and 1993, economists heralded the beginning of a recovery for Europe and a more solid recovery for the United States. But, these predictions failed to materialize.

## **5.5 1992, 1993 – Maastricht Treaty**

The year 1992 brought about one economic event with far-reaching repercussions: the signing of the Maastricht treaty. This treaty represented a pledge among member states of the European Union to create the European Monetary Union and thus bring to completion the economic integration among member states of this economic and political bloc. It promised to form an economic area that could, in size and importance, compete with the United States. It also promised to

converge economically and provide conditions for the establishment of a unified currency. It was crucial that a single currency require the various nation states to abide by strict fiscal and monetary rules that the Maastricht criteria defined. Western Europe was thus given ambitious targets in terms of inflation, interest rates, fiscal deficits, and debt levels, which would dominate economic policy of individual states for years to come. In order to qualify for European Monetary Union Membership in the first round, countries agreed to slash their government deficits to not more than three percent of GDP annually, to reduce government debt to below 60 percent of GDP, to keep inflation to no more than 1.5 percent above the three best performing members in the previous year, to keep their currencies within the normal fluctuation bands of the European Monetary System, and to keep their interest rates at no more than two percentage points above the average of the three members with the lowest inflation rates.

But lengthy delays connected to the ratification of the treaty by member states created turmoil in the international financial market. This was cited as one of the main causes of Europe's sluggish growth in 1993. Late in 1992, two currencies, the Italian lira and the British pound, were forced to withdraw from the European Monetary System due to divergent economic developments in various countries of the system. In 1993, bands within which currencies were allowed to move without central bank intervention were also widened (to 15 percent from 2.25 percent). This gave countries more monetary policy leeway, but set back monetary unification significantly.

Economic recovery around the world was further hindered by difficulties in the 1992 Uruguay Round of GATT talks. In Uruguay, nations of the world tried to negotiate a new system that would replace the GATT for adjudicating trade disputes. The aim was to create institutions with stronger enforcement abilities for coercing nations to comply with agreed upon reductions in trade barriers. The Uruguay Round was particularly difficult since it attempted to extend anti-protectionist measures to previously untouched areas, like trade in services, fibers, and agriculture.

The United States fared better than Europe in 1992 and 1993, but fell short of economists' expectations for fast paced growth that was typical of earlier recoveries. Large problems remained with fiscal deficits and deficits in trade, particularly with Japan. For instance, America's trade deficit with Japan alone in 1993 reached 60 billion dollars and 116 billion dollars overall. These trade imbalances persisted throughout the 1990s despite improvement in domestic fiscal balances later in the decade. While the U.S. welcomed the strengthening of the yen in this period as a means to battle these imbalances, Japanese leaders repeatedly sought international cooperation against their currency's strength, fearing it would hurt their economy.

## 5.6 1994 – US and European Recovery, WTO

Actual recovery from the slump of the early 1990s came about only in 1994, with the exception of the United States which began doing better earlier. The United States had by then begun growing at such a pace, that 1994 saw a series of successive interest rate hikes by the Federal Reserve to prevent inflationary pressures from rising. European economies, including Germany, then ceased to contract and began growing quite solidly.

Improvements in Western European economies generally led to better economic performance in Eastern Europe. The most advanced countries in the area, which had in the meantime also progressed the most on liberalization and restructuring, particularly saw an export-led return to a growth path for the first time since the breakdown of Communism. These countries had made inroads in stabilizing their economies, particularly in combating inflation and promoting currency stability, and privatizing the functional portion of Communist era industries, partly with the assistance of foreign capital.

Russia's reforms in the same period were stalled amid continued political turmoil that was marked by infighting between President Boris Yeltsin, along with reformist forces within Russia's government, and still widely popular anti-reform forces. Industrial output continued to decline, inflation and ruble instability were high, and Russia's key role in international economic policy produced a continued struggle for increased handouts from international financial institutions. However, there was some cause for optimism for Russia when the International Monetary Fund insisted on the meeting of certain conditions before providing further loans. That forced the Russian government into an ambitious pledge of reducing inflation (to seven percent per month) and cutting the fiscal deficit to below 10 percent GDP. Russia surprised the international community by actually succeeding in meeting these targets, resulting in vastly larger inflows of foreign investment as sentiment about the previously 'lost' country gradually began to improve.

The year 1994 also brought a turnaround on the trade front with the final signing of treaties that created the World Trade Organization with the strictest ever rules and strongest ever enforcement mechanisms. It involved most countries of the world. The system withstood several tests later in the decade as countries challenged others' trading practices. Nonetheless, it showed its limits too, as in the end compliance remained a voluntary matter. A good example was that of a trade war between EU states and the United States over U.S. export of hormonally treated beef that has brewed over years as parties involved refused to abide by WTO rulings on the matter.



## **5.7 1995 – Recovery Continues, Mexican Crisis**

Recovery trends throughout most of Europe retained their momentum in 1995. Growth in the West continued on a more solid footing and positively affected the East. Optimism over Eastern European prospects was running at an all-time-high. Poland grew at a fast pace and was closely followed by its neighbors, with positive signs even in the less advanced parts of the region. Early in 1995, Hungary adopted a radical package of austerity measures aimed at curbing burgeoning trade imbalances and curbing the fiscal area. The Bokros package, as it came to be known after its chief architect, Hungarian Finance Minister Lajos Bokros (who later resigned after the package temporarily seriously cut into the standard of living in the country), became somewhat of a blueprint for effective radical fiscal reform to promote growth in transition economies. Its key features included a one-third reduction in the budget deficit through radical expenditure cuts, an import surcharge to reduce the trade gap, and significant forint devaluation to boost trade. An opinion poll at the time of the passage found two thirds of the Hungarian population “outraged” by the measures.

The Mexican financial crisis that exploded in late 1994 and early 1995 did much to erode the excitement over emerging markets investment opportunities built up over years. After the country’s economy hit a cyclical downturn and a peasant rebellion in the region of Chiapas scared foreign investors, a sudden withdrawal of foreign investment inflows created pressure on the peso currency. The currency was devalued late in December 1994, leading to problems with foreign debt financing for the state and for companies. Mexico was bailed out with a package of some \$40 billion provided mainly by the United States and the International Monetary Fund. The effect was an overall withdrawal of Western investors from emerging markets, as a bubble - built up over years- burst. The crisis also posed a major challenge to the IMF, which by responding rapidly and providing a sizable loan, was seen by many as reinventing its role in the world economy.

## **5.8 1995, 1996 – US New Economy and Maastricht**

The United States continued growing in 1995 and 1996 while European economies, in particular Germany, experienced a less healthy period. Europe was to a large degree “plagued” by its efforts to stand by the conditions of the Maastricht treaty set out for creating the single European currency. As the 1998 deadline neared for an EU political decision on which countries would be able to become part of the Eurozone in 1999, countries were forced to employ a combination of real deficit cutting and creative national accounts book-keeping to assure their role within the EMU.

Already in 1996 many economists voiced concerns over how long growth in the United States could persist. The country was seen approaching what had been seen as full employment levels. However, despite widespread pessimism and belief about the way the American economy functions based on empirical evidence, the economy continued on a strong growth path until the end of the decade. This prompted some to come up with theories of fundamental changes in the U.S. economy. According to some economists, a “New Economy” had resulted from the advance of information technologies, a growing openness of the United States to trade with other players in the global economy, and a continued shift away from manufacturing and even away from services to technology based industries. In this new economy, proponents claimed, traditional ideas about overheating of the economy based on unemployment data were no longer relevant, as the economy could supposedly grow much faster than previously thought without triggering inflation. For many years, economists believed that when U.S. unemployment fell below six percent, inflation would accelerate. However, even after unemployment fell to 5.2 percent in 1996 and continued declining in subsequent years, inflation remained tame, below three percent. The Federal Reserve, to some extent, gradually gave in to the new idea by allowing its traditional inflation and unemployment ‘speed limits’ to loosen. The stable monetary environment that resulted gave rise to another phenomenon – a steady rise in stock market prices, bringing the Dow Jones industrial average index from 6,000 points late in 1996 to well over 10,000 in late 1999. While some see the spectacular rise in stock-market prices as a confirmation of new economy theories, others, including many Fed officials, have stepped up their warnings of an impending crash as this alleged “bubble” bursts.

Another event of key importance to the emerging markets was the Russian election of 1996. An ailing President Boris Yeltsin stood up to tough opposition, running against anti-reform candidates, in particular Genadi Zyuganov of the re-legalized Russian Communist Party. Aside from fears of Western investors who mostly withdrew due to concerns over the election outcome, Russia continued to suffer from the effects of the drawn-out Chechen conflict. But, Russia’s economic reforms continued their bumpy ride amidst frequent cabinet reshuffles and new conditions from Western aid donors.

## **5.9 1997 – Asian Financial Crisis, Europe’s New Left**

The year 1997 marked the beginning of the Asian financial crisis, another blow to investor confidence in emerging markets. The crisis began in Thailand, Malaysia and Indonesia. It then spread to other countries in the region, including South Korea and the Philippines. The crisis was a result of severe macroeconomic imbalances, structurally fragile financial systems in the region, and the reaction of

the markets as they became unsustainable in the second half of 1997. In particular, sizable deficits in the countries' current accounts were financed primarily by short-term capital inflows and resulted in a severe economic meltdown as investors rushed away. Subsequently, currencies of several former Asian tigers were subject to speculative attacks by currency investors. The real economy then came near to collapsing as output declined and unemployment rose. No consensus exists among experts as to the true causes of the crisis. But, most see the weaknesses in the countries' banking systems as key. Massive inflows of investment from abroad had allowed banks to exercise insufficient prudence in their lending practices, resulting in a heavy burden of bad loans. A related cause is seen in traditional Asian cronyism, as poor lending practices were supported by interconnections between the state, banks and corporations. Some policy-makers in Asia see the main culprit being the very openness of their economies to capital inflows (and outflows) and the ensuing vulnerability to investor sentiment.

Some Asian economies, such as China, Hong Kong, Taiwan and Singapore, suffered the effects of the crisis to a far lesser degree. Although most countries hit by the crisis gradually began to recover in 1998 and 1999 (partly thanks to loan assistance from the IMF), it had taught the world financial community an important lesson in particular about banking systems and the need for their supervision. This has led to a global drive for tighter rules for banks in emerging market economies. The United States, thanks to the continued buoyancy of its economy, suffered only very minor reverberations of the crisis. Most European countries were largely unaffected due to weaker ties to the region.

Growth in the European Union in recent years also failed to live up to expectations, partly because of measures required to meet conditions for the implementation of a single currency, and partly because of Europe's suffering from long-term structural inefficiencies in its labor markets and other regulated areas affecting enterprise. As a result, elections across Europe have brought political forces to the forefront of what has become known as the New Left. In Great Britain, Tony Blair replaced John Major in office in 1997 after 18 years of conservative rule. Also, mainly due to voters' disenchantment with the state of the economy, Helmut Kohl, German Chancellor of 16 years, was forced out of the office in 1998 and replaced by Gerhard Schroder, a Social Democrat.. Similarly in 1997, Lionel Jospin, a socialist, replaced a center-right coalition that had been in power. The shared policies of the New Left, in general, include a left-right mixture with a stronger social element combined to varying degrees with economic realism of the right.

## **5.10 1998 – Russian Crisis**

A year after the Asian financial crisis broke out in mid-1998, the Russian economy also entered into crisis state. The ruble came under pressure due to concerns about the overall health of the Russian economy and the inability of numerous successive prime ministers nominated by President Boris Yeltsin to deal with it. The currency fell and shares tumbled significantly. This happened despite central bank efforts to raise interest rates and despite government announcements of spending cuts and enforcement of a tighter tax discipline. Although the currency stabilized a few weeks later, mainly thanks to foreign donors' willingness to come to rescue, the stability of the economy as a whole remained fragile along with the political situation.

## **5.11 1999 – Euro Introduction, EU Accession Talks**

The Euro project entered a further key phase when the currency was launched (though not yet in paper form) in the beginning of 1999. The 11 participating countries irrevocably locked in their exchange rates with each other and with the euro. The newly created European Central Bank took charge of monetary policy and started setting exchange rates for all participants. Markets received the new currency quite hesitantly, showing no signs of plans to quickly replace the importance the dollar plays as a reserve and transaction currency. Furthermore, already in its first few months the euro saw a major dip to the dollar, from which it has not yet recovered. Nonetheless, the so-called Eurozone saw more optimistic prospects for growth in 1999 by showing a positive signal for transition economies in Eastern Europe, some of which had suffered magnified effects of lower demand for imports in EU countries. For these economies, the later part of the decade brought about more economic differentiation as the effects of structural reforms carried out after the fall of Communism brought their fruits. While growth in Poland remained strong and Hungary accelerated towards the end of the decade, the Czech Republic saw its GDP first slow and then even decline in 1998.

Most reforming countries in Eastern Europe have entered the path to EU membership. The Czech Republic, Poland, Hungary, Slovenia, Estonia (and Cyprus) opened formal membership talks in 1998. Six other countries, including Slovakia, were invited to join the process in December 1999. Although debates still rage both in academic and policy-making circles over the various aspects of the enlargement process and its effects, it will clearly push Europe even more into the spotlight as an economic area due to increased size. The effects on the candidate countries, including Slovakia – should it succeed – are likely to be even more profound.

As Slovakia proceeds on its path to integration with the West, and to bringing its economy in line with Western economies and the global economy, it may well become more sensitive not only to developments in its export markets, but also to overall emerging markets movements once the country becomes a more popular investment destination. While Slovakia was largely unaffected directly by most world economic events of the 1990s described above, the events of the next decade may carry far more relevance.

## 6 Foreign Trade

**Marek JAKOBY**

M.E.S.A.10

Participation in international economic relations is of vital importance for the Slovak Republic. Like other spheres of the economy, foreign trade has been significantly influenced by the transformation process. It is also affected by the structure of the economy, primarily industry. From the beginning of the transformation, there have been two basic issues in the field of foreign trade: a trade balance deficits and insufficient changes in the structure of foreign trade.

The deep trade balance deficits incurred between 1996 to 1998 are connected with the disproportional development of domestic supply and demand. Maintaining of the fixed exchange rate of koruna, some steps in the field of trade policy, and external factors such as the boom in the relevant exporting items segments have had an influence on trade. However, the main reason for insufficient changes in the structure of trade has been the enduring low qualitative competitiveness of Slovak producers which has led to the unsuitable qualitative structure of Slovak export. Thus, inadequate changes in the structure of trade relate to the present insufficient progress in real restructuring of the business sphere.

In the sphere of the foreign trade, there is an absence of an integrated conception of state foreign trade policy. This is due to the absence of an integrated economic policy. Increasing export performance still remains one of the main challenges for the Slovak economy.

## 6.1 Introduction

Foreign Trade (FT) is one part of the commodities and services circulation sphere. It involves the exchange of material goods with foreign countries. The two basic functions of foreign trade are: transformation and growth. The function of transformation rests in the adjustment (transformation) of created GDP before its consumption. The function of growth has an impact on the effective utilization of domestic sources. Through these two functions, the country obtains additional sources of economic growth. It is executed in two levels:

- sales rising abroad (export rising) enable the domestic entities to increase the specialization level and the efficiency in reference to lower unit costs achieved;
- imports supply the country with products, which are not domestically produced or products which could only be produced at prohibitive cost.

Considering its small internal market, the Slovak Republic belongs to a group of countries where foreign trade plays a key role. Small countries are usually dependent on raw materials and other imports and need to place their products in other foreign markets. Slovakia has also inherited extensive production capacities from the pre-transformational period which do not produce sales in the domestic market. The existing base does not provide the requested products assortment, mainly of investment and consumption character, to the domestic market (OECD, 1999). In many cases, foreign trade represents a significant factor in economic growth. Slovakia is a country with the most open economy among Central European transition countries (see the table 1).

TABLE 1. The Openness Level of Selected Transition Countries, in 1997, %

	SVK	CZ	H	PL	SLO
Export/GDP	49.5	43.8	41.8	18.0	46.0
Sales/GDP	109.6	96.0	88.2	47.6	97.4

Source : CESTAT

Slovak foreign trade is one of the spheres most notably marked by economic transformation. The economy has been affected by the changes in nominal growth and territorial structure of foreign trade exchange. After 1989, nominal growth was related to the removal of the state monopoly in the field of foreign trade relations, and to the foreign trade liberalization. The trade exchange base shifted from the former Council for Mutual Economic Assistance (Comecon) markets to those of the European Union.

The negative aspects of Slovak foreign trade are the surpluses of merchandise imports over exports (trade balance deficit) and the insufficient change in the commodities structure. The latter occurs when a significant part of the overall

export consists of lower added value products and lower processing level products. Therefore, the competitiveness of these products is very sensitive to price changes on world markets. Finally, the industrial structure and the export structure are closely related to the trade balance deficit growth seen in the first years of transformation. This can be attributed to the Slovak exporters and their inability to neutralize the growth of domestic demand for foreign products by increasing their exports. On the side of import, Slovakia still remains dependent on strategic raw materials, mainly oil and gas from Russia. Partial diversification has not yet been accomplished.

In addition, the backwardness of utilized technologies depicts the need for raw materials for domestic production, thus conserving the existing commodities structure.

## **6.2 Development in the Basic Indicators of Slovak Foreign Trade**

From 1991 to 1993, Slovakia's foreign trade showed a negative balance but in 1994, trade results improved, and the balance of trade peaked at a surplus of SKK 2.6 billion. This improvement was the result of a favorable situation on world markets, a 10 percent devaluation of the Slovak koruna in 1993, and introduction of 10 percent import charge.

However, by 1995, Slovakia's foreign trade slipped into a deficit again, and continued on this path until it reached a peak of SKK 80.9 billion in 1998. This deficit growth was due to:

- an absence of industrial restructuring;
- an inability to achieve better results on foreign markets;
- an inability to preserve the fixed exchange rate of koruna.

The fixed exchange rate became a political question and endured till October of 1998. As a result of the factual appreciation of the Slovak koruna (fixed exchange rate and higher inflation rate than in most trade partners countries), Slovakia attained a price reduction in imports and Slovaks exports declined in price competitiveness. The unit labor costs also had a negative impact on Slovakia. Their growth pace was one of the highest throughout the transition economies in 1995-1997 (see Lukas, 1999).

In the scope of foreign credits and state guarantees from 1995 to 1998, the government's policy can also be considered faulty. State guarantees flowed practically and exclusively to the field of infrastructure without achieving the increase of export performance and a recurrence of gained foreign currency. The overall volume of state guaranteed loans represented 14 percent of GDP in 1999 (SKK 100 billion, see OECD, 1999). The practical depletion of state finance cannot be expected to change in the near future and any advancement in providing state guarantees to pro-export projects is not predicted.



In 1994, GDP growth was powered mainly by an expressive foreign demand and thus by export. In the following period, a strong growth in imports and increasing deficit reflected the growing disparity between the disproportionate increase of domestic demand and the slow increase of domestic supply (production). In 1996, the impact of export (foreign trade) upon GDP growth was negative due to a lower real value when compared to that of 1995 (OECD, 1999). The trade balance deficit also significantly contributed to the current account's deficit. It represented 10 % of GDP in 1996-1998.

In order to make accurate comparisons concerning the historical development of Slovak foreign trade, we cannot use data before 1993. Prior to this date, Slovakia was a part of the former Czechoslovak Federative Republic and mutual trade with the Czech Republic was a part of inner trade statistics.

**TABLE 2. Basic Indicators of Merchandise Foreign Trade of the Slovak Republic**

	1993	1994	1995	1996	1997*	1998	3Q1999**
Export, SKK billion	167.5	214.4	255.1	270.6	324	374.9	303.9
Change ( %)		28	19	6.1	19.7	15.7	9.9
Import, SKK billion	193.5	211.8	260.8	340.9	392.4	455.8	336.4
Change ( %)		9.5	23.1	30.7	15.1	16.1	0.9
Balance of Trade, SKK billion	-26	2.6	-5.7	-70.3	-68.4	-80.9	-32.6
Change (SKK billion)		28.6	-8.3	-64.6	1.9	-12.5	24.2
Balance of Trade/GDP	-7	0.6	-1.1	-12.2	-10.5	-11.3	-5.6
CA/GDP	-5.4	4.8	3.7	-11.2	-9.9	-10.1	-5.6

\*Based on the methodical change of statistics in 1997 the values are not fairly comparable.

\*\*Preliminary indicators. CA is the current account of balance of payments.

Source: The Statistical Office of the Slovak Republic, The Ministry of Economy and The National Bank of Slovakia

Table 2 confirms the relatively dynamic development of foreign trade since 1993. It is expressed by high export growth, with the exception of the 1996 drop, and import in the period 1993 – 1998. After a strong expansionary phase of import cycles on the crucial markets of OECD countries in 1994 and 1995, a change occurred in 1996. Slovakia, as well as remaining transition economies, experienced a notable slow-down of the growth and a decline of the demand on OECD markets (OECD, 1999). After the favorable year of 1994, growing import rates in 1995 and mainly in 1996 led to a trade balance deficit, which exceeded 10 % of GDP for three subsequent years. 1996 marked the biggest import expansion and the key role was played by the cancellation of the import duty on cars with small engine capacities (+ SKK 17 billion in imports) and the import of airplanes in the frame of the Russian debt settlement (+ SKK 8.7 billion).

In 1998, the balance of trade showed a record deficit of SKK 80.8 billion, representing 11.3 % of GDP. In 1999, a remarkable improvement in the balance of

trade was achieved, thanks mainly to a decrease in import growth. Exports grew by 9.9 % (+SKK 27.4 billion) on year-to-year terms, whereas import grew by 0.9 % (+ SKK 3.1 billion) in the first nine months. Consequently, the trade deficit fell to 57.3 % of what was measured in the nine months of 1998.

Merchandise trade is usually used for foreign trade evaluation and less attention is paid to services. In Slovakia, the trade with services is slowly decreasing. This creates a paradox because trade services still represent about 20 % of exports and imports (see Table 3).

TABLE 3. Services to Goods Ratio in the Foreign Trade of Slovakia

	1993	1994	1995	1996	1997	1998	1999*
Export, Services to Goods Ratio, %	35.9	33.7	27.7	23.4	26.3	21.6	20.1
Import, Services to Goods Ratio, %	26.8	24.2	20.9	18.3	20.4	17.6	16.8

\* data for 1-3Q of 1999.

Source: NBS

TABLE 4. Development of Foreign Trade with Services, SKK billion

	1993	1994	1995	1996	1997	1998	1999*
Export	60.1	72.3	70.7	63.4	73	80.9	61.1
Import	51.8	51.2	54.4	62.3	70.5	80.2	56.6
Balance	8.3	21.1	16.3	1.1	2.5	0.7	4.5

According to balance of payments. \* data for 1-3Q of 1999.

Source: NBS

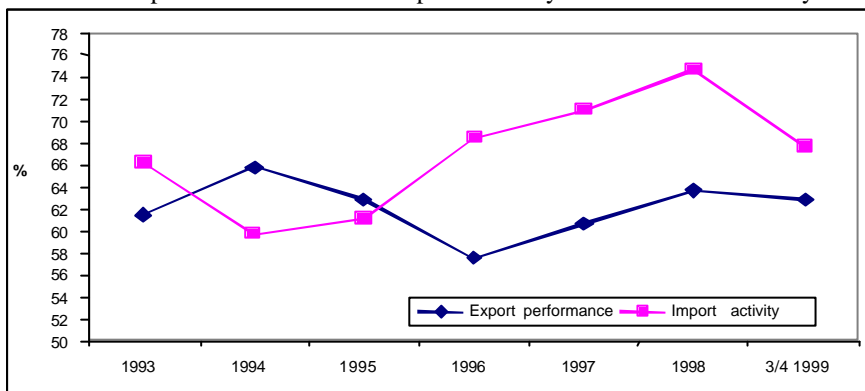
In 1996, a significant drop in the active balance of services (Table 4) was caused by an increase of foreign currency expenditures in tourism (+ SKK 5.3 billion). Slovakia achieves a surplus in the balance of services thanks mainly to the transit of natural gas, which in turn contributes to a surplus at the balance of transport. Moderate surplus is also being achieved in the field of tourism.

Next to the basic indicators of foreign trade, it is useful to measure development in export performance and import intensity. Export performance is usually expressed as a ratio of exports of goods and services to GDP. As we can see from Chart 1, there was a clear decline in the export performance after 1994. The lowest level was reached in 1996 and was accompanied by a notable growth of import intensity (import/ GDP).

Rising imports are caused by an insufficient domestic supply level. The latter was not corresponding to growing domestic demand. The aforementioned high raw materials dependency and high material demands of the Slovak economy was also involved. In 1998, the disproportion between domestic demand and supply became apparent when real growth in imports of goods and services (9.5 %) was 2.3 times higher than domestic demand growth (4.1 %).

The reason for this increase of imports can be attributed to decrease of import surcharge in harmony with the WTO (World Trade Organisation) decision, the cancellation of the  $\pm 7\%$  fluctuation range of koruna on October 1st of 1998, and the quick follow-up 19% depreciation of the Slovak currency. The cancellation of the fixed exchange rate regime with the fluctuating range came relatively too late; NBS's effort to keep the exchange rate steady in the pre-election period cost USD 1 billion from August to September. As a result, foreign currency reserves dropped to the level of 2.3 times that of average monthly import and well below the level considered a safe minimum.

CHART 1. Export Performance and Import Intensity of the Slovak Economy



Source: Author's calculations based on the data of the Slovak Statistical Office and NBS

As an immediate effect of the aforementioned reasons, the foreign trade deficit reached SKK 10.9 billion. This was due to the importers' effort to accumulate sufficient stocks when facing the expectation of further koruna depreciation. Throughout 1998 the deficit was stabilized at SKK 5 – 6 billion, with the exception of April (8 billion deficit due to the reduction of the import surcharge from 7 to 5 percent) and December when the deficit reached SKK 8.5 billion. The latter being attributed to the traditional Christmas shopping. The development of both curves in 1999 confirms that an improvement in the balance of trade was achieved due to the growth pace decline of import, influenced by the weakening of koruna, rather than by higher export performance.

An interesting fact emerges if we calculate foreign trade data for 1999 in USD. The nominal export growth of 9.9% is lower than the depreciation of crown against USD (about 15%). Despite the nominal growth, exports expressed in the foreign currency declined.

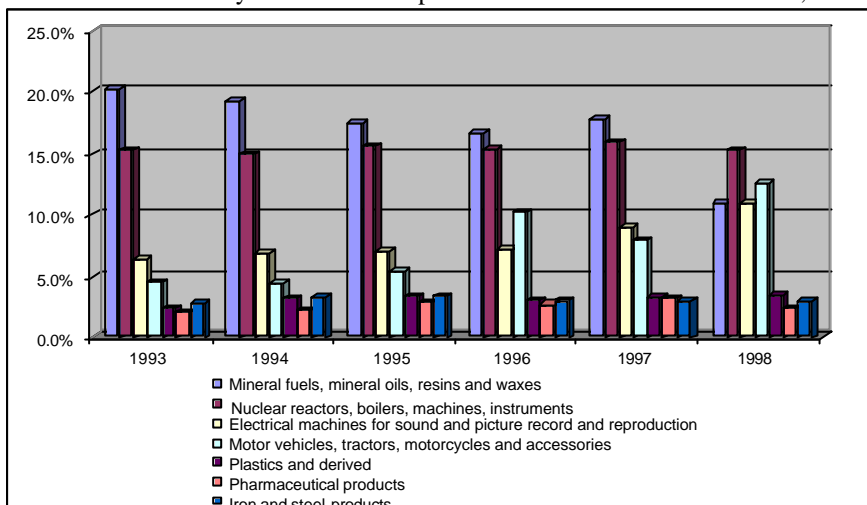
### 6.3 Commodity Structure

Chart 3 illustrates the fact that since 1995 the weight of exported iron and steel has decreased. This can be considered as a positive trend. However, it is important to realize that this fact is related to the demand cycle (OECD, 1999) and the general price decline in this segment. In the case of Slovakia, this segment is particularly sensible due to the export fall and the steel production fall that affected the second biggest employer in Slovakia and the biggest Slovak exporter – Východoslovenské železiarne Košice (VSŽ). In 1996, the company's revenues dropped by 23.3 % and export declined nominally by 11.5 % (Top Trend 1997). A positive sign is seen in the increase of export of audio - visual equipment and motor vehicles. This is a modern sector with higher added value. This growth was mainly accomplished thanks to Volkswagen Bratislava, one of the biggest foreign investors in Slovakia. This corporation had an overall export of SKK 56.4 billion in 1998, and became the biggest Slovak exporter. Yet, Volkswagen's impact on decline of trade deficit is not this enormous. The company imports, according to available data, about 85 – 90 % of its inputs.

Along with Volkswagen, there are other companies producing components for the car industry that have increased their exports remarkably. According to The Automotive Industry Association (Zväz automobilového priemyslu, ZAP), Slovak companies increased their deliveries to the world's cars manufacturing concerns in 1998 by SKK 9 billion to the total amount of SKK 26 billion (ZAP, 1999). However, as seen from the Chart 3, the remaining part of machine industry did not increase its share in export until 1998. This relates to the actual agony of most machine producing companies within the former ZTS concern. The DMD Holding, which should have co-ordinated and improved business activities of single companies according to the original intentions, has not brought about the desired effect. At present, Slovak export is still dependent on the same products as it was before 1989. The most serious problem is that these products are, for the most part, on a low processing level and destined for intermediate consumption. The export competitiveness of these products depends mainly on price factors. This position is unstable due to the possibility of price growth of inputs and dependency on the target markets booms.

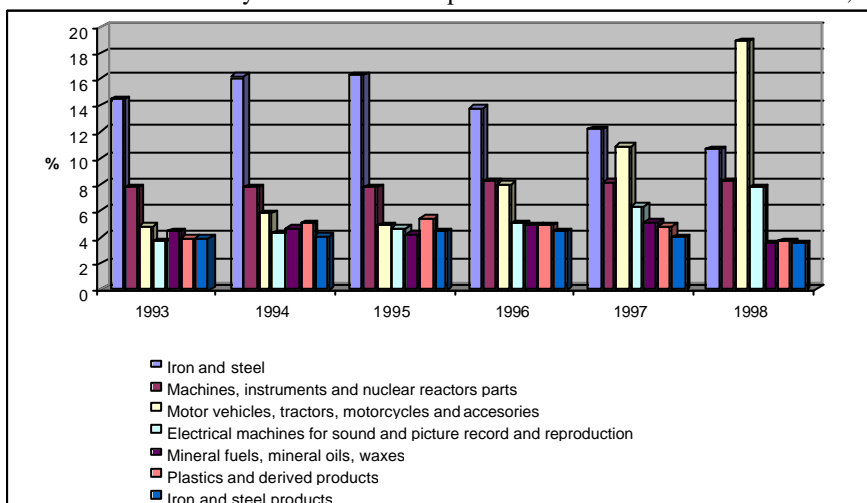
The real appreciation of the currency can also negatively influence price competitiveness. For example, we can present the problems with VSŽ's sales in 1998 due to the competition from producers in the Ukraine and Southeast Asia. The competitiveness of their products (Ukraine and SE Asia) rose significantly after devaluation of their currencies. VSŽ itself admitted that higher added value products that were more resistant to macroeconomic shocks presented only 15 % of the overall production in 1998.

CHART 2. Commodity Structure of Import. Selected Customs Tariff Items, %



Source: Ministry of Economy

CHART 3. Commodity Structure of Export. Selected Customs Tariff Items, %



Source: Ministry of Economy

## 6.4 Effect of Foreign Investments

In order to adapt to more sophisticated production, Slovak producers need to improve the scope of industrial restructuring, attract new technologies, know-how, and adopt new managerial and marketing methods. However, in order to create a

new institutional framework one needs an effective ownership structure, and sufficient investment sources. The first of the preconditions was questioned by the previous privatization style. The availability of investment sources is strongly limited due to problems in the banking sector, particularly in state controlled banks. In addition, interest rates are too high and the capital market has virtually collapsed. Lastly, foreign direct investments (FDI) stock is far from being sufficient. Despite the existence of this fact, companies with foreign capital participation contribute significantly to foreign trade exchange. It is documented in Table 5.

Since 1994, more than a third of overall foreign trade has been realized by companies with foreign capital. Each year, since 1996, their total imports have exceeded their exports. This has strongly influenced the trade balance results.

TABLE 5. Foreign Trade of Foreign Capital Companies to Overall Foreign Trade Ratio

	1994		1995		1996		1997		1998	
	SKK bill.	%	SKK bill.	%	SKK bill.	%	SKK bill.	%	SKK bill.	%
Export	63.6	37	85.6	34	96.5	36	108.2	37	120.7	32
Import	65.7	42	89.9	36	131.7	39	152.8	44	158.5	35
Balance	-2.1	-	-4.3	75	-35.2	50	-44.6	66	-37.8	47

Source: NBS

There is an indication that the high deficit of the balance of trade is caused mainly by the consumer goods import of big trading companies. According to the NBS, their overall import share of the companies with foreign capital meant almost 40 % (SKK 53.9 billion) in 1998, whereas their overall export share meant 5.5 % (SKK 6.6 billion). Abstracting from the trading companies influence, foreign capital companies created a trade surplus of SKK 9.4 billion in 1998. A relatively small stock of FDI (without trading companies) produced almost a third of the overall Slovak export (30.3 % in 1998) and at the same time contributed to import by 22.9 %. Another fact proving the positive effect of FDI is that 16 companies with foreign capital, coming under 80 Top Trend biggest exporting companies in Slovakia in 1997, increased their sales to export on a year-to-year basis by almost SKK 9.7 billion. This was an increase of 27 % on average (Top Trend, 1998). A higher inflow of foreign direct investments, mainly to production sectors, is needed for further improvement of the trade balance and dynamic export growth.

## 6.5 Competitiveness of the Slovak Production

The effects of devaluations of the Slovak koruna from 1990 and 1993 had enhanced price competitiveness of Slovak products. After 1994, this effect slowly

faded. Meanwhile, the Slovak government did not create the necessary institutional and real prerequisites for the strengthening of non-price competitiveness. Under a fixed exchange rate regime and with an inflation level higher than in western countries, the koruna appreciated in real terms since 1995. This negatively affected price competitiveness of the Slovak production on foreign markets. Since 1996, the cheap labor force effect started to fade away slowly. At the same time, real salaries growth markedly overran the labor force productivity. The year 1996 ended with a record trade deficit of SKK 70.2 billion. This was reevaluated two years later and it was determined to have been SKK 80.9 billion.

TABLE 6. Comparison of Product Groups Competitiveness

	SR	MHVEK
Products with High Labor Force Intensity	1.39	0.77
Products w/ High Capital Costs Intensity	0.95	1.03
Highly Sophisticated Products	0.57	0.94
Products of Traditional Sectors	1.74	0.88
Products of Modern Sectors	0.58	0.96
Short-time Consumption Products	1.63	0.95
Production Consumption	1.64	0.84
Long-term Consumption Products	0.71	0.95
Investment and Component Products	0.57	0.93

Comparison is based on import by export coverage ratio. MHVEK means small developed European countries. Source: Outrata (1998)

Slovakia establishes itself on foreign markets mainly with products of high labor and capital intensity (Table 6), i.e., products of traditional sectors, which reach higher values of import by export coverage ratio. Based on the purpose of use these are the products of short-time consumption and products destined to production consumption – such as raw materials, materials or intermediate products. They have been traditionally established in international trade thanks to price competitiveness and they represent 50 % of exports and 27 % of imports. The share of long-term consumption goods and investment-component products in overall processing industry exports represent 34 % and they make up 44 % of imports (Outrata, 1998). On the other hand, Slovakia is constrained to import products of high sophistication that are represented by modern sectors, i.e., long-term consumption products and investment products.

A comparison of Slovakia with other small developed European economies (Table 7) provides another useful source of information about the price competitiveness of Slovak products. Compared to MHVEK, the Slovak economy achieves better indicators' values with products of higher labor and capital intensity in traditional sectors. These sectors have a character of short-time consumption intended for production consumption (Outrata, 1998). These conclusions are also confirmed by the Terms of Trade assessment. Due to the

absence of the last two years' of statistical results, we can only present the 1994 to 1996 developments in Table 8.

**TABLE 7. Competitiveness of Products Groups Based on Selected Indicators.**

Group of Products	TB/added value		Import by Export Coverage Ratio		RCA	
	SR	MHVEK	SR	MHVEK	SR	MHVEK
Products w/ High Labor Force Intensity	64.1	-21.7	1.39	0.77	54.1	-31.4
Products w/ High Capital Intensity	95.7	1.9	0.95	1.03	16.5	-33.1
R&D Intensive Products	-136.7	-28.6	0.57	0.94	-34.1	-11.0
Products of Traditional Sectors	107.8	-9.8	1.74	0.88	76.8	-17.4
Products of Modern Sectors	-201.6	-34.2	0.58	0.96	-33.2	-9.2
Short-time Consumption Products	82.9	1.9	1.63	0.95	70	-9.9
Production Consumption	123.2	-16.8	1.64	0.84	71	-22.5
Long-term Consumption Products	-18	-9.2	0.71	0.95	-12.8	-10.2
Investment and Component Prod.	-142.8	-14.7	0.57	0.93	-35.7	-12.3

MHVEK – small developed European countries. TB: Trade balance

Source: World Economy Institute of the Slovak Academy of Sciences

**TABLE 8. Terms of Trade in Slovak Industry.**

Products	Export Price Growth / Import Price Growth Ratio 1994-1996
Traditional Branches	0.98
Modern Branches	0.89

Source: World Economy Institute of the Slovak Academy of Sciences

The values presented show that export and import prices of traditional sectors developed at approximately the same pace between 1994 –1996 (Terms of Trade ratio is close to 1, see Table 8). Export prices, in modern branches, did not keep pace with import prices (Outrata, 1998). Presently, the Statistical Office of the Slovak Republic neither monitors the Terms of Trade developments nor foreign trade prices. This practically disables any further analyses of this indicator.

For a more detailed commodity structure analyses of Slovak foreign trade we can measure the competitiveness of Slovak export by means of RCA ratio.

Values of Tables 9 and 10 confirm that Slovakia achieves higher comparative advantages by commodities intended for production consumption. This includes products from iron and steel, aluminum and products from aluminum, chemical synthetic or artificial silk, salt, sulphur, moulds and stones, gypsum, lime and cement and products for short-time consumption (clothes, shoes, paper and



paperboard products). The biggest positive change can be seen in the production of motor vehicles and accessories.

As seen from the comparison of Tables 9 and 10, the same group of eighteen items retained the highest comparative advantage in 1998. However, for many of them, the relative weight has shifted. Along with the move of the group “Vehicles different from rail track vehicles” represented by aforementioned Volkswagen, positive moves were registered by traditional items mainly (clothes, shoes, paper and paperboard), and intermediate products, as well (aluminum and aluminum products, organic chemical products). Export of all these product groups represents a significant portion of relevant sectors production, thereby resulting in their vital dependency on foreign markets.

TABLE 9. Export Items with Highest Comparative Advantage in 1994

No.	Customs Tariff Chapter	RCA	Export*	Import*
1	72 Iron and Steel	13.42	16.28	2.86
2	44 Wood, Wooden Products and Charcoal	2.86	3.41	0.55
3	54 Chemical, Synthetic or Artificial Silk	2.74	2.95	0.21
4	62 Textile and Textile Accessories, other than Knitted	2.01	2.54	0.53
5	94 Furniture, Medical and Surgeon Furniture	1.87	2.76	0.89
6	39 Plastics and Plastic Products	1.81	5.03	3.21
7	40 Caoutchouc and Related Products	1.46	2.83	1.37
8	48 Paper, Paperboard and Cardboard, Paper Products Salt; Sulphur, Moulds and Stones; Gypsum;	1.42	3.46	2.05
9	25 Lime and Cement	1.32	1.90	0.58
10	64 Shoes, Leggings and Similar Products	1.19	1.75	0.56
11	70 Glass and Glass Products	1.12	1.64	0.52
12	89 Ships, Boats and Sailing Constructions	0.89	0.90	0.01
13	86 Railway and Tramway Locomotives	0.87	1.41	0.55
14	73 Iron and Steel Products	0.83	4.16	3.33
15	87 Vehicles different from Rail Track Vehicles	0.81	5.25	4.44
16	76 Aluminum and Related Products	0.30	1.34	1.04
17	29 Organic Chemical Products	0.22	3.03	2.81
18	4 Milk and Milk Products, Eggs, Honey	0.19	0.57	0.38
TOTAL			61.42	26.09

\*share in total export or import (%).

TABLE 10. Exported Items with Highest Comparative Advantage in 1998

No	Customs Tariff Chapter	RCA	Export*	Import*	$\Delta P^{**}$
1	72 Iron and Steel	8.15	10.63	2.48	0
2	87 Vehicles different from Rail Track Vehicles	6.27	18.86	12.62	13
3	62 Knitted Textile and Textile Accessories, other than	3.15	3.72	0.56	1
4	48 Paper, Paperboard and Cardboard, Paper Products	1.76	3.59	1.84	4
5	44 Wood, Wooden Products and Charcoal	1.74	2.44	0.71	-3
6	76 Aluminum and Related Products	1.51	2.52	1.01	10
7	54 Chemical, Synthetic or Artificial Silk	1.22	1.70	0.48	-4
8	64 Shoes, Leggings and Similar Products	0.98	1.72	0.75	2
9	94 Furniture, Medical and Surgeon Furniture Salt; Sulphur, Moulds and Stones; Gypsum;	0.93	2.23	1.30	-4
10	25 Lime and Cement	0.91	1.27	0.37	-1
11	70 Glass and Glass Products	0.79	1.40	0.61	0
12	89 Ships, Boats and Sailing Constructions	0.76	1.17	0.41	0
13	29 Organic Chemical Products	0.63	2.52	1.90	4
14	73 Iron and Steel Products	0.61	3.54	2.93	0
15	86 Railway and Tramway Locomotives	0.58	1.54	0.96	-2
16	40 Caoutchouc and Its Products	0.57	2.07	1.51	-9
17	4 Milk and Milk Products, Eggs, Honey	0.25	0.44	0.19	1
18	39 Plastics and Related Products	0.24	3.74	3.51	-12
<b>TOTAL</b>			<b>65.1</b>	<b>34.13</b>	

\*share in total export or import. \*\*Change of rank against 1994. Source: Ministry of Economy

TABLE 11. Imported Items with Highest Comparative Disadvantage, in 1994

No.	Customs Tariff Chapter	RCA	Import*	Export*
1	27 Mineral Fuels, Mineral Oils and Related Products	-14.62	19.26	4.64
2	84 Nuclear Reactors, Boilers, Machines, Instruments	-6.97	14.86	7.89
3	85 Electrical Machines and Instruments and Parts	-2.56	6.92	4.35
4	26 Metallic Ores, Slag and Ashes	-1.93	2.03	0.09
5	90 Optical Instruments and Machines	-1.90	3.40	1.50
6	30 Pharmaceutical Products	-1.02	2.29	1.27
7	38 Various Chemical Products	-0.42	1.43	1.01
8	88 Airplanes, Space Ships and Parts	-0.32	0.43	0.12
9	28 Inorganic Chemical Products	-0.14	1.18	1.05
<b>TOTAL</b>			<b>51.81</b>	<b>21.92</b>

\* share in total export or import. Source: Ministry of Economy

TABLE 12. Imported Items with Highest Comparative Disadvantage, in 1998

No.	Customs Tariff Chapter	RCA	Import*	Export*	$\Delta P^{**}$
1	27 Mineral Fuels, Mineral Oils and Their Products	-7.47	11.02	3.52	0
2	84 Nuclear Reactors, Boilers, Machines, Instruments	-7.12	15.33	8.17	0
3	85 Electrical Machines and Instruments and Parts	-3.18	11.01	7.80	0
4	30 Pharmaceutical Products	-1.61	2.47	0.85	2
5	90 Optical Instruments and Machines	-1.60	2.45	0.84	0
6	26 Metallic Ores, Slag and Ashes	-1.06	1.13	0.08	-2
7	38 Various Chemical Products	-0.66	1.21	0.54	0
8	28 Inorganic Chemical Products	-0.50	1.13	0.62	1
9	88 Airplanes, Space Ships and Parts	-0.49	0.62	0.13	-1
10	2 Meat and Edible Offal	-0.21	0.26	0.05	-
TOTAL			46.63	22.61	

\* share in total export or import \*\* – Change of rank against 1994. Source: Ministry of Economy

From 1994 to 1998, export growth in several commodity groups such as clothes and shoes may be related to the growth of wage-labor for branded foreign companies. Such companies bring only a low added value of the production. Both sectors are characterized by a significant scope of excess capacities. In the sector of clothing and textiles alone, the wage-labor represented about 70 % of overall production in 1999 (Trend Top 1999 v priemysle, see also the Table 13). It is significant to emphasize that this trend is not sustainable in the long-term, since the increase of labor costs will probably result in a transfer of such production to other countries with a cheaper labor force.

A striking growth in the export of aluminum and related products from SKK 2.9 billion in 1994 to SKK 9 billion in 1998 was achieved by the group of former ZSNP companies in Žiar nad Hronom. Most of this was attributed to those with a significant foreign investor. As a consequence of the aluminum price drop in 1997 and 1998, a slowdown in export growth has occurred. The export growth of paper, paperboard and paper products was assisted by the global boom in this sector after 1993. This sector has a positive impact on trade balance because it utilizes extensive domestic raw materials basis. In the last few years, many significant modernization investments have been carried out in this sector (SCP Ružomberok, Harmanecké papierne, Assi Domän Štúrovo) and have been accompanied by the foreign investors accession (Assi Domän and SCA Mölnlycke). The position of raw construction materials (sulphur, moulds and stones, gypsum, lime and cement) in export commodity structure remained practically unchanged during the examined period. On the contrary, there was a notable drop (12 ranks) of comparative advantage (as well as of overall export share) of plastics. This drop was caused by an import growth of 135 % (to SKK 16 billion) in the relevant period that sharply exceeded the export growth of 30 % (to SKK 14 billion).

The presented conclusions were also confirmed by export developments in the first three quarters of 1999. Along with the continuation of the positive growth trend in the export of machines and appliances (29.2 %) and vehicles (17 %), a clear year-to-year export growth was recorded in mineral products (39.9 %). In addition, the export growth of wood and wooden products (27.7 %) and stone, gypsum and cement conserve to a certain extent the existing inappropriate commodity structure.

TABLE 13. Export to Revenues Ratio of Selected Sectors in 1998, %

Cellulose and Paper Industry	Production of Aluminum and Related Products	Organic Chemical Products**	Cloth-making Industry	Leather and Shoe-making Industry
64.4	72.7	59.8	64.4	60.3

\* The sector is represented by ZSNP group numbers. \*\* Sector is represented by production of basic chemicals (OKEC 241). Source: Top Trend in Industry 1999, Ministry of Economy

On the side of imports, products of modern sectors (machine industry, electrical machines and equipment, see tables 11 and 12), beside a relatively stable rate of input raw materials import, show the biggest competitive disadvantage, and account for a high share in total import. Almost half of total import was represented by practically the same group of items, as in 1994, with only some small inner moves noted.

Based on import tariff classification, exports were dominated by transport vehicles, basic metals and their products, appliances and electrical equipment, textile and textile products. Share of motor vehicles in total export grew from 10.9 % in 1997 to 18.9 % in 1998.

Slovakia imported mainly machines, appliances and electrical equipment, vehicles, raw materials, fuels, and chemical products. The share of mineral fuels in total import ratio dropped from 17.7 % in 1997 to 10.9 % in 1998. This drop, however, was achieved by lower world prices in 1998 rather than by a reduction of the energy intensity of the Slovak economy. In regard to the growth in oil prices in the second half of 1999, the depreciation of the Slovak koruna and the stagnation of overall import growth, it is worth noting that hydrocarbon fuels import ratio has grown again in 1999.

## 6.6 Transformation Effect

The transformation effect is another useful and simple indicator that shows the progress in the area of restructuring and in the improvement of the foreign trade structure. It is calculated as a ratio of final products export (classes 5,6,7 and 8 of

international classification SITC) to raw materials and materials import (SITC classes 2 and 3).

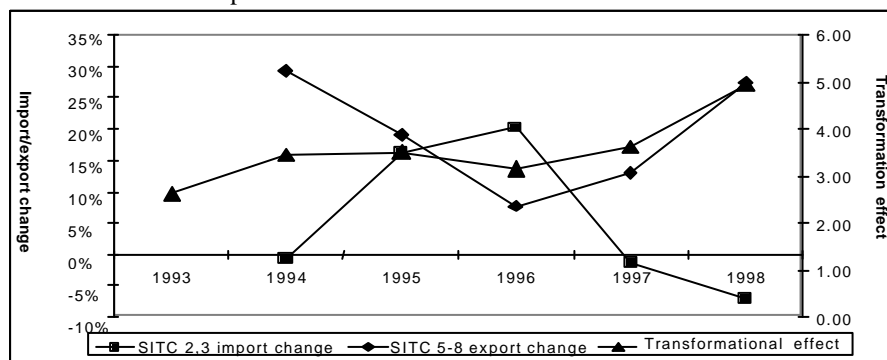
TABLE 14. Comparison of Transformation Effect in Slovakia and the Czech Republic.

	1991	1992	1993	1994	1995	1996	1997	1998	1-2Q1999
SR	1.58	2.31	2.64	3.44	3.62	3.18	3.28	4.94	5.23
CR	2.85	3.13	4.95	5.20	5.40	5.44	5.81	7.80	-

Source: M.E.S.A. 10 calculations based on data from Statistical Offices of the Slovak Republic and the Czech Republic

According to Table 14, Slovakia experienced its first drop in the transformation effect in 1996. This signifies that raw materials import grew quicker than the export of final production. The development of the transformation effect since 1993 and its relation to the development of export and import of relevant SITC groups is demonstrated in the Chart 4. After improvements of the transformation effect in 1994 caused by a sharp year-to-year growth of final products export 1995 showed practical stagnation. This was caused by an almost equivalent percentage growth of export and import of relevant commodity groups. Higher growth of import in 1996 resulted in the historical fall of the transformation effect. Some improvement can be observed in 1998 and during first half of 1999 when the transformation effect increased to 4.94 and 5.23 points, respectively. This development was favorably affected by the export of machines and appliances. This resulted in a growth of SKK 60 billion and an impressive shift of share in total export from 27.5 % to 40 %. Furthermore, the fall of world raw material prices, especially crude oil, presented another positive impact.

CHART 4. Transformation Effect and Year-to-Year Change in Import/Export of Relevant SITC Groups



Source: Author's calculations, based on the data from the Statistical Office of the Slovak Republic

Compared to the Czech Republic, the transformation effect in Slovakia is still apparently lower.

## **6.7 Economic Policies in the Area of Foreign Trade**

After experiencing insufficient progress in the restructuring of the Slovak economy and the stagnation of non-price competitiveness, the Slovak government decided to solve the trade deficit issue by means of import limitations. Significant precautions restricting imports were adopted, especially after 1996. In 1996, as a result of cancellation of import duty on small capacity engine vehicles, balance in trade with vehicles contributed to a record overall deficit. Given the relatively low general level of import duties (3.5 % in 1997) and the limited possibility to increase duties due to membership of Slovakia in the World Trade Organisation (WTO), import surcharges became a favorite tool to face trade deficit. Although its real effect is just short-term, it has become a rewarding additional source of state budget revenues.

In 1997, three legal precautions were adopted to regulate imports; the Law on Protection Against Dumping, the Law on Protective Import Precautions, and the Law on Subsidies and Equalization Precautions. The purpose of the first and third regulations was to face the unfair practice of goods imported for dumped prices or supported by forbidden subsidies. The second one, the Law on Protective Import Precautions, possesses a clearly protectionist character. It uses vague formulations such as “in the case of serious loss,” or “in the case of serious loss threat” to domestic production sector in order to enable an increase of import duty or to limit the imported amounts through tariff quotas.

While these regulations can be considered more or less common, the introduction of import deposits in May of 1997 was considered a completely non-standard precaution. The measure was adopted as a reaction to the same step taken by the Czech Republic. Under this measure, importers were obliged to deposit 20 % of imported value to a non-interest-bearing account for 6 months. Fortunately, the import deposits lasted only a very short time and were replaced by an import surcharge in July 1997.

The most controversial precaution measure was the strengthening of certification requirements on imported goods in the autumn of 1997 that practically liquidated numerous small importers. Crucial points included a requirement to submit the certificate, and a confirmation of the fact that the commodity is not a subject to certification directly on the border. It also required going through a long drawn out procedure for certificates arrangement, and was further complicated by the fact that even renowned international brands were not acknowledged.

Apart from the fact that this certification strengthening most severely affected small importers (M.E.S.A.10, 1997), this precaution only delayed imports; it had no real effect (decline) on the demand for foreign goods (OECD, 1999).

Ineffective functioning of export-promotion institutions is another weakness of Slovak foreign trade. The institutions have been viewed as non-transparent and ineffective. Even after the new government came into office in 1998, no significant progress in the sphere of institutional support of foreign trade was recorded.

Export-promotion in Slovakia is provided primarily by Eximbanka and Foreign Trade Promotion Fund (Fond na podporu zahraničného obchodu - FPZO). Eximbanka, founded in 1997, has not met expected targets regarding the promotion of Slovak exports. In 1998, Eximbanka supported only 0.8 % of overall export through export credits. That is a relatively low value compared to similar institutions in the Czech Republic (5.5 %) or Austria (9.5 %). The number of sources aimed for insurance operations in Eximbanka is also insufficient. According to Eximbanka's governor, this institution had only SKK 1.3 billion for insurance operations at the end of 1999, whereas the similar Czech institution EGAP disposed of CZK 70 billion for the same purpose. Eximbanka did not succeed in obtaining sufficient external funds and still uses controversial obligatory contributions of importers and exporters corresponding to 0.05 % of individual imports and exports as a significant source of revenues. These will be cancelled in the first half of 2000. Another criticism is the fact that Eximbanka, as an institution established under special law, is not liable to the Law on Banks, or to NBS supervision. It does not have to be managed in accordance with the circumspect enterprising rule. Eximbanka's activities can thus be in conflict with the interests and aims of the NBS's monetary policy (M.E.S.A. 10, 1998).

FPZO, which was founded to promote Slovakia abroad, was financed till January 1, 2000 by similar obligatory contributions of exporters and importers. At the same time, there exists an indication that enterprises are not familiar with current FPZO activities even though FPZO works with significant funds. Since 1998, the obligatory contributions revenues alone reached SKK 800 million.

## **6.8 Territorial Structure**

The territorial structure of Slovak foreign trade has improved since the start of the transformation. Until 1993, the export to EU countries corresponded roughly to a quarter of total exports (see Chart 5), and by 1998, it had increased 50 %. This trend can be partially attributed to the accession of new countries into the EU in 1995. Such development was enabled by a gradual implementation of the liberalization provisions in the scope of the Association Agreement that was asymmetrically more advantageous for Slovakia.

A quick reorientation of Slovak exporters to more solvent western markets along with the continuing dependency of the Slovak economy on Russian raw materials has resulted in a further deepening of the Slovak-Russian foreign trade deficit (see Chart 6). In 1997, the bilateral trade deficit reached SKK 42 billion. In 1998, another change in the territorial structure of Slovak export was recorded when OECD markets made up 89.9 % of total Slovak exports.

Export to OECD countries increased by 21.2 % on year-to-year terms, export to the EU increased by 37.6 %, and export to CEFTA (Central European Free Trade Association) countries remained unchanged.

With regard to individual countries, Slovak export to Germany increased by 41.7 %, to Austria by 19.8 %, and to Italy by 38.3 %. On the other hand, the biggest drop was recorded in export to Russia (36.1 %), and the Czech Republic 7.7 %. Germany became the most important export market with 28.9 % share, overtaking the Czech Republic (20.3 %). The latter has been slowly falling since 1993 in both export and import despite the existing customs union.

Trade exchange with the Czech Republic was specifically affected by a recession of the Czech economy between 1997-1999. The largest foreign trade deficit was recorded in trade with Russia (SKK -38.2 billion), Germany (SKK-9.4 billion) and the Czech Republic (SKK - 8 billion). A long-term passive balance of trade with Russia has its roots in Slovakia's great dependency on the Russian raw materials. From Germany and the Czech Republic Slovakia imports mainly motor vehicles, machines, and machinery equipment. This is also confirmed by the commodity structure in 1998 with mineral fuels and machines and mechanical equipment recording highest trade deficits (SKK 36.8 billion and SKK 42.3 billion, respectively).

CHART 5. Share of Selected Territories in Total Slovak Export, %

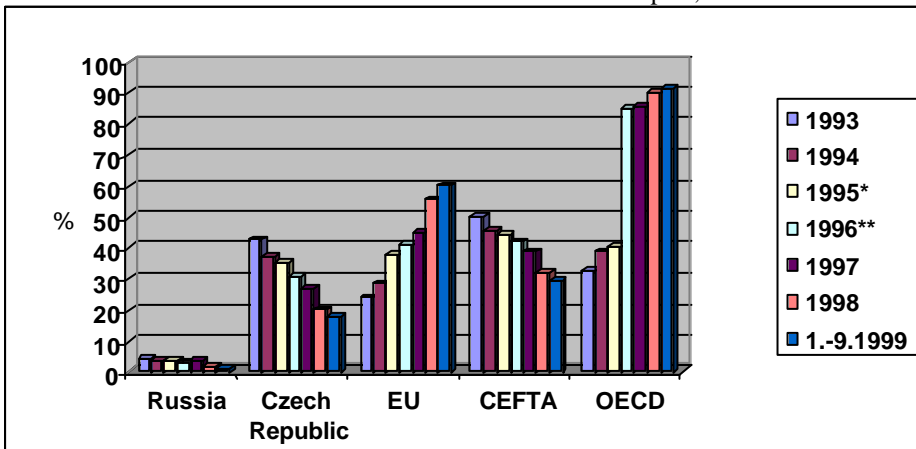
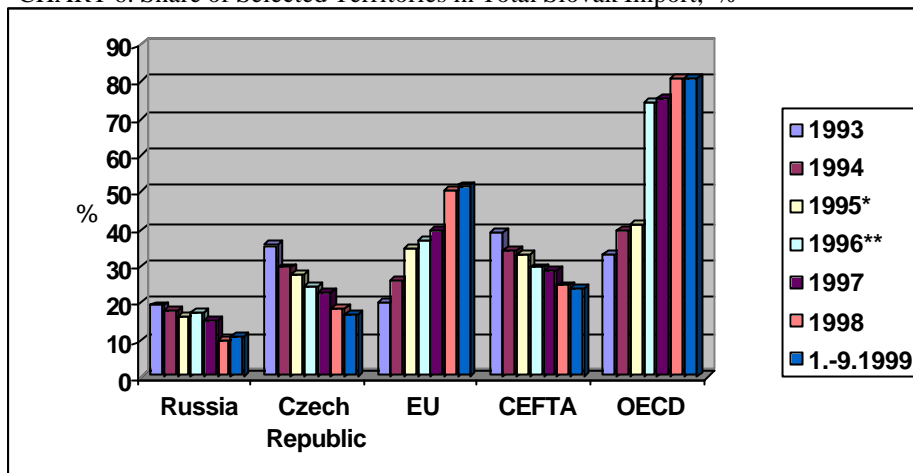




CHART 6. Share of Selected Territories in Total Slovak Import, %



\*Austria, Sweden and Finland joined the EU, \*\* The Czech Republic, Poland and Hungary joined the OECD, Source: The Statistical Office of the SR

## 6.9 Conclusion

Participation in international economic relations is of vital importance for Slovakia. Problems result mainly from insufficient raw materials basis and limited domestic market. The significance of international economic relations is proven by the high and growing ratio of foreign trade to GDP.

As in other scopes of the economy, the transformation process has significantly affected foreign trade. Foreign trade closely follows the structure of the economy, specially industry, since industrial companies export a relevant part of outputs and obtains a significant part of inputs through import. Two main problem issues have come about since the beginning of the transformation. First, namely a negative balance of merchandise exchange with foreign countries and secondly, insufficient changes in the commodity structure of the trade.

Big deficits in the balance of trade from 1996 to 1998 are connected mainly with the disproportion between the development of domestic demand and supply of domestic producers. Another significant factor was the maintaining of a fixed exchange rate of koruna, some trade policy measures (e.g., cancellation of custom duties on small capacity engine vehicles in 1996), as well as external factors (growth in relevant export item market segments). Insufficient changes in the commodity structure of trade were caused by the insufficient qualitative competitiveness of Slovak producers and unsuitable qualitative structure of Slovak export. Some progress has been noted due to foreign investments. Unsatisfactory

changes of the commodity structure are closely related to the recent weak progress of real restructuring of the business sphere.

Furthermore, the absence of an overall foreign trade policy concept is another negative factor. It is rooted in the missing overall state economic policy. Enhancement of export performance remains one of the key challenges for the Slovak economy. Foreign trade should become a relevant factor in achieving sustainable high economic growth.

Basic prerequisites for an increase of export performance include:

- real restructuring of enterprise sphere, including a functioning bankruptcy mechanisms with the possibility to restructure particular company under the surveillance of creditors, in order to revive financial flows;
- significantly increasing FDI influx;
- continuing a reasonable fiscal policy in order to push down interest rates and utilizing the tax policy to promote a higher savings ratio, thus leading to a decline of import demand;
- restructuring and privatization of banks;
- capital strengthening of Eximbanka;
- unifying export promotion activities of FPZO, trade-economic departments of foreign embassies and trade chambers;
- developing a complex foreign-trade policy.

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## 7 Labor Market

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Since 1994, Slovakia's economic growth has been highly rated by GDP dynamics but this has not been reflected in the area of employment, particularly with respect to job creation.

In 1994, growth was jumpstarted by a revival of exports. Later problems appeared related to the external economic imbalances. The government achieved continued growth mainly due to a generous investment policy matched with rising public consumption. Over a period of time, this strategy proved to be unsustainable and at the end of 1998 new restrictions failed to support job creation. Overemployment was sustained throughout the 1989-1995 period, and the decline of real output was greater than the decline in employment. 1996 was the only year that had a gross labor productivity indicator (measures as the share of real GDP on employment) higher than the 1989 level.

Slow and non-transparent implementation of key structural reforms is the major cause of the aforementioned declines. Initially, overemployment was kept static by maintaining unprofitable enterprises through delaying bankruptcies or preparing revitalization schemes. Efforts to maintain employment moved slowly and this also delayed restructuring. During 1989-1999, some of the aforementioned restructuring barriers were removed and this action led to a further decline in employment. It is predicted that this situation is not likely to change.

## **7.1 Introduction**

Slovakia's worst macroeconomic indicator has always been the country's high unemployment rate. The initial sharp rise in unemployment during the transition period was perceived as a consequence of economic restructuring. Ten years after the transition period, the unemployment rate remains above double-digit levels and has recently increased. In this chapter, we will explain the underlying causes that help maintain this situation.

The chapter contains a brief description of how basic labor market indicators developed after 1989. We have provided internationally comparable indicators that were calculated using the methodology employed in the European Union and by the International Labor Organization. Some data may differ from what has been previously published in Slovakia. For instance, in Slovakia the definition of population of productive age is limited by the pension age whereas in the European Union, the definition applies to the 15-64-year old age group.

A thorough analysis required comparison of data from several sources, particularly from selective surveys. Selective surveys have not been commonly used in the past but they offer the advantage of internationally comparable data. We used the selective labor force surveys (equivalent to Labor Force Surveys) which have been carried out in accordance with International Labor Organization methodology. This data does not necessarily correspond with the regular administrative data (from unemployment registry, enterprise reports, etc.). We compared the key indicators with the European Union averages (mainly from the Community Labour Force Survey) and also with comparable data from the Visegrad-four countries (Czech Republic, Hungary, Poland and Slovakia).

The chapter presents a description of the situation, the stylized facts, and the results of academic studies. A brief description of the key Slovak labor market problems is presented at the beginning of the chapter.

## **7.2 Employment**

### **7.2.1 Global Changes and Productivity**

From 1989 to 1995, the real GDP declined faster than the overall employment. The initial transitory decline in output was accompanied by a significant - but not proportional - decline in employment. For example, at the beginning of the 1989-93 period, real GDP in constant prices fell by about 25 % while overall employment declined by about 15 %. If we compare industrial output developments and employment, these values are about 38 % and 25 %. The turning point came in 1996 when the gross labor productivity indicator (measured as the

ratio of real GDP to total employment) began to rise above the 1989 levels. (Table 1 shows the development of labor productivity in the main sectors of the economy.)

TABLE 1. Labor Productivity by Sectors 1989-1997

Index 1989=100	1990	1991	1992	1993	1994	1995	1996	1997
Industry	97	87	84	83	91	96	99	103
Construction	97	70	91	70	71	75	78	86
Agriculture	95	94	78	92	90	97	105	108

Note: Real output in 1995 constant prices divided by total employment in the sector. Source: Calculations based on data from the Statistical Office of the Slovak Republic

The initial period of transition in Slovakia was marked by a significant decline in employment. According to administrative data, total employment in the 1989-98 period declined cumulatively by almost 20 percent. Employment fell both in absolute terms as well as in relation to the size of the productive age population. This decline can be divided into three phenomena:

- demographic changes;
- move into unemployment;
- move into the state of economic inactivity (outside of the labor force).

During the transitory period the size of the productive age population increased. Under the conditions of transitional depression, demographic pressure was demonstrated mainly by rising unemployment. This can be shown by a simple calculation using administrative data. In 1990, the shares of the employed, unemployed and economically inactive individuals in the 15-64 years age group were approximately 72 %, 1 % and 27 % respectively. By 1998, these shares changed to approximately 56 %, 12 % and 32 %. The share of employed individuals in the 15-64 years age group thus fell by 15 percentage points, while the share of inactive individuals rose by five percentage points and the share of the unemployed by double that amount. On the basis of this calculation, we can conclude that the decline in employment represented a relatively greater burden on unemployment than it did on the outflow into economic inactivity.

The overall trend in unemployment can be assessed using administrative data and data from LFS. The administrative data reported by firms show that overall employment fell by almost 18 % during the 1989-97 period. This decline was more extensive for women; their employment fell by almost 25 % compared with a 9 % decline for men. The share of women on overall employment fell by four percentage points. Overall employment fell in every year except for two.

Administrative data tend to underestimate employment in comparison with LFS data. This data show positive tendencies in employment growth during the

years 1995-96, but from 1997 overall employment began to fall. The change in 1997 was -4.7 % overall and -6.7 % for women. Employment continued to decline in 1998 and 1999.

Many current problems in the area of employment can be attributed to the relatively high share of industry on overall employment and to the current crisis in some industrial sectors. The industrial structure of Slovakia is characterized by a high portion of heavy industries and the prevalence of production with lower value added. The situation is particularly critical in engineering which represents the third largest sector by volume of production (after chemicals and heavy industries). Productivity growth in engineering is presently achieved mainly through labor force reductions. This leads to further tensions in the labor market.

### **7.2.2 Structural Changes in Employment**

The sectoral breakdown of unemployment has undergone significant changes in the transition period (Table 2). Administrative data show that the share of employment in industry on overall employment fell from 44 % to 37 % and the share of services rose from 44 % to 54 %. Employment in agriculture, which originally represented 12 %, fell below 9 %. Although Slovakia has traditionally been the more agriculturally oriented part of the former Czechoslovakia, the current share of agriculture on overall employment is fairly low. According to LFS data, the share of employment in agriculture is 8 %. That share is not much more than the average in the EU (5 % in 1997) and less than the comparative levels in Portugal, Greece and Ireland.

A significant difference between Slovakia and the EU persists in terms of the share of industry on overall employment – in Slovakia it is some 10-percentage points higher. The opposite tendency persists in employment in services. That share is almost 13 percentage points lower in Slovakia than the EU average. These data suggest that the process of approximation to the EU employment structure may further reduce the share of industry on employment and raise the share of services.

Employment levels according to gender and age groups show no significant changes since 1994. The current level of employment for the 15-64 years age group is 58.8 %, close to the comparable statistic of 60.5 % for the EU. With regard to gender differences, we can still observe relatively higher employment levels for women and relatively lower employment levels for men than the averages in the EU, 50.5 % and 70.5 % respectively. It must be noted that in Slovakia the pension age for men is 60 years and for women 53-57 years. Those ages are lower than in other transition economies and in the EU. Consequently, employment levels based on “real” productive age population (15-54 women/59 men) in Slovakia are still higher than the EU average. On the basis of limited time

series data (since adequate LFS data from before 1994 are not available), it is clear that employment has declined the most for young people aged 15-24.

TABLE 2. Changes in the Sectoral Structure of Employment

	1994	1995	1996	1997	1998	EU15 '97 <sup>(a)</sup>
Total (in thousands of persons)	2 178,5	2 243,5	2 293,7	2 185,2	2 171,9	149 042
% Share of Women	46.2	46.0	45.8	44.9	45.1	41.8
Index Previous year=100	99.2	103.0	102.2	95.3	99.4	100.6
% Share in: <sup>(b)</sup>						
Agriculture	9.9	8.7	9.1	8.2	7.5	5.0
Industry	39.7	38.9	39.9	39.4	39.6	29.4
Services	50.4	52.4	51.0	52.4	52.9	65.6

Note: Employment according to ILO definition, LFS data. (a) EU data from the Community Labor Force Survey. (b) Total shares expressed as employment in the sector / total employment. Shares of women expressed as employment of women in the sector / total employment in the sector. Source: Statistical Office of the Slovak Republic, for (a) Employment in Europe, European Communities, 1998

The formation of the private sector began practically in 1990 and continued in 1991 through small-scale privatization. The share of the private sector on overall employment was about 1 % in 1989. At present, this share has surpassed 60 %. This increase has been achieved at the expense of employment in the public sector. That share fell from 80 % to 35 %. The third group, represented by employment in cooperatives, has registered a decline to less than a half and now constitutes only less than 7 %. Cooperatives may also be included in the private (non-public) sector. The private sector consistently displays faster employment and output value growth than the public sector.

The regional breakdown of employment reflects one of Slovakia's key contradictions – a high degree of regional segmentation. Regional diversification of employment is not quite as important in terms of overall value, but its structure is. Bratislava's share on overall employment constitutes more than 14 % and the shares of other regions range between 10 and 13 %. This corresponds to the shares of population of productive age in the regions, however the sectoral structure of employment tends to display a greater concentration. There are many mono-industrial districts specialized in one or only a few sectors (for example, engineering – Považská Bystrica, Dubnica nad Váhom, Martin, Zvolen, metallurgy – Košice, Žiar nad Hronom, chemical industry – Humenné, leather products manufacturing – Topolčany). Typical agricultural districts located mainly in the southeastern lowlands display particularly high unemployment levels.



Regional concentration is also reflected in the regional breakdown of entrepreneurs – legal entities. Bratislava’s dominant status is affirmed by its high share (28 %) within Slovakia. According to the OECD (1999), Bratislava’s share of entities with foreign capital is 52 % and 20 % of the individual entrepreneurs are based there. The tendency towards vast divergences between the capital and the rest of the country is also apparent in Czech Republic and Hungary. In this respect, we must mention the role of foreign investment in reviving job creation. Hungary, with the most foreign direct investment per capita among the associated countries, has not seen a major impact from these investments on reviving the labor markets in crisis regions. Regional differences in this respect that have existed already in 1990 have further intensified during the transition period. Foreign investors have focused mainly on the Budapest area and on a few well-developed regions (for example, the districts Győr-Moson-Sopron, Pest, Vas) rather than on crisis regions in the north and east of the country. Following the implementation of the Hungarian government’s support programs foreign investors have “crossed the Danube” and headed for the crisis regions. According to data from the Hungarian Ministry of Social Affairs and Family, foreign investment in the crisis regions has not really acted as a significant job creation stimulus.

Regional segmentation in Slovakia has had severe repercussions on the labor market situation. In conjunction with the very low level of job creation, there are many districts where job opportunities for the unemployed are negligible.

### **7.2.3 Flexibility of Working Time and Hours Worked**

Working time limits give the Slovak labor market an omen of inflexibility.<sup>97</sup> LFS data for the last quarter of 1998 show that 80 % of workers (including the self-employed) work 40 to 43 hours per week.<sup>98</sup>

According to LFS data, the extent of part-time labor is very modest. In the last quarter of 1998, some 2 % of employees worked part-time. For women, the

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<sup>97</sup> The Labor code sets the maximum weekly working time at 43 hours. Regular weekly (full-time) working time may oscillate between 40-43 hours, depending on the nature of the job or the economic sector. Since 1991, it is possible to set a different weekly working time for full-time employment (not exceeding 43 hours) in collective contracts. This does not, however, concern the public sector. Working time for part-time employment (the so-called shortened working time) may be set in the contract at the request of the employee or the employer. Due to the high level of unemployment, the maximum limit on overtime hours per week or per year (8 hours per week or 150 hours per year) acts as a deterrent from working overtime, although there are exceptions. But workers cannot be made to work longer than the above-mentioned maximum limit.

<sup>98</sup> Some 15 % work more than 43 hours and only 5 % work less than 40 hours. Approximately two thirds of part-time employees worked less than 30 hours per week. About a half of part-time workers worked between 20 to 24 hours per week. There were no significant differences between the numbers of hours worked by men and women.

share was higher (3 %) than for men (0.8 %). These shares are very low in comparison with the averages in the EU. There as many as 17 % of the workers work part-time (6 % of men and 32 % of women). These sizable disparities indicate that the Slovak labor market is quite inflexible in terms of working time. A majority of the economically active population is either employed full-time or unemployed. Employers achieve the necessary flexibility through temporary contracts. This, in turn, promotes segmentation of the labor market, and creates a group of temporary or seasonal workers who, during a crisis, are the first to be hit by unemployment. Further LFS data from the last quarter of 1998 (Table 3) show that only 0.5 % of employed workers were underemployed due to their inability to find a full-time job or because their employer was unable to provide them with full-time employment.

It is a widespread view that the “second job” phenomenon is very common in transition economies. Survey data does not support that viewpoint. The data suggests that only a very modest share of workers have a second job. Administrative data show some 3 % of employees with an additional job, while LFS data indicate an even lower share – 1 % on average (1.2 % for employed men and 0.8 % for employed women). Only 0.8 % of men and 0.5 % of women indicated that additional income was an incentive to hold a second job. These relatively modest figures are surprising in the view of the relatively low standard of living. One possible explanation may be that most additional activities are not recorded.

TABLE 3. Part-time Work, Underemployment and Additional Job

% of workers	Part-time	Second Job
Total	1.9	1.0
Men	0.8	1.2
Women	3.2	0.8
	Underemployed	Reason: additional income
Total	0.5	0.6
Men	0.1	0.8
Women	0.9	0.5

Note: Last quarter, 1998. Source: LFS, Statistical Office of the Slovak Republic

### 7.2.4 “Hidden Employment”

The share of the hidden economy on Slovak GDP before the year 1990 was estimated to be around 3 %. The share has increased during the initial period of transition to 15-20 %. There are no regular evaluations on the extent of the shadow economy. Hajnovicova (1995) evaluated the volume of shadow (unregistered)

production and activities in 1993 to be about 12.8 % of GDP. Out of that, production reaching 5.6 % of GDP was estimated as hidden due to statistical reasons, such as the non-response of small and medium enterprises. Among sectors of industry, the largest share in shadow economy was attributed to trade, hotels and restaurants (38 %), followed by trade services (26 %), and construction (15 %). The rest was allocated mainly to the processing industry, transportation and agriculture.

TABLE 4. Estimates of Hidden Production in Slovakia, 1993-96

	1993	1994	1995	1996
In SKK billions	43.3	51.5	54.6	63.0
% of total value added	13.0	13.1	12.0	12.0

Source: Infostat and Statistical Office of the Slovak Republic

Another source provides estimates on the development of the hidden economy in Slovakia in relation to the total value added. As can be seen in table 11, the volume of hidden production was increasing in nominal terms. However, the estimated share of hidden production in total value added declined between 1993 and 1996 from about 13 to about 12 %.

TABLE 5. Average Wage 1989-1998

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Average Wage (SKK/month)										
Nom., 1989=100	100	104.4	120.0	144.6	171.2	200.3	229.0	259.5	293.6	305.5
Real, 1989=100	100	94.4	69.6	75.7	72.8	75	78.2	83.8	89.2	91.8
Minimum Wage (SKK/month)										
% change year/year	-	-	-	10.0	11.4	0.0	0.0	10.2	0.0	11.1
Cost of Living Index										
% change year/year	-	10.6	56.0	10.7	23.1	13.6	9.6	5.8	6.2	6.6
Index 1989=100	100	110.6	172.5	191	235.1	267.1	292.7	309.7	328.9	350.6
Minimum Wage / Average Wage, %										
	-	-	53.1	48.4	45.5	38.9	34.1	33.1	29.3	30.0

Note: Average gross wage in SKK per month. Nom. = nominal

One of the aspects of a shadow economy is unregistered employment. The volume of the so-called envelope salaries has not yet been estimated. However, given the relatively high load of taxes and contributions<sup>99</sup>, the phenomenon of envelope salaries is believed to be spreading, especially in the small private sector.

<sup>99</sup> According to data from the Cost of Labor Information System, the average burden of taxes and contributions in 1997 represented about 42.2 % of total labour costs.

### 7.2.5 Vacancies and Structural Imbalances

Job creation in Slovakia appears to be very low. The numbers of vacancies reported to the labor offices by employers represent an indicator of the job-creation process. Despite the usual deficiencies of the vacancy data, it is believed that the reporting of vacancies is relatively high. This is mostly due to the legal obligation of employers to report their vacancies to the labor offices. Further interaction between employers and labor offices, such as providing wage subsidies and loans, is conditioned on the reporting of vacancies.

The Research Institute of Labor, Social Affairs and Family organized a survey of the state of vacancy reporting and the co-operation between employers and labor offices in several Slovak districts (Liska et al., 1996). The results show that co-operation depends on the size of enterprise. For example, in small firms employing up to 24 employees, the ratio of reported vacancies to the total number of created jobs was between 50 and 75 %. Large firms, with more than 500 employees, achieved the most effective reporting. The ratio of reported to total created jobs was as high as 90 to 95 %. On the average, firms, via channels other than labor offices (mediating agencies, advertisements, etc.), recruited 45 to 55 % of the workers.

In the light of these figures, it is alarming that the numbers of reported vacancies are very low compared to the numbers of registered unemployed. At the end of 1998, there were about 39 registered unemployed per one registered vacancy. In some regions, the ratio was close to 80. It is noteworthy that at the end of 1998, half of all the vacancies was suitable for workers with a lower apprentice education, i.e., those with practical skills and minimal general education. Cumulative inflow of vacancies in 1996 was more than 120 thousand, and in 1997 it was more than 150 thousand. Compared to the stocks of vacancies, these figures imply that the average duration of vacancy is several months.<sup>100</sup>

Structural imbalances between labor demand and supply, from the regional point of view, can be illustrated by a simple indicator of the mismatch between the total numbers of vacancies (V) and unemployed (U). The ratio  $(U-V)/U$  can be interpreted as the share of unemployed that cannot be placed in regular jobs by the labor offices. Values close to 1 indicate that whatever the absolute number of vacancies, the value is negligible compared to the number of unemployed in the given group. After 1990, the average value of the indicator in every Slovak district (with three to four exceptions) was above 0.95. The same was true for time series of the indicator in particular districts. With the exception of the very early

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<sup>100</sup> The calculation is likely biased upwards due to the fact that "cleaning" of the vacancy register may be done in regular intervals and it may lag behind the true time when the vacancy was occupied.

period (end of 1990), the average value of the indicator was higher than 0.95. These results imply that the Slovak labor market is characterized by a permanent and severe shortage of notified vacancies available to the unemployed.

## **7.3 Wages**

### **7.3.1 Wage Growth**

Despite the fact that wage regulation was in effect only on an irregular basis and during short periods of time, nominal wages grew modestly. Growth was so slow after 1989 that the real wage gap was not closed by the end of 1998. Real wages were initially undermined by the price liberalization of 1991, which resulted in an annual drop of 27 %. At the end of 1998, real wages were still about 8 % below the level of 1989, and the preliminary results prove that real wages have modestly dropped during 1999 (see Table 13).

Slovakia is a country with a traditionally low level of income inequality. Rutkowski (1996) studied wage differentiation in transitional economies during the early transition period. He found Slovakia to be an exception among all the studied countries. Slovakia had the lowest degree of wage inequality and low levels of relative poverty incidence. Other academic studies seem to confirm these results (Garner, Lubyova and Terrell, (1994), OECD (1996)). Rencko (1995) reported that in 1994 about two thirds of employees were receiving less than two times the minimum wage and 90 percent were below the level of three times the minimum wage. This led to the conclusion that in the initial stage of transition, wages were viewed more like a tool of macroeconomic stabilization. The microeconomic functions of wages was neglected, especially in regard to the worker's motivation.

Real wage growth in Slovakia has been relatively modest. During the period between 1989-98, average nominal wages grew by more than 300 %, but in real terms, they actually fell by 8 %. Minimum wage legislation was introduced in 1991. The level of minimum wage is determined by ad hoc administrative decision. In 1991, it started at 2000 crowns per month, and in 1999, it was 3,600 crowns per month. The latter is about one third of the average wage in the national economy. Since its introduction in 1991, minimum wage has been blamed for providing disincentives to employment, mainly due to its low amount as compared to non-labor income from social benefits.

### **7.3.2 Wage Differentiation**

Data, from the latter phases of economic transition, show substantial progress in wage differentiation. Data suggest that the differentiation by individual characteristics, such as education or occupation was more pronounced than the

differentiation by aggregate characteristics, such as type of ownership or sector of the economy. Workers in the agricultural sector experienced the largest drop of relative wages. In 1989, the wage levels in agriculture and industry were approximately equal, but in 1998, the employees of the two sectors ended up with 79 % and 100 % of the national average, respectively. Wages in construction have been traditionally higher than the national average, reaching 103 % of the national average in 1998. That figure is roughly equal to the pre-transition figure.

As to the breakdown of average wages by branch, the highest wages are observed in financial services. Relatively high wages are also found in public administration, defense, real estate, and research and development. In the primary sector, relatively high wages can be found in mining and energy industry. The latter is also known for having the largest discrepancy between the increases of labor productivity and real wages (in favor of real wages) among the industrial branches. Hotels, restaurants, education, trade, health and the social sector, are among the sectors with relatively low wages. Their average wage is comparable to that of agriculture and forestry.

**TABLE 6. Wage Structure 1989 - 1998. Average Wage by Economic Sector**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Average Wage (SKK/month)										
Total	3 142	3 281	3 770	4 543	5 379	6 294	7 195	8 154	9 226	10 003
% of the average in:										
Agriculture	102	103	98	91	85	82	81	81	80	79
Industry	102	101	102	100	102	103	104	104	104	100
Construction	108	107	102	102	103	103	104	107	108	103

Note: Data based on statistical reports for the Statistical Office of the Slovak Republic. A continuous time-series cannot be constructed for the service sector due to changes in sectoral classification and the lack of representative aggregated data. ECU equivalent: SKK 38.3 at the end of 1997, EUR equivalent: SKK 43 at the end of 1998. Source: Statistical Yearbooks of the Slovak Republic and Statistical Office of the Slovak Republic

TABLE 7. Wage Structure. Average Gross Wage by Ownership Type

	1997		1996	1997
Selective Survey <sup>(a)</sup>		Company Reports <sup>(b)</sup>		
Total (SKK/month)	10 886	Total (SKK/month)	8 224	9 369
% share by ownership:		% share by ownership:		
Private	95.9	Private	101.6	100.5
Cooperative	89.7	Cooperative	78.6	77.1
Public	86.0	Public	98.6	99.6
State	106.6	State	99.7	100.7
Foreign	104.9	Foreign	126.8	128.9
Political Parties/NGO	81.3			
Sector				
International Private	103.5			
Mixed	110.2			

Note: (a) Calculations based on data from the Labor Cost Information System. (b) Excluding employees of small enterprises and employees of private enterprises not registered in the trade register (hence, overall averages in various tables differ). Source: (a) Štruktúra miezd zamestnancov v SR, 1997, Statistical Office of the Slovak Republic. (b) Rocenka práce, sociálnych vecí a rodiny 1997, Ministry of Labor, Social Affairs and Family of the Slovak Republic

TABLE 8. Gender Wage Gap (ratio of average gross wages)

Women / Men, share in %	1995	1996	1997
Total	80.09	78.42	78.0
By Education Level:			
Primary	74.5	73.8	73.9
Apprentice Lower	77.5	75.9	67.5
Vocational Lower	77.5	75.9	72.6
Apprentice Full Secondary	83.5	81.4	75.7
High School	78.5	81.6	68.1
Vocational Full Secondary	74.5	77.3	74.7
University	79.1	77.5	84.2
Scientific	79.9	86.7	107.6
By Wage Grids:			
Lowest Ratio (7-th grid)	77.6	78.3	
Highest Ratio (11-th grid)	96.3	97.0	
Contract Wage	64.5	70.6	

Notes: In 1995 and 1996 based on average hourly wages at end of year. In 1997, it was based on the average monthly wages during the year. Wage grids are used in budgetary sphere. Usually there are 12 wage grids. Source: 1995 and 1996 from Kostolna and Hanzelova (1997), for 1997 own calculations based on enterprise survey "Information System on the Cost of Labor"

Wages in the private sphere on average do not seem to differ substantially from those in the state sector (table 15). The highest pay can be found in firms with foreign ownership, and the lowest pay can be found in co-operatives and non-profit organizations, such as municipal and political organizations and charities. Gender wage gap in Slovakia is of the order of 20 percent, which means that average wage of females represents about 80 % of that of males (table 16). Gender differentials are most pronounced in the case of contract wages (i.e., bargained wages in the entrepreneurial sector) and in lower wage grids. The differentials are persistent but due to increasing wages and education, a gradual decrease can be seen.

There is a clear tendency in Slovakia towards the increasing returns of education. Results based on the enterprise survey "Information System on the Cost of Labor" (Table 9) illustrate substantial and increasing wage differentiation according to education. In 1998, the wages of the lowest and highest education group represented about 80 % and 160 % of the average.

Filer, Jurajda, and Planovsky (1999) estimated development of returns to education in Slovakia, using the same enterprise survey data ("Information System on the Cost of Labor"). The analyzed sample ranged from 1.9 to 3.9 % of the total labor force in the Slovak Republic. In 1997 the coefficient capturing effect of college education as compared to primary school education was 0.7. A comparable figure for the Czech Republic was 0.8. Roughly comparable figures from other countries' studies include 0.64 for the United Kingdom, 0.73 for Western Germany, 0.56 for Italy and 0.42 for Sweden. The authors have documented that by 1997 the returns to education in Slovakia reached the level observed in traditional market economies. The returns to education in Slovakia increased substantially between 1995 and 1997, and reached a level two to three times higher than the 1984 level. Returns to education increased more in the private sector and were greater in the younger population. The rate of increase was approximately equal for men and women.

Regional wage structure is influenced by the presence of large cities (such as Bratislava, Kosice, Banska Bystrica). The highest wages (123 % of the total average) are observed in Bratislava. The lowest wage level was found in the region of Presov, in the eastern part of the country, where the unemployment rate is the highest. Rencko (1995) in his analysis of wage policy in Slovakia concluded that there is an indirect (downward-sloping) relationship between the unemployment rate and the wage level among Slovak districts.



TABLE 9. Wage Structure. Average Gross Wages by Education Level

	1996	1997	1998
Total (SKK/month)	9 106	10 086	65,92 <sup>(a)</sup>
% share by education level:			
Basic	81.7	66.1	78.3
Apprentice	94.5	86.1	92.6
Vocational	87.6	75.3	86.4
Full Secondary Vocational	93.9	93.9	101.3
High School	99.6	86.9	101.0
University	156.9	189.1	158.6

Note: Based on enterprise survey "Information System on the Cost of Labor"

(a) In 1998 gross hourly wages in SKK in the last quarter. Source: Statistical Yearbook of SR (1996), Analysis of wage structure of employees in SR (1997), Statistical Office of SR

The overall load of taxes and social security contributions is relatively high. The average load of taxes and social insurance payments represents more than 20 % of an employee's gross wage. According to the enterprise survey "Information System on the Cost of Labor," taxes and insurance payments in 1997 represented an average 23 % of gross employee's wage. Wages also represented an average 68.8 % of the employer's total labor costs. An additional 24.8 % of the employers' labor costs were obligatory social insurance contributions and 1.6 % were taxes related to the employers' wage payments. These figures imply that the total burden of taxes and obligatory social insurance payments in 1997 represented an average 42.2 % of the total labor costs. Tax load is increasing over time, due to the fact that the income brackets for various tax rates were denominated in absolute nominal terms in 1992. These income brackets had not changed by 1999 and have only been modified in 2000 (see Chapter about fiscal policy).

## 7.4 Unemployment

### 7.4.1 Unemployment Data

At the beginning of the transition, the initial steep increase of unemployment was welcomed as a signal of the economy's restructuring. However, after ten years of transition, the Slovak labor market remains trapped with a double-digit and increasing unemployment rate. Unemployment in Slovakia is monitored by the National Labor Office (registered unemployment) and by the Statistical Office. The latter has been performing regular quarterly Labor Force Surveys since the second quarter of 1993. These surveys provided internationally comparable unemployment statistics

according to the ILO definition of unemployment.<sup>101</sup> The comparison of data related to the evolution of unemployment has been compiled from the previously mentioned resources and is represented in Chart 1.

In 1991, the unemployment rate in Slovakia increased sharply from almost zero to 12 %. Since then, it has been fluctuating around double-digit levels. At the end of 1998, it reached about 16 % (428 thousand persons). A new concept of “available registered job seekers” was introduced by the Ministry of Labor as a restrictive definition of registered unemployment. It was designed to identify the registered unemployed who would be immediately available for work (excluding those in retraining, caring for children, or receiving sickness allowances). The corrected unemployment rate is approximately 1 % lower when compared to the total registered unemployment rate.

Labor market dynamics, as captured by flows into and out of registered unemployment, is weak. By using monthly data averages from separate calendar years, one can show that the total unemployment turnover (the sum of inflow and outflow) represents less than 20 % of unemployment stock (table 10). Weak labor market dynamics is also reflected in the magnitude of the monthly unemployment flows, which have rarely exceeded 10 % of unemployment stock. In 1990-91, the inflows prevailed over the outflows. This was due to a high unemployment stock. Later the inflows and outflows became roughly balanced, thus conserving the high unemployment stock. In 1997 and 1998, inflows once again prevailed over the outflows.

TABLE 10. Unemployment Dynamics. (Registered Unemployment)

In %	1990	1991	1992	1993	1994	1995	1996	1997	1998
Inflow / Stock	66.2	18.3	8.8	10.7	7.4	8.5	9.8	9.9	9.4
Outflow / Stock	28.5	5.2	10.0	7.9	8.2	9.4	9.9	9.4	7.7
Outflow / Inflow	43.1	28.4	113.8	73.9	110.0	110.7	100.9	95.5	81.4
Turnover	94.7	23.5	18.9	18.5	15.6	17.9	19.7	19.3	17.1

Note: Data refer to annual averages computed from monthly data (flows are 1/12 of annual flows, stocks are averages of end of month stocks in the indicated year).

Turnover = (Inflow + Outflow) / Stock. Source: National Labor Office of SR

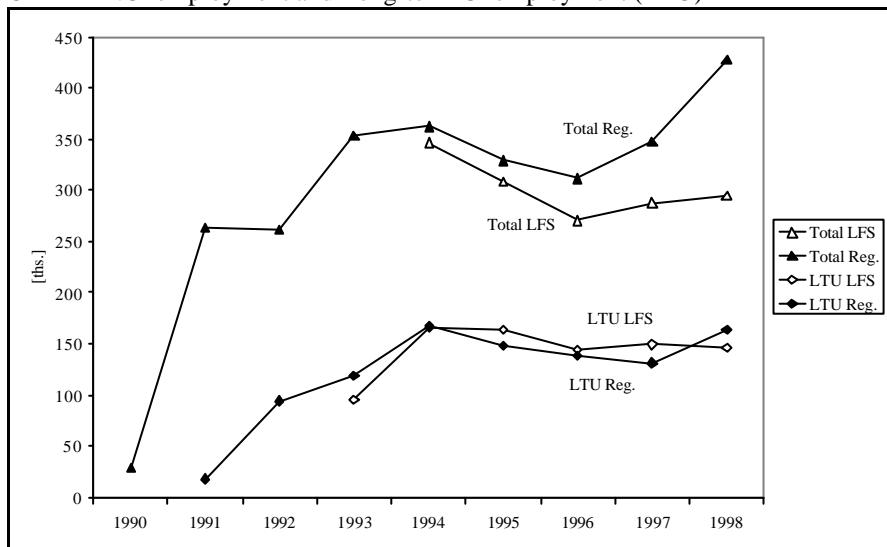
Registered unemployment in Slovakia is higher than LFS unemployment. This implies the possibility of disincentive effects on unemployment insurance and

<sup>101</sup> According to this definition, a person is considered unemployed if he did not work for wage or another form of compensation in the past week, is actively seeking a job and is able to enter employment within the next two weeks. Registration with the labor bureau is not taken into account, since it usually entails various institutional and administrative anomalies. The ILO definition thus better reflects the economic essence of unemployment than data on registered unemployment.

social benefits. The discrepancy between the LFS-based and registered unemployment rate at the end of 1998 was close to 5 percentage points in favor of the latter (11.8 versus 16.4 %). In terms of long-term unemployment, the difference between registered unemployment and the LFS unemployment is much less pronounced. Chart 2 demonstrates that the large discrepancy between the registered and LFS unemployment is mainly due to the group of short-term and medium-term registered unemployed.

Soon after the beginning of transition, long-term unemployment started to increase until its share in the total unemployment according to LFS data reached approximately 50 %. This share is relatively high. However, it was only slightly higher than the EU average of 1997, which was 49 % in total, 48 and 51 for males and females, respectively. Comparable Slovak figures were 52 % in total, 50 and 54 % for males and females, respectively. The share of registered long-term unemployed at the end of 1998 was 38 %.

CHART 1. Unemployment and Long-term Unemployment (LTU)



Note: According to unemployment register (Reg.) and Labor Force Survey (LFS). Registered end of year, LFS last quarter. Source: National Labor Office of SR, Statistical Office of SR

## 7.4.2 Structural Aspects of Unemployment

Educational structure of long-term unemployed reveals that the most vulnerable are those with the lowest skills and education. According to LFS, at the end of 1998, the group with basic or no education represented 37.5 % of long-term

unemployment, and their share in total unemployment was 27.4 %. The share of people with less than complete secondary education in long-term unemployment was 75 %.

The Slovak labor market's low labor mobility is a frequently mentioned problem. Internal migration of the population is one form of mobility. After 1980, the extent of internal migration in Slovakia had a declining tendency (Table 11). Although the past three years have seen a moderate revival, neither absolute nor relative indicators come close to the 1990 levels. The volume of moves falls with increasing distances. Migration within districts (to shorter distances) prevails over migration between regions. In 1998, the intensity of migration reached about 16 persons in one thousand. This figure appears too low to reduce regional segmentation in the labor market.

Commuting represents another form of labor force mobility and is applicable mainly within shorter distances. In this respect, we must mention a significant improvement in the registry of job openings that now allow access to job information in all Slovak districts.<sup>102</sup> But even a major increase in mobility could not significantly help reduce overall unemployment at the present. There is an intense and persistent lack of job openings in all Slovak regions and districts. The imbalance between the numbers of registered unemployed and the job openings have become worse in all of Slovakia's regions (Chart 2). The situation is most critical in the Košice and Nitra regions where there are 80 registered unemployed per job opening. Traditionally, the situation is the best in the Bratislava region. The situation in the Trenčín and Trnava regions is also quite good with "only" about 20 registered unemployed per job opening. These indicators suggest that mobility cannot be expected to have a greater effect on reducing unemployment because the labor supply exceeds demand extensively in almost all regions.

In spite of this, the differences between unemployment levels among regions are growing. The Slovak labor market is permanently marked by a significant regional segmentation. Regional differences in unemployment are among the most significant differences. The unemployment level is traditionally lowest in Bratislava and highest in the Rimavská Sobota district (over 30 %). The spreads between registered unemployment levels in various districts have been growing in the long-term and currently exceed 30 percentage points. The situation of the individual districts is depicted by Chart 3.

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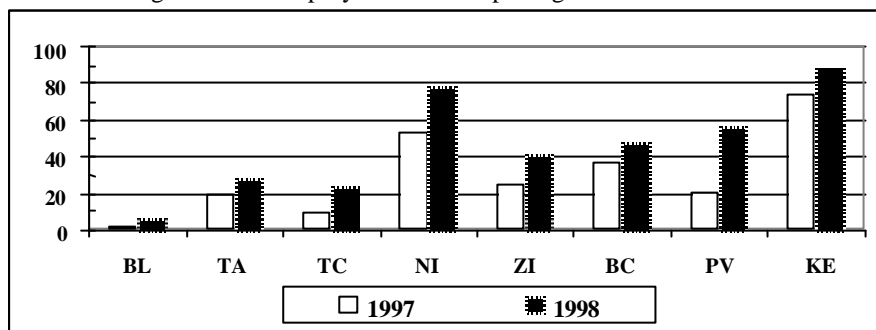
<sup>102</sup> Before 1998, information exchange on job openings took place mainly between neighboring districts. The National Labor Bureau of the Slovak Republic established a central electronic registry of job openings to allow the exchange of information on job opening between all districts. Listings of job openings are also regularly published in selected media.

TABLE 11. Internal Migration in Slovakia

	1980	1985	1990	1995	1996	1997	1998
Number of Migrants	115.6	102.2	100.8	68.3	80.2	82.5	84.8
of that % shares:							
Within Districts	56.5	57	59.4	55.8	50.0	43.5	44.0
Within Regions	24.0	23.3	22.5	23.5	50.0	33.4	33.8
Among Regions	19.5	19.7	18.1	20.7	-	23.1	23.2

Note: Migration defined as the change of permanent address. Data for regions for 1996 are not available. Source: Statistical Office of SR

CHART 2. Registered Unemployed Per Job Opening



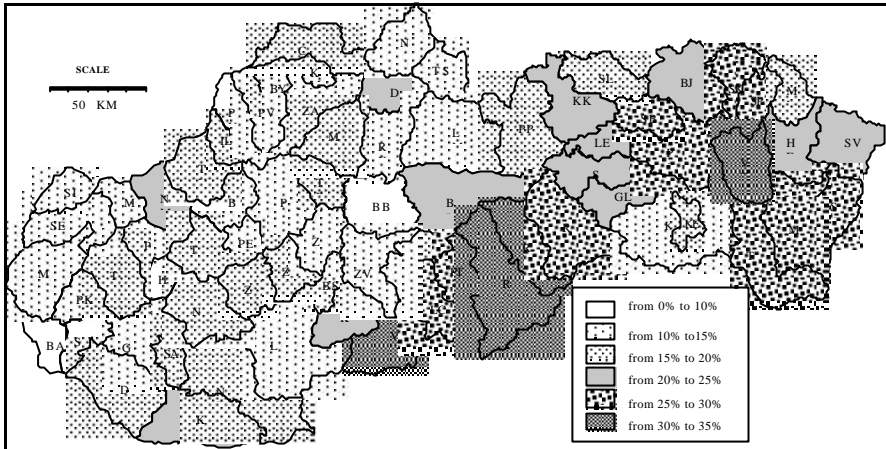
Note: Data as of December 31 of the given year. Regions: BL Bratislava, TA Trnava, TC Trenčín, NI Nitra, ZI Žilina, BC Banská Bystrica, PV Prešov, KE Košice. Source: Own calculations based on National Labor Bureau data

TABLE 12. Development of Unemployment Rate Variability Among Districts.

(%)	1991	1992	1993	1994	1995	1996	1997	1998
Standard Deviation	3.2	3.7	4.9	5.1	4.8	5.1	6.0	7.3
Coefficient of Variation	25.1	30.9	29.6	31.5	32.9	34.8	42.6	41.6

Note: Computed on the basis of registered district unemployment rates at the end of the indicated year. Standard deviation is an absolute measure of variability, coefficient of variation is a relative measure of variability (st. deviation/mean). A break in the geographical division of SR occurred between 1996 and 1997 (see the text). Source: Own calculations based on data from the National Labor Office of SR

CHART 3. Unemployment in Slovak Districts at the End of 1998.



Note: Data on registered unemployment as of December 31. Source: National Labor Bureau

Table 12 captures the development of unemployment levels' variance among Slovak districts. Absolute variance, expressed as the standard deviation, has more than doubled in the 1991-98 period. Relative variance expressed as the variance coefficient has almost doubled in that period.<sup>103</sup> We can thus conclude that during the transition period, differences in unemployment levels between Slovak districts rose both in absolute and in relative terms.<sup>104</sup>

The distinction between the standard deviation and the coefficient of variation mentioned above show the situation in different regions (CPHR, 1999). The region of Bratislava has the lowest unemployment rate and the lowest variability of district unemployment rates in absolute terms. In relative terms, the internal (inter-district) variability is the largest in the Bratislava region. An opposite tendency holds for the region of Presov, where the highest unemployment rate is

<sup>103</sup> Standard deviation is an absolute measure of variance. It is sensitive to the overall magnitude of the given variable: it has a tendency to rise along with the measured variable. Therefore, in years with higher average unemployment we can see higher absolute variance levels. We therefore include the relative variance measure – the variance coefficient – expressed as the standard deviation divided by the average unemployment level. This allows us to compare the variance in the various years regardless of the overall unemployment level.

<sup>104</sup> Certain portion of the increase in variance between the years 1996 and 1997 is a consequence of the new administrative territorial organization. A shift from 38 to 79 districts caused districts to become smaller and more homogeneous and differences between them increased. A minor decline in variance towards the end of the period under scrutiny is favorable from this viewpoint.

accompanied by a low relative variability among districts. Judging by both absolute and relative variability criteria, the largest segmentation of labor market, in terms of unemployment rates, is present in the regions of Banska Bystrica, Trencin and Kosice. The lowest segmentation can be seen in the region of Nitra.

According to LFS, the unemployment rate for the age group 15-64 was 12 % in the last quarter of 1998. This seems to be slightly higher than the EU average of 10.6 % in 1997. The incidence of unemployment in Slovakia is relatively high for females and for young people. Unemployment rates for females have been persistently higher than for males. At the end of 1998, the difference was about two percentage points (11.1 as compared to 12.9 %). Young people under 25 years seem to have a serious handicap in the Slovak labor market as their unemployment rate was about 27 % at the end of 1998 and 24 % as of 1997. In this category, the comparable EU average value for 1997 was 21 %.

For the youngest and the oldest group of the labor force, the female unemployment rate is lower than that of males. In the young group (15 to 24 years) this may be partially due to the effect of military service. Employers are reluctant to accept young men before military service. Under the current budget deficit, the waiting period for starting military service tends to increase. Authorities are considering shortening the obligatory military service. Another explanation of the lower unemployment rate of the young females is their relatively large withdrawal from the labor force. Females aged 21 to 25 have a much larger exit to out-of-labor-force status than their male counterparts.

It is difficult to assess the position of ethnic groups in the Slovak labor market because of the lack of suitable data. The main difficulty arises from the fact that among the three main indicators - employment, population and unemployment - only the latter two are monitored by nationality. The fact that the unemployment register contains information on nationality has been criticized by the representatives of Roma<sup>105</sup> and Hungarian minorities. Further data limitations are caused by the biased nationality structure of the population data (self-reporting based Census) and the absence of aggregate statistics on unemployment by nationality. The limited available information is provided in table 13.

According to aggregate indicators, at the end of 1996 there were 62 thousand unemployed Romas registered at the labor offices. This figure represented 19 % of

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<sup>105</sup> Notably the fact that in the sake of prevention of the self-reporting bias, the ethnicity was determined by the labour office staff. The grounds for separate monitoring of Romas come mostly from the fact their characteristics and reasons of their low ability to integrate into the society are so specific that they cannot be unambiguously "diluted" and split-up among the other disadvantaged groups, as this would hide one of the substantial causes of the problem. Monitoring can be also useful in the sense that it illustrates the bad labour market position of Romas, preparing grounds for more targeted actions.

all the registered unemployed. This can be compared to the share of Romas in the Slovak population of 1.6 % (according to the official census data), or to the population share of less than 10 % (according to the most generous estimates). Furthermore, the share of unemployed Romas receiving unemployment benefits is lower than the average share. This is mostly due to the long periods of unemployment for Romas. After exhausting their eligibility period for insurance-based unemployment benefits, they are transferred to the open-ended social security benefits. Of course, the aggregate comparison can be used only as a rough illustration, because it does not capture all the facts, such as the age structure of the population.

Individual data on the unemployed are aggregated at the district level. At this level the nationality information falls out (with the exception of the Roma ethnic group), and the data collected and published by the National Labor Office do not contain a breakdown by nationality. Therefore, the evidence about unemployment of separate nationalities is mostly anecdotal. For example, a study dedicated to the evaluation of active labor market policies in Slovakia (Lubyova and Van Ours, 1999) indicates that in total inflow into unemployment during 1993 in 20 selected Slovak districts, there were 4 % of Hungarians, 5 % of Romas and the rest of Slovaks. With respect to the main examined indicator, exit rate to regular jobs, Hungarians were not different from Slovaks. The Romas had a lower exit rate to jobs than any other group.

TABLE 13. Unemployment by Ethnic Groups.

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total	39 603	301 951	260 274	368 095	371 481	333 291	329 749	347 753	428 209
Roma (%)	21.2	15.5	15.5	14.0	13.5	16.6	19.0	19.2	n.a.
Eligibility for Unemployment Benefits <sup>(a)</sup>									
			1992	1993	1994	1995			
Total (%)			33.6	33.4	22.9	27.0			
Roma (%)			15.2	10.7	4.7	5.3			

Notes: (a) Within-group share of those with insurance-based unemployment benefits.  
Source: National Labor Office of SR

No strong statements can be made on the basis of aggregate data about the Roma unemployed. These data do not capture whether the situation is mostly due to prejudiced employers, voluntarily unemployed Romas, or both factors. Therefore, only anecdotal evidence and studies based on special surveys can clarify the situation. So far, the studies have led to the conclusion that Romas have the greatest difficulties in the labor market and none of the studies could measure the discrimination and incentive effects. Nevertheless, it is clear that the key to the



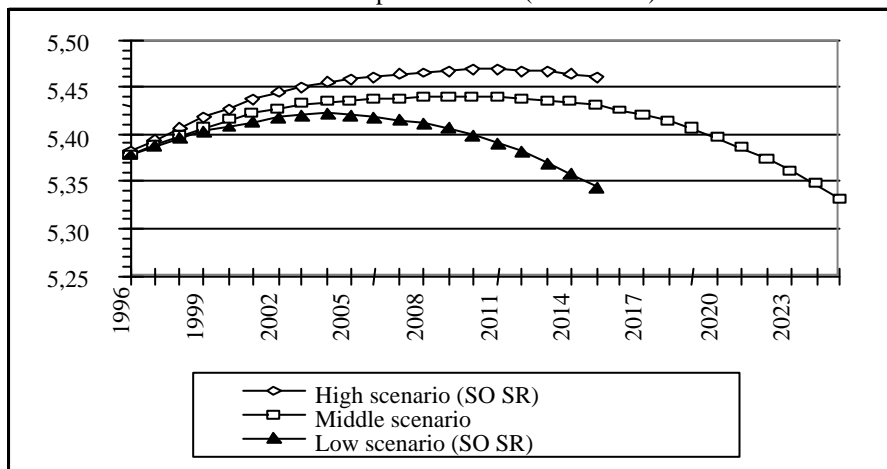
solution of weak labor market position of the Romas lies in increasing their educational opportunities.

## 7.5 The Effect of Demographics on the Labor Market

### 7.5.1 Overall Development

The demographic situation in Slovakia is relatively favorable in comparison with other transition economies. Due to the strong years in the 70s, the size of the productive age population is growing both in absolute terms and as the proportion of the total population. The so-called dependency ratio, defined as the ratio of post-productive age population to the population of productive age is still declining slightly. It is expected to grow only after 2005 – 2010. The significant decline in birth rates after 1989 is reflected by a new, alarming tendency. Despite annual increases in the absolute number of women of reproductive age, the absolute birth rates are constantly declining.

CHART 4. Forecasts of Slovak Population Size (in millions)



Source: Statistical Office of the Slovak Republic and author's calculations

The high and low scenarios of the population forecast in Chart 4 were prepared by the Statistical Office of the Slovak Republic on the basis of 1995 demographic data (as a revision of the original forecast based on 1993 data). We computed the middle scenario on the basis of 1995 demographic data. The actual mortality levels in 1994 serve as the basis point for the high scenario and the 1995 mortality levels are used in the low scenario. Age-specific mortality rates from 1995, slightly reduced further, serve as the basis for the middle scenario. The

middle scenario assumes a constant reduction in birth rates until 2005 and a very mild subsequent growth.<sup>106</sup>

The effect of demographic factors on the labor market is likely to be unfavorable in the short-term. The labor supply should increase, but we cannot expect a corresponding revival in job creation. In the long-term, population aging should be reflected by an increase in the pension age, which will further raise the supply of labor.

Regional differences in Slovakia in terms of population size and the level of economic activity are much less pronounced than in the area of unemployment. The share of regions on total population ranges approximately between 10 and 14 %.<sup>107</sup> But birth data vary significantly, rising as one moves from the west to the east. The highest gross birth rate levels in 1998 were reached in the Prešov and Košice regions (13.6 promile and 12.6 promile), while the Bratislava region only recorded 7.9 promile. Gross mortality levels fluctuate a less – from 8.5 promile (Prešov region) to 11.5 promile (Banská Bystrica region). These demographic developments foreshadow deterioration in the labor market, particularly in the eastern part of Slovakia, if job creation is not revived sufficiently for the labor market to absorb the growing supply of labor.

### **7.5.2 Economic Activity of the Population**

The transition period can be divided into two stages according to developments in the population's economic activity. Before 1994, the economic activity of the population declined quite significantly, much more so for women (administrative data show a decline in their economic activity by almost 22 % between 1989 and 1994). After 1994, the level of economic activity declined more slowly. According to the OECD (1996), the level of economic activity in Slovakia has traditionally been lower than in Czech Republic (although the difference is small – to the tune of 5 percentage points). This tendency persisted throughout the transition period. The level of economic activity in Slovakia declined more in comparison to the Czech Republic and Poland, but less than in Hungary.

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<sup>106</sup> The implied total birth rate per woman of reproductive age in 2015 is 1.33, 1.42 and 1.60 for the low, middle and high scenarios respectively.

<sup>107</sup> Despite relatively equal shares of the population, the population density in the individual regions varies widely (from 70 to 302 people per square kilometer), a consequence of different sizes of the regions.

TABLE 14. Level of Economic Activity by Age and Gender in 1998.

Age	Total	Men	Women
15-64	66.8	73.2	60.4
15 – 24	43.2	45.3	40.9
25 – 49	87.2	92.6	81.7
50-64	42.4	55.6	31.0
65+	1.5	2.3	1.0
15-59M/54W	72.5	76.4	68.3
Total	45.7	51.1	40.6

Labor supply / population of productive age in %. Source: Own calculations based on LFS and population data from the Statistical Office of the Slovak Republic

International comparisons of the levels of economic activity are complicated by the variety of data sources and the different productive age definitions. In the EU, data from labor force surveys and data on population between the ages 15 and 64 are used for comparative purposes. Since the implementation of LFS in Slovakia in 1993, it is possible to provide comparative data for Slovakia (Table 14). In 1997, the level of economic activity was 67.6 %, almost identical with the EU average in the same year (67.8 %). Comparative data, for the Slovak Republic for the men are 75 %, and for the women are 61 %. This indicates that our men are relatively less active and women relatively more active than the EU average (78 % and 58 %).

In 1998, the level of economic activity of the population between the ages 15 and 64 again declined slightly and reached 66.8 %. The highest levels of economic activity were achieved in the 25 to 49 years age group: 94 % for men and 81 % for women. A very low level of economic activity, 1.4 %, among the oldest group (over 64 years), reflects the low statutory pension age in Slovakia. A mere 2 % of men and 1 % of women over 64 years of age are economically active. The low pension age for women (53 to 57 years) is clearly reflected in the significant decline of their economic activity after 55 years of age. This indicator is some 10-percentage points lower than for men.

We can conclude that the economic activity of the Slovak population reaches levels comparable to the EU average at the present time and that we cannot predict a significant decline that would reduce the supply of labor.

The shares of preproductive, productive and postproductive age population on total population in 1998 were 20.4 %, 61.8 % and 17.8 % respectively (data based on “real” productive age of 15-54 years for women and 59 years for men). Age structures of other nationalities in Slovakia display wide fluctuations. The Romany ethnic group deviates the most from this structure. The share of postproductive age population in the entire Romany population is only 5 % and in the productive age population it is only 40 %. Accordingly, we can expect major pressures on the

labor market from this group, particularly in the eastern part of Slovakia. Other nationalities have a lower share of preproductive population in general and a higher share of postproductive age population than citizens of the Slovak nationality.

It is difficult to assess the position of minorities in the Slovak labor market due to the absence of appropriate statistics. The main difficulty lies in the fact that of the three main indicators – employment, population and unemployment – only the latter two are tracked on the basis of nationality. The bias in the tracking, the ethnic breakdown, of the population poses a further obstacle (the census is based on self-reported data). Summary data on unemployment is not broken down by ethnicity and the absence of such data contributes to the problem. Administrative data on employment are based on company reports and do not contain the ethnicity of employees. The structure of employment by ethnicity is followed in LFS, but is not available on an aggregated level.

## 7.6. Labor Market Policies

### 7.6.1 Passive Labor Market Measures

Passive labor market policies in Slovakia have often been subjected to institutional reforms. As institutions in practice adjusted to rapidly changing conditions, frequent reforms became common in other transition economies as well. Major tightening reform, inspired by the soaring payments for unemployment benefits, occurred in most countries during 1991-1992. In Slovakia, this restrictive reform took place in early 1992. Originally designed as a 12-month entitlement, period for unemployment benefits was halved. The eligibility conditions for unemployment benefits were tightened and replacement ratios were slightly decreased (from 65 and 60 %, corresponding to the first and second half of the entitlement period, to 60 and 50 %, respectively). The reform was applied retroactively, i.e., to citizens that had become unemployed prior to January 1, 1992.

TABLE 15. Public Expenditure for Employment Policies, % of GDP

	1991	1993	1994	1995	1996	1997	1998
Employment Service <sup>(a)</sup>	1.02	0.80	0.82	1.16	1.29	1.08	1.08
Labor Market Training <sup>(b)</sup>	0.02	0.03	0.02	0.03	0.03	0.04	0.02
Subsidized Employment <sup>(c)</sup>	0.13	0.26	0.39	0.67	0.62	0.36	0.22
Unemployment Benefits	0.86	0.50	0.38	0.31	0.33	0.43	0.54
Retirement Pensions	6.7 <sup>1989</sup>	8.9	8.4	8.3	8.2	8.0	8.1

Notes: (a) Total expenditures on passive and active labor market policies, (b) Including training of employees supported by the labor offices, (c) Youth measures are part of

subsidized employment. Source: National Labor Office of SR, Ministry of Labor, Social Affairs and Family of SR

Unlike in other transforming economies, the unemployment insurance system in Slovakia was loosened in 1995, and additional relaxing steps followed in 1996 and 1997 (through the extension of support periods, less strict entitlement conditions, etc.). The period for unemployment benefit payments was extended according to the age of the unemployed individual. It later depended on the length of the preceding period of payments in the Employment Fund. This reform was caused by budgetary considerations. Insurance payments were shifted from the state budget to the National Labor Bureau. This was done on behalf of unemployed beneficiaries. Savings in the state budget were achieved through an increase in the number of beneficiaries. At present, this period is again being shortened due to pressure created by the rising passive costs. This situation is a result of growing unemployment and the reduction of the upper limit of unemployment benefits.

These reforms in passive policies were particularly reflected by fluctuations in the share of the unemployed entitled to receive unemployment benefits (Table 16). The restrictive reform in 1992 cut this share from 82 % to 34 %. The relaxing reform of 1995 was reflected by an increase of the share from 23 % in 1994 to 28 % in 1998. Following restriction in 1992, the number of registered unemployed temporarily fell, but it is difficult to distinguish the effects of reforms from seasonal and other factors.

TABLE 16. Registered Unemployed Receiving Unemployment Benefits ( % share of total unemployment)

	1991	1992	1993	1994	1995	1996	1997	1998
Total	82	34	34	23	23	28	27	28
Male	81	34	34	23	23	30	29	30
Female	83	33	35	23	23	26	24	26

Source: National Labor Office of SR, Ministry of Labor, Social Affairs and Family of SR

Mass retirement, including disability pensions and a special old-age pension, has been a popular measure used throughout the transition period to reduce labor market pressures. Pensioners and workers of retirement age gradually withdrew from the labor force. As can be seen from table 17, the share of employed pensioners in overall employment declined from about one-third to about 10 % during the transition period. Currently it is possible for old age pensioners to work and receive both their pension and a reduced salary, providing that their labor contract is for a definite period up to one year (can be renewable, though). Exits to early retirement represented between 4 and 5 % of unemployment inflow. Early

retirees do not have to be registered in the unemployment register prior to their retirement. Early retirement can be granted within two years prior to reaching the regular retirement age. The person must be laid off for so-called organizational reasons and he/she cannot be offered a suitable job. Given the low statutory retirement age, early retirement can be granted as early as at the age of 51 years for females and 58 years for males. For some groups of workers, the retirement age can be even lower, depending on the so-called labor categories. Labor categories classify the jobs into groups with preferential treatment. This extensive usage of retirement as a labor market tool will have to come to an end in the near future, because the pay-as-you-go pension scheme may soon approach a negative balance.

TABLE 17. Early Retirement Pension Schemes

	1989	1993	1994	1995	1996	1997
<b>Annual Inflows</b>						
Early Retirements	-	19 546	15 996	17 250	14 142	15 675
Relation to un. Inflow (%)		4.7	4.9	4.8	3.7	3.9
Share of Employed	1984	1987	1990	1992	1994	1996
Pensioners	33.3	32.7	27.7	13.1	12.6	10.4

Note: All shares are in %. Source: Ministry of Labor, Social Affairs and Family of SR

## 7.6.2 Active Labor Market Measures

Active labor market policy (ALMP) may be aimed at improving the functioning of the labor market from several perspectives. However, in practice, ALMP are usually aimed almost exclusively at reducing unemployment. The choice of appropriate measures or approaches of ALMP should depend on the prevailing type of unemployment in the given labor market. In this respect, we can briefly address certain types of unemployment (summed up in Box 1).

Of the three situations described in Box 1, transition economies suffer the most from the third problem – insufficient job creation. Causes include the lack of capital resources, large uncertainty regarding future market and sectoral developments, and technological and managerial deficiencies and so on. The existence of long-term unemployment and structural unemployment is more of a secondary phenomenon – a consequence of weak job creation. It is difficult to analyze structural imbalances when there are few job openings for people with a variety of professions and educational backgrounds. Structural ALMP measures aimed at more effective placement of the unemployed in open jobs (like retraining or labor mobility promotion) are effective only when these openings exist. Programs aimed at job creation make sense in the Slovak labor market, although the manner of their implementation is questionable.

The policies were introduced in 1991 and gradually developed into a comprehensive system of more than eight basic types of programs. The last major re-organization occurred in 1997. Until the end of 1996, the active labor market policies in Slovakia contained the following measures: socially purposeful jobs, publicly useful jobs, retraining, counseling, sheltered workplaces for the disabled, subsidies for shortened working hours, jobs for school graduates. Act No. 387/1996 Coll. on employment has been effective since January 1997. It stipulated the following active labor market measures: retraining, support of job creation, support of employment of specific target groups, support for prevention of layoffs, support for maintenance of existing jobs, support for elaborating proposals for revitalization of employment, support for employment of disabled.

**BOX 1. Types of Unemployment from the Perspective of Appropriateness of ALMP Use.**

There are enough job openings in the labor market, but unemployment is high due to a structural imbalance in terms of profession or education between the unemployed and the openings. The recommended approach in this case is to retrain the unemployed, after a certain initial unemployment period. The initial unemployment period is required to give the unemployed a chance to look for a suitable job. Those who fail to find an appropriate job can then get retrained. This action will raise their chances of gaining employment. Retraining also prevents deterioration of working habits due to longer periods of unemployment. But this type of structural unemployment is more characteristic for OECD countries than it is for transition economies.

Job creation exists in the labor market, but the outflow of the unemployed is lower than the number of jobs created. This is due to a high share of the long-term unemployed. The long-term unemployed both search less intensively than others and are less accepted by employers who tend to hold prejudices against them. In this case, retraining of the long-term unemployed represents the optimal approach. The supply side of the labor market (employers) does not require special subsidies, since job creation occurs spontaneously. Again, this type of unemployment is more common during the growth phase of the economic cycle in OECD countries. During the initial revival period in an economic cycle, certain unemployment inertia takes place. This is attributed mainly to the so-called hard core of the long-term unemployed. This group was created during the preceding period of economic recession.

The situation in the labor market is characterized by insufficient job creation. In this case it is important to find the causes behind this situation. If it is lack of capital or insufficient liquidity, subsidies or other forms of job creation support would be the appropriate measure to take in the hope of creating a multiplication effect (i.e., a certain self-reproduction of jobs in functioning enterprises). It must be noted that other measures, other than the ALMP measures, may be even more effective. A favorable credit policy would be very effective. Job creation is the appropriate measure, if insufficient job creation is a consequence of poor adaptation of new, modern production technologies. This can be augmented by management, expert retraining, and training. Source: Lubyová, CPHR, 1997

When the old and new structures of active programs are compared it becomes obvious that more attention is currently being paid to the preventive, as well as to specific groups (disabled, older people, long-term unemployed, young and school graduates). The original job creation programs were formally unified into one program of job creation, but the distinction between the two types of jobs was preserved. It is also interesting to note that counseling is not included in the new structure of active labor market tools. This implies that counseling has to be financed from labor offices' general administrative budgets. This risks that it will be eliminated in favor of the labor offices' operational needs. Many experiences prove that individual work and counseling are the most effective methods of bringing about change in problem groups of unemployed.<sup>108</sup>

In this context, we must note that the financing of active measures is now being scaled down significantly due to the increases in passive payments being made to the unemployed. In the first quarter of 1999, the ration of active and passive expenditures was 1 : 14. With these circumstances in mind, the Ministry of Labor, Social Affairs and Family is preparing the unemployment policy plan. Given the insufficient job creation and the existence of a large "hard core" of the long-term unemployed with low qualifications, preference is being given to the short-term target of creating public service jobs. A pilot program with individual approaches and retraining for the young unemployed is under preparation in several districts in eastern Slovakia. It is there that the unemployment problem is the most rampant.

The new ALMP instruments system has several drawbacks. The character of certain instruments (barriers to firing, for example) violates the insurance principle of premium collection. The selective use of certain instruments invites corruption, distortions of the market competition among enterprises and substituting of economic employment policies. A solution could be found in an across-the-board application of the programs. This could be in the form of tax and contribution reductions granted for employing persons from the target groups. Another critique of the current system stems from the fact that after the geographic and administrative reform of 1996, the number of district labor offices was approximately doubled (according to the number of new districts). The system is administratively costly, especially when the National Labor Office estimates that among 79 district labor offices, only 40 are supervising a "real" labor market (Table 18).

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<sup>108</sup> The new "New Deal" policy of Tony Blair's government in Great Britain is based on a highly individual approach to the unemployed, particularly to the younger age groups. But this approach is very costly and is financed mainly by proceeds from gas industry privatization in Great Britain.



A more detailed breakdown of active labor market expenditures is given in table 19. It is obvious that socially purposeful jobs were the most important throughout the period, followed by publicly useful jobs and retraining. The shares of publicly useful jobs were higher at the beginning and at the end of the period. Retraining has been used modestly and the rest of the programs occupied only a negligible share of total expenditures.

TABLE 18. Employment Service.

	1991	1993	1995	1997	1998
Number of Staff	2 026	1 128	3 527	4 441	4 462
Unemployed / Staff	149	326	94	78	96
Staff / Unemployed	0.007	0.003	0.011	0.013	0.010
Number of Placements				107 889	111 204
Placements / Staff				24	25
Placements / Unempl.				0.31	0.26

Source: National Labor Office of SR, Ministry of Labor, Social Affairs and Family of SR

TABLE 19. Active Labor Market Measures Towards the Unemployed. (Unemployment data are end of year stocks)

Reg. Unemployed	1991	1992	1993	1994	1995	1996	1997	1998
% share in:								
Training	0.8	2.9	0.9	0.8	1.1	1.0	2.0	0.2
Subsidized Jobs:								
Public Works	3.1	8.9	0.9	1.8	8.5	5.8	5.8	0.5
Other	6.9	39.3	30.9	27.7	32.8	30.5	18.0	7.8
Expenditures	1991	1992	1993	1994	1995	1996	1997	1998
Total (mil. SKK)	523	3 813	1 107	1 896	3 899	4 290	3 099	2 289
% share on:								
Training	9	8	11	6	4	5	7	7
Disabled	0	1	1	1	3	2	5	5
Subsidized Jobs:	91	92	88	93	93	93	40	
Active / Passive	0.19	2.23	0.60	1.11	1.79	1.40	0.78	0.42
Contrib./Exp.				1.23	1.02	0.97	1.06	1.03

Note: Subsidized jobs include public works, youth measures and socially purposeful jobs (subsidized jobs in private sector). The latter includes start-up loans. Source: National Labor Office of SR, Ministry of Labor, Social Affairs and Family of SR

Stocks of created jobs were built up, in the course of 1992, to approximately 120 thousand, and then stabilized. The stocks were strongly built up after two major inflows of equal size. These inflows occurred in the financing boom of 1992, and in the first half of 1995. The latter inflow was a result of the changed priorities in 1995, that resulted in more means being put into publicly useful jobs at

the expense of other programs. After the large inflows, the stocks were rapidly depleted because of the limited duration of publicly useful jobs. The large numbers of trainees in 1992 were due to the boom of active labor market policies in Slovakia, and were connected to the split of the Czecho-Slovak Federal Republic. Means for the active labor market policies in the federal budget had to be spent prior to the split of the federation.

The structural considerations of labor market mismatch presented in earlier sections of this chapter imply that there is a potential scope for the structural active labor market measures, such as retraining and the promotion of labor mobility. However, at the current stage, the absolute lack of vacancies does not allow for a successful application of these tools. First of all, it is necessary to boost the job creation. This could be done by subsidized job creation within the active labor market programs, but the volumes of jobs created in that manner will never be sufficient. For example, the stocks of existing socially purposeful jobs and publicly useful jobs never exceeded the level of approximately 150 thousand during the period 1990 – 1996. The numbers of registered unemployed (not speaking about other job seekers) are close to 400 thousand.

**TABLE 20. Retraining of Unemployed and Employees Provided by Labor Offices**

	1992	1993	1994	1995	1996	1997	1998		
<b>Persons in Retraining</b>									
End of Year Stock	10 282	4 432	3 744	4 666	3 772	7 494	1 194		
% share									
Unemployed	73	72	78	80	84	91	87		
Employees	27	28	22	20	16	9	13		
<b>Expenditures</b>									
Total (million SKK)	70.7	117.4	108.2	164.1	200.6	257.6	167.0		
% share									
Unemployed	96	96	96	97	98	97	98		
Employees	4	4	4	3	2	3	2		
<b>Expenditures / Inflow</b>		1995		1996		1997		1998	
Total ( thousand SKK)		8.0		9.0		9.6		11.1	
Unemployed		8.3		9.5		10.0		11.3	
Employees		3.2		2.8		4.4		5.5	
<b>Successful Completion / Inflow (%)</b>									
Total		-		104		87		142	
Unemployed		101		103		85		140	
Employees		-		116		105		195	

Source: National Labor Office of SR

## BOX 2. Evaluating the Effectiveness of ALMP Programs.

It is quite complicated to assess the effectiveness of ALMP programs. Studies based on an analysis of individual data are usually skewed by a certain selective bias. This bias makes it more difficult to interpret the results. Positive effects of a program on an individual are usually measured by the individual's increased probability of gaining permanent employment after participating in the program. Program participants are compared to other unemployed, although it is very difficult to account for the non-random process of selecting program participants. If a certain program is aimed at a given group of unemployed, there is a risk that the probability of gaining employment for this group is systemically skewed by certain factors characteristic for the group that differentiate it from other groups of unemployed. It is then hard to interpret comparative results with individuals who have not participated in the program. Studies based on individual data can yield conflicting results, and promote moreover with ambiguous interpretation.

The general practice of ALMP program implementation poses another problem in evaluating their effectiveness. Local offices are frequently evaluated according to their success in implementing the various programs. The number of retrained persons who found a job after attending training may serve as one indicator of success. An effort to reach high effectiveness can then lead to a tendency to only include more "able" individuals who do not have to depend on the labor bureaus' assistance. The "hopeless" cases, such as the unqualified unemployed, may gradually become long-term unemployed. Earlier participation in the programs may be able to prevent such a result. In many OECD countries, there is a growing belief that it is better to prevent long-term unemployment from arising than to have to focus on getting the long-term unemployed back to work.

Many selective distortions of results in researching the effectiveness of ALMP programs can be avoided by analyzing aggregated data. This data usually include the entire set under scrutiny (all Slovak districts, for instance). But the analysis of the aggregated data also poses certain difficulties. Some processes are difficult to identify in aggregated data. For instance, in assessing the outflow of unemployed due to participation in ALMP programs, a certain turnover of unemployed within the same jobs is not taken into account. Several registered unemployed may take turns in the same job, while the rest of them return into registration. These multiplication effects result in overestimation of the real effect of created jobs on the outflow of unemployed and result in underestimation of the program costs per participant.

The so-called dead-weight loss and substitution are further factors obfuscating the real effects of ALMP programs on the labor market situation. The dead-weight loss means that funds for ALMP are used to create jobs that would have been created even without support from ALMP funds. This problem is particularly noted when jobs are created in the private sector (in our case with the so-called socially beneficial jobs or their current modifications). In this situation, access to credit is difficult or almost impossible, ALMP funds substitute for loans that should come from the banking sector. Labor market institutions cannot effectively find out whether an entrepreneur applying for a subsidy to create a job really depends on the subsidy or whether he would have created the job without it. In the latter case, the subsidy is partly substituting for a bank loan.

Source: Lubyová, CPHR, 1997

TABLE 21. Selected Results of a Study on the Effectiveness of the Use of Funds from the Employment Fund of the Slovak Republic (Liška, Prušová, Bradáčová, 1996)

	LUCENEC		RIMAVSKÁ SOBOTA	
	1994	1995	1994	1995
Number of Jobs				
SBJ	533	1314	1 005	2 313
PWJ	172	907	335	2700
Dead-weight (a)				
SBJ	-	45 – 51 %	-	52 - 68 %
PWJ	-	10 – 35 %	-	11 - 14 %
Prematurely Terminated Jobs				
SBJ	20 %	20 %	-	-
PWJ (< 6 mon.)	22 %	52 %	0 %	23 %
Effectiveness of Spending (b)				
SBJ	-	49 – 55 %	-	32 - 48 %
PWJ	-	65 – 90 %	-	86 - 89 %

Notes: „ - “ denotes that data are not available. (a) The percentage of jobs that would have been created even without support from ALMP funds (expert estimate). (b) The corresponding share on expenditure (100 % - % of dead-weight). Source: Liška, Prušová, Bradáčová (1996), Hodnotenie efektívnosti vynakladania finančných prostriedkov z FZ SR na aktívnu politiku zamestnanosti v okrese Lucenec a Rimavská Sobota, The Research Institute of Labor, Social Affairs and Family, Bratislava

The development in retraining (captured by Table 20) documents poor usage of this instrument. Between 2 and 4 % of the overall retraining budget were annually spent on the retraining of employees. At the end the 1992, employees represented almost one third of the trainees. Later, their share declined to about one tenth of the retrained persons. Expenditures per trainee are lower for the employed. Labor offices provide up to 50 % of costs and, in justified cases, the coverage may be even higher. The contribution is conditioned by the prevention or reduction of mass layoffs, or by the condition of at least 12-month employment after the course completion. The rate of successful course completion within separate calendar years appears to be higher for employed trainees than for unemployed (table 20).

A case study from two Slovak districts of Lucenec and Rimavska Sobota (Liska et al., 1996b) indicates that the rate of success in retraining of unemployed was rather high. In 1994, about 80 % of retrained unemployed were placed in jobs after completing their retraining. In 1995, the share was close to 60 %. Possibly this was a result of the practice that an ex-ante promise of job-placement was required by many labor offices before retraining. When one considers the severe shortage of reported vacancies, the strategy does not appear unreasonable.

In most Slovak districts, retraining has been applied modestly when compared to the subsidized job programs. The high share of poorly educated people found in long-term unemployment (almost 80 % of long-term unemployed have less than complete secondary education) indicates the need for sizeable retraining after the job creation is boosted.

Problems arising in evaluating the effectiveness of ALMP programs are treated in greater detail in Box 2. No systematic studies of dead-weight losses have been carried out in Slovakia. The data available are either anecdotal by character or based on expert estimates. Emmerich (1994) dealt with a program of socially beneficial jobs (SBJ) and states in his study that at a seminar for entrepreneurs, using an SBJ program, five of the seven entrepreneurs present said that the jobs concerned would have been created even without financial support from the labor bureau. Although they represent a small sample of entrepreneurs, the number of jobs then created was relatively high. In total, they have created 207 jobs since 1991, 156 of that subsidized through an SBJ program. Líška, Prušová, Bradáčová (1996) tried to estimate the dead-weight loss of funds used for ALMP in two Slovak districts – Lucenec and Rimavská Sobota. Their data was based on expert estimates, and the results for the various programs are summarized in Table 21.

The above-mentioned substitution effect is another undesirable phenomenon of ALMP programs. This means that a subsidized job has to be taken by a registered unemployed or a member of a certain target group (e.g., a recent graduate). The person then in essence takes the job opportunity from another applicant. That applicant may be unemployed or is not yet unemployed may become unemployed as result of this substitution. The effects of substitution and dead weight losses are not unique to Slovakia. They occur wherever ALMP programs are used. Empirical research has been focused on evaluating job creation support in the private sector in Australia (1989), Norway (1989) and the Netherlands (1992), and was summarized in a study by Calmfors (1994). The research has come to the alarming conclusion that both of these problems have jointly affected 70 to 90 percent of funds expended to support the creation of these jobs. In Sweden, research found that measures aimed at preventing lay-offs at enterprises in crisis are far more effective (up to 40 %) than measures aimed at creating new private sector jobs. However, one needs to keep in mind the nature of these lay-offs in Sweden and in transition economies may extend the agony of unsustainable enterprises. Attempts to prevent lay-offs may increase the risk of dead-weight effects and violate the Employment Fund's proclaimed insurance principle.

## 7.7 Disincentive Effects of Pensions and Social Benefits

The disincentive effects of pensions and social benefits are among the most dominant issues related to the labor market and social insurance system in Slovakia. This section briefly presents several simulations comparing the rate of substitution of labor income with social income for selected types of households. The level of minimum income and the composition of households fundamentally affect the defined levels of social benefits of the given household and it also affects the potential disincentive effects in terms of employment. Developments in minimum income for selected types of households and its relationship to gross income from labor (minimum wage and average wage) are presented in Table 22.

TABLE 22. Developments in Minimum Income (MI), Wages and Living Costs in the Initial Period of Transition and at Present.

MI by Household Type	1991	1992	1993	1994	1995	1998
1 Adult	1 700	1 700	1 980	1 980	2 180	3 000
2 Adults	3 050	3 050	3 510	3 510	3 850	5 100
2 Adults + Child 0-6 yrs.	4 100	4 100	4 710	4 710	5 190	6 450
2 Adults + 2 Children 0-6 yrs.	4 500	4 500	5 160	5 160	5 650	7 800
2 Adults + Child 15+ yrs.	5 000	5 000	5 720	5 720	6 320	6 870
2 Adults + 2 Children 15+ yrs.	5 800	5 800	6 620	6 620	7 240	8 640
Minimum Wage	-	2 000	2 200	2 450	2 450	3 600
Average Wage	3 748	4 519	5 261	6 088	7 144	9 600
Cost of Living Index (1989 = 100)	173	191	235	267	293	351

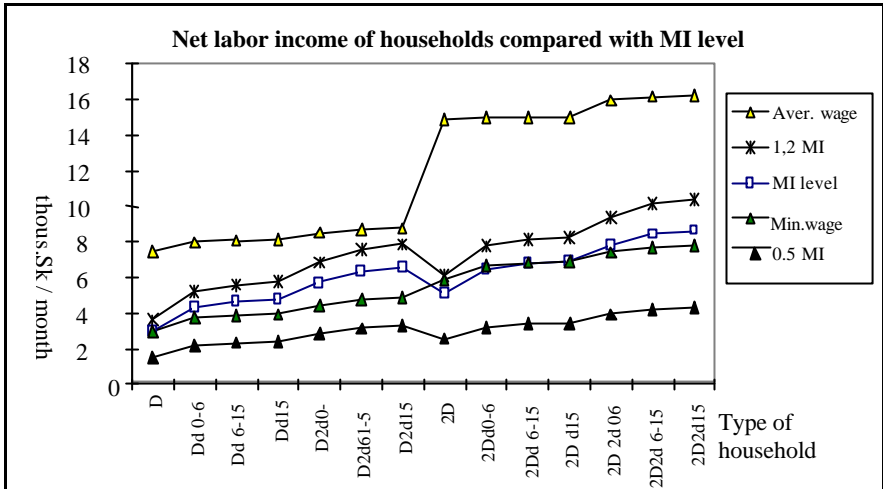
Source: Hanzelová, Kostolná, Lubyová, 1999

The intensity of disincentive effects on the minimum income institution can be viewed in the example on selected types of households. Law no. 195/1997, on social assistance, set limits on guaranteed income according to need. In further treatment of disincentive effects of social benefits, we have to distinguish among cases of work activity (entitlement to have income augmented to the level of 1.2 times the minimum income), cases of material need for objective reasons (entitlement to have income augmented to the level of 1 times the minimum income) and cases of material need for subjective reasons (entitlement to have income augmented to the level of 0.5 times the minimum income). The following figure depicts the situation in the development of income from labor for various types of households in comparison with the guaranteed income limits. Chart 5 shows that households with income from labor at the level of the average wage, a 1.2 multiple of MI does not pose disincentives, since their income from labor does not fall below this level. The situation differs for households where income from labor is equal to the minimum wage. Labor activity will lead to a higher income

due to the implementation of the new limit at 1.2 times MI for all households (the 1 times MI limit would only apply to raising the income of households with a single adult). The 1.2 times MI limit thus presents new stimuli for households with two adults. Without the new limit, income from labor in these households would virtually copy the 1 times MI level and income would be unlikely to increase due to labor activity. The 0.5 times MI level appears very low in comparison with income from labor of groups earning the average wage. The difference for the group earning the minimum wage is not significant, but labor activity on the average doubles the income in comparison with the status of material need for subjective reasons.

Children allowances are among the benefits that are most often blamed for providing disincentive effects for employment, especially since the introduction of means-testing. The introduction of two levels for entitlement leads to a situation where an increase in gross labor income leads to a decline in net household income. This is attributed to a reduction or complete elimination of child benefits. The existence of such limits may act as a disincentive, for instance in deciding whether one or both parents of dependent children should seek employment. Limits for gross income from labor of households whose net income declines due to the loss of entitlement for family benefits depend on the income from labor and the households' make-up. For instance, if a household with two adults and a child younger than 6 years exceeds the 1.28 times the average wage limit, its child benefits will be reduced. If it exceeds the 1.78 times the average wage level, it will lose child benefits completely. The elasticity of total net income of households with respect to gross income from labor is negative in certain discrete intervals. Net income decreases if gross income increases due to a reduction in or the loss of entitlement to child benefits. The level and magnitude of income decline increases with the number and age of dependent children.

CHART 5. Situation of Various Types of Households in Various Positions of Material Need.



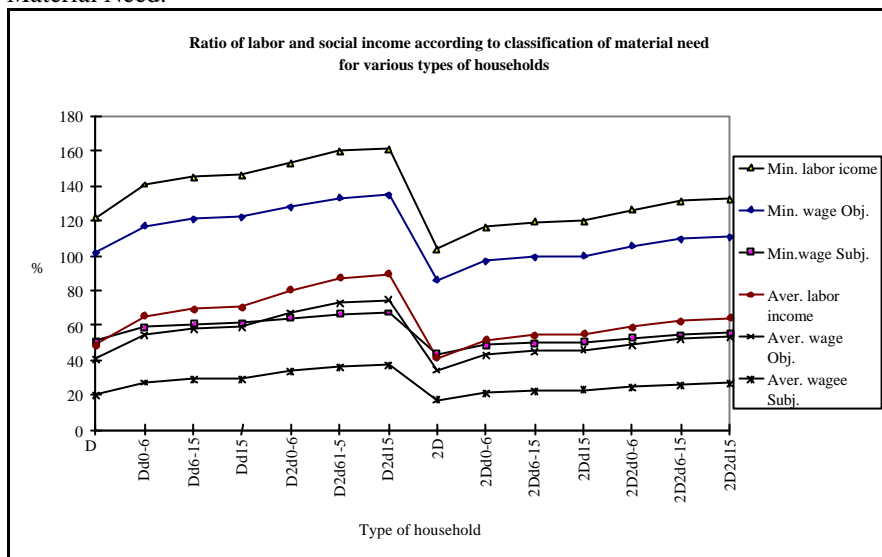
Note: Explanation of x-axis labels: The type of households is determined by the number and age of its members. “D” denotes adults, “d” denotes children; number before the letters D or d denote the number of adults or children; numbers at the end mark the age interval of the children. (For example, 2D2d6-15 denotes a household consisting of two adults and two children between 6 and 15 years of age. Source: Hanzelová, Kostolná, Lubyová, 1999

Chart 6 illustrates the so-called rate of substitution of labor income by social income consisting of social benefits (according to the law on social assistance) and child benefits. In the case of labor activity, it is the rate of income substitution from labor. This is determined by a combination of labor and social income that augments overall income to the 1.2 times minimum income level. We can see that the substitution rate significantly exceeds 100 percent for low-income households (up to 160 percent depending on the number of children) that have adults working for the minimum wage. In the case of objective need, the rate of substitution exceeds 100 percent if the household includes dependent children.

The rate of substitution is relatively low for households with average potential income from labor. Similarly, the rate of substitution is quite low for low-income households in need for subjective reasons – between 40 and 60 percent in all cases. It is debatable whether or not a 60 percent rate of substitution would act as a disincentive. There appears to be no general answer to this question. The overall disincentive effects of these social benefits depends both on the number of households in each category and on their subjective preferred rate of substitution of labor income by social income.



CHART 6. Situation of Various Types of Households in Various Positions of Material Need.



Notes: Explanations for the graph: X-axis labels – see explanation of Chart 5. Average wage and minimum wage denote the income from labor of adult members of the household. Employed denotes the situation when adult members of the household are employed, Obj. and Subj. denote the scenarios when adult members of the household are not employed, but are entitled to social benefits augmenting household income to the appropriate minimum income level (objective reasons for material need) or to the level of half the minimum income (subjective reasons for material need). Source: Hanzelová, Kostolná, Lubyová (1999)

A registered unemployed is a typical example of a socially dependent citizen. We have therefore focused on assessing the rate of substitution of labor income for the unemployed throughout the duration of their unemployment. Since we again take into account social benefits, we have to employ the concept of model households. The decline in the rate of substitution is greater for higher income households. For low-income households, the rate is 80 percent and it declines to 40 percent only in the case of subjective material need. For households earning the average wage, the rate of substitution oscillates around the 50 percent level while receiving unemployment benefits. In the case of objective material need, it occasionally falls below 50 percent after a shift to social benefits. The presence of children raises it above this level, especially for households with a single adult. The rate of substitution, in the case of subjective material need, falls to about 30 percent. This can be considered low enough to rule out disincentive effects.

In general, we can conclude that disincentive effects of social benefits in the Slovak Republic exist, but apply to very specific situations that are dependent on the composition of households and the potential income from personal labor. Disincentive effects for low-income households with dependent children may be quite strong. However, one must exercise caution in making general judgements because disincentive effects depend on subjective factors.<sup>109</sup> We can conclude that the recent introduction of stricter conditions for social benefit entitlements (the introduction of the so-called subjective reasons for material need) have markedly reduced their disincentive effects. But the effect of this reduction may not be significant since a shift to employment depends on objective conditions in the labor market. These conditions are critical at present.

## 7.8 Conclusion

The current economic situation in Slovakia negatively affects the labor market. Although Slovakia has recorded fairly rapid economic growth measured by GDP developments since 1994, this growth has not had an effect on employment, particularly in terms of job creation.

Throughout the 1989-1995 period, the state of overemployment has persisted. It has established that real output declined more when compared with 1989 levels than did employment. Only in 1996 did the gross labor productivity indicator (measures as the ratio of real GDP to total employment) rise above 1989 levels. The slow implementation of key structural reforms is largely responsible for this situation. Keeping unprofitable enterprises alive (for example by postponing bankruptcies or preparing revitalization plans) has contributed to maintaining employment, that has in turn slowed down and postponed restructuring. The elimination of some of these restructuring barriers in the 1998-99 has led to a decline in employment. This decline seems likely to continue because only restructured enterprises can create more job opportunities.

In terms of changes in the sectoral structure of employment, Slovakia has followed much the same path as other transition economies. Approximation to EU employment structure can be expected to lead to further transfers of employment from industry to services. This shift will most likely occur through higher unemployment (as long as job destruction outpaces job creation).

Slovakia is marked by significant regional differences. Bratislava differs greatly from the rest of the country in terms of GDP, in terms of the concentration of entrepreneurial activities, and foreign investment. The Slovak labor market is

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<sup>109</sup> Some people may for instance prefer employment that bring income roughly equal to social benefits, since it keeps them socially active and may present a perspective of higher income from labor in the future.

also permanently marked by high regional segmentation and significant differences in unemployment levels. Bratislava has traditionally had the lowest unemployment and the Rimavská Sobota district has had the highest. The spread between registered unemployment levels in various districts has been increasing in the long term and is currently exceeding 30 percentage points. Internal mobility of the population had once declined by about 20 %. This occurred during the 1990-98 period.

At present, it is difficult to speak of structural unemployment in Slovakia (i.e., of unemployment caused by imbalances between job openings and the unemployed in terms of profession, education, location, etc.), since the number of job openings is negligible in comparison with the number of the unemployed. In the short term, the room to apply structural labor market policy instruments, such as retraining or labor mobility support, is limited. But the need for retraining and education will increase significantly after job creation recovers. The education level and qualifications of the Slovak labor force are far from optimal. There is a dominance of unqualified workers among the long-term unemployed and a lower share of university students among 18-24-year olds than in the EU. There is also a lower share of employment in the tertiary sector (qualification-intensive) than in other EU countries. Education and retraining can play a particularly large role for the Romany ethnic group. This ethnic group is currently in desperate position in the labor market.

Economic activity of the population has declined to levels comparable with the EU average during the economic transition period and is not expected to significantly decline further and reduce the supply of labor. International migration has a negligible effect on the Slovak labor market. The share of legally employed foreigner on the total workforce was 0.23 % in 1998 and their share on total employment was 0.27 %.

The Slovak labor market is very rigid in the use of working time and part-time work. LFS data suggest that most economically active individuals are either employed full-time or unemployed. Employers achieve required flexibility by the use of limited-period contracts. This promotes labor market segmentation by singling out a marginalized group of limited-period or seasonal workers. This group is the first to be affected by unemployment at times of crisis. Low registered shares of workers with a second job may indicate a higher degree of unregistered activities.

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## 8 Funding of Social Security

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Until 1990, social security had been part of a sweeping social policy that was conceived in the fifties and sixties, and up until 1993, it had been funded from the state budget. The existing comprehensive system of benefits catered to the needs of the citizen from the cradle to the grave coupled with poorly differentiated wages.

The 1990s was a time of dramatic social and economic changes. A new economic situation called for addressing the new social phenomena (such as, for instance, unemployment). In conjunction with addressing the above phenomena, there grew a need to draft and implement systematic changes in social policy, since the then welfare system was a burden to the economy in transition. Among the earliest interventions into the system was the introduction of the principle of benefit targeting. Despite the positive input of other implemented changes, the fact whether these measures were systemic by their nature, especially from the point of view of an actual need to change the concept, needs to be questioned.

The earliest comprehensive concept of the welfare system transformation was drafted as late as 1996. The social security system leaned on three fundamentals: social insurance, state social support, and social assistance. Significant delays accompanied the implementation of the individual reform steps and a number of them (i.e., acts) were never put into effect. Among the greatest inputs of this concept was a change in the State-citizen relationship. State assistance is conditioned by material and social need which an individual is unable to cope with on his/her own, and neither can he/she be helped by his/her family.

In the autumn of 1999, a draft of a new social insurance concept was introduced, taking into account the reform steps that had been undertaken earlier. The proposed system of social insurance includes all the state-regulated benefits that are paid out on the basis of the paid insurance premium. The individual portions of insurance will be structured by the nature of the insurance (basic, obligatory, optional, commercial). A common feature of both concepts is the need to enhance the citizen's personal responsibility.

## 8.1 Introduction

The objective of this chapter is to present an analysis of the basic conditions that establish the core of the welfare system in Slovakia. The purpose of this part is also to highlight the correlation between the condition of the economy and the standard of the welfare system. The chapter is broken down into two parts. The first part contains a description of the adopted concepts of the welfare system transformation and the steps implemented, as well as its institutional development. The second part analyzes the creation of resources, social security expenditures, and the management of the pension security and sickness insurance fund. The relevance of this chapter is supported by data obtained from the Statistical Office of the Slovak Republic, and international comparisons involving data collated from available foreign sources.

## 8.2 Social Reform

The federal scenario of the social reform that formulated the fundamentals of the new welfare system was elaborated, together with the scenario of economic reform, in the autumn of 1990. In 1991, the foundations of the employment policy and wage income policy were adopted.<sup>109</sup>

In Slovakia, after the 1992 elections, an act on social and health insurance was hastily passed, and the Slovak Administration of Social Security was renamed the National Insurance Company in order to operate as an umbrella organization for all insurance funds (i.e., pension, health, and sickness funds). Under pressure from the International Monetary Fund, the principle of a targeted granting of child allowances and the state compensatory grant was introduced. In 1994, the National Insurance Office was split, and the original Slovak Administration of Social Security was changed to the Social Insurance Office. The system of health insurance was conceived in a novel way, and a pluralist system of social insurances was introduced.

Social reform in Slovakia is to be seen in the context of two facts. The first concerns the relationship between social policy and the economy (i.e., employment issues). After 1989, there were efforts made to introduce an equilibrium into this relationship, and it was assumed that the adopted sociopolitical decisions would facilitate the establishment of a sound economic environment in the country.

Another fact concerns the relationship between the newly drafted system of social security and the system of social security inherited from the previous period.

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<sup>109</sup> The new taxation system was adopted by the Federal Assembly of the CSFR in April 1992.

Originally, as the transformation concept indicated, these goals were to be met by passing and enforcing nineteen acts related to labor activities and twenty-one acts related to social security. The anticipated deadline was January 1, 1998, and it was to largely involve amendments of acts.

The concept of the welfare system transformation was approved by the National Council of the Slovak Republic in January 1996; it concerned the establishment of a social protection system. This system was based on three fundamentals:

- social insurance;
- state social support;
- social assistance.

### **8.2.1 Social Insurance**

In the 1996 concept, the following was included under social insurance by the architects of the reform:

- sickness insurance<sup>110</sup> which consists of a system of benefits of short-term nature that are funded continuously from the resources composed of the insurance premium paid by employers, employees, and the State to the public Social Insurance Office;
- pension security<sup>111</sup> which is composed of a system of benefits of long-term nature funded in a fashion similar to sickness insurance;
- supplementary pension insurance<sup>112</sup> tying into pension insurance and regulated by the State; these are based on the employer-employee principle and funded from the contributions remitted to the individual accounts of insured persons;
- indemnification for occupational injuries and occupational diseases which is currently ensured by the commercial Slovak Insurance Inc., based on the employers obligatory liability insurance.

Despite the fact that social insurance was conceived as the core of the entire system in the 1996 concept, its implementation reports the greatest delays. The act that was to change social security to social insurance was not passed. Among the

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<sup>110</sup> Sickness insurance is set forth in the Act No. 54/1956 Coll. on the sickness insurance of employees and the Act. No. 32/1957 Coll. on sickness care in the military, as amended. It includes sickness benefits, family care benefits, compensatory grants in pregnancy and maternity.

<sup>111</sup> Pension security is laid down in the Act No. 100/1988 Coll. on social security, as amended. It includes old-age pension, pension for the years worked-off, widow's/widower's annuity.

<sup>112</sup> Supplementary pension insurance are set forth in the Act of the National Council of the Slovak Republic 123/1996 Coll. on supplementary pension insurance of employees. The Act was put into effect on July 1, 1996.



reasons for not passing the act is the fact that if the insurance principle were to be introduced, this would entail the elimination of all the features of false solidarity from the current system; therefore, the amount of pension would correlate directly with the overall amount of the insurance premium paid. The current system computes the pensions based on the 1998 act which ignores the current wage differentiation and wage dynamism. Actually, the computation considers only income up to SKK 10,000 and ignores higher income. This is so despite the fact that for several consecutive years, the upper income limit for the payment of insurance premium contributions has equaled eight times the minimum wage (SKK 32,000 presently). So, instead of insurance, one is concerned with an odd combination of tax and insurance, whereby it is viewed as insurance in an income up to SKK 10,000, while above this amount, the income is taxed, in fact (outside the framework of personal income tax and other transfers), by a 27.5 percent tax rate, which is paid jointly by the employer and employee.

In the social insurance area, the act on supplementary old-age insurance was passed which, however, does not include all employees. It does not cover the employees of organizations funded and co-funded from the state budget, and neither does it include self-employed professionals. This situation should be resolved by passing an act on civil service, and in the case of self-employed professionals, by an amendment of the tax law that is envisaged to introduce tax allowances for supplementary old-age insurance. The said act allows for the participation only of those employees in supplementary old-age insurance whose companies have decided to contribute to supplementary old-age insurance.<sup>113</sup> Hence, the participation of an employee is contingent on the participation of his/her employer. This limiting factor together with the economic situation in companies has resulted in the limited use of this instrument.

The Czech Republic, for example, has opted for the "civil" principle and passed an act on supplementary old-age insurance with state contributions. So, as opposed to Slovakia, any citizen of the Czech Republic is eligible to supplementary insurance and a state contribution irrespective of his/her employer. Since February 1994, when the said act was passed in the Czech Republic, over forty pension funds have been established that manage the contributions of 1.5 million clients. With pension funds operating for several years already, it may be stated that the system of supplementary old-age insurance is widely used as a system of short-term savings.<sup>114</sup> The original idea of establishing long-term funds

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<sup>113</sup> As of December 31, 1998, three insurance companies, operating in the Slovak Republic, effectively provide supplementary insurance.

<sup>114</sup> A cap of Kc 500, at which the state contribution is still raised, is too low to encourage bigger savings. In addition, a guarantee in the event of a pension fund bankruptcy is non-existent; the state contribution is not indexed, and the like.

available to the capital markets has been materialized, in both countries, in order to encourage citizens to save over the long-term.

### **8.2.2 The State Social Support**

The state social support is to be composed of a system of direct financial contributions of the State, to partake in the solution of some events in the lives of families and citizens.

As early as the spring of 1992, the first draft of the system of benefits was agreed between the national and the federal ministries of labor and social affairs. The basis of this system are contributions associated with children in families.<sup>115</sup>

In 1994, an act on child allowances<sup>116</sup> was passed which enacted the very first allowance of the future system of state social support. This act introduced a targeted granting of the allowance, which means that the allowance is granted to a person who really needs it. The allowance is also bound with the income of persons under review and their subsistence level.

### **8.2.3 Social Assistance**

Although the earliest principles of the act on social assistance were drafted in early 1992, the act was passed as late as May 1998.<sup>117</sup> It fulfilled the Article of the Constitution of the Slovak Republic No. 39, Para. 2, which ensures that he/she who is in material need, shall be rendered necessary assistance. The replacement of the concept of “social care” by “social assistance” is to express more appropriately the fundamental change in the approach of the State to the citizen, who is in need. The change lies in the fact that the role of the State is only to assist the citizen in overcoming his/her crisis situation, whereby it is expected that the citizen will actively seek ways out and solutions. Hence, the rendering of social assistance is conditioned by material and social need an individual is incapable of coping with by himself/herself or with the help of his/her family.

The act stipulates the forms of coping with the citizen’s material or social need. The forms include: social counseling, legal protection, social services, social assistance benefits, services, and monetary benefits to offset the social consequences of severe disabilities. These benefits are derived from subsistence levels.

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<sup>115</sup> Includes child allowances, parental allowance, and child birth benefits

<sup>116</sup> The Act of the National Council of the SR No. 193/1994 Coll. on child allowances and additional child allowances invalidated the state compensatory grant for children which was temporarily introduced at the time of price deregulation in 1990. The amendment No. 196/1998 changed the allowance amount.

<sup>117</sup> The Act of the National Council of the SR No. 195/1998 Coll. on social assistance.

In 1998, the Subsistence Level Act<sup>118</sup> was passed from which claims for additional poverty level benefits are derived. The Act lays down the concept of subsistence level as a socially recognized minimum income level of a natural person below which the condition of material need takes place. The monetary limit is set on the basis of the evaluation of the income of the other members of the economic household; therefore, the limit varies depending on the various household structuring. The benefit represents a difference between an individual's income and his/her subsistence level, and is set depending on the causes of material need (subjective reasons and objective reasons), and (not)having wage-earning revenue.

The adjustment of the subsistence level will be implemented so as to reflect the growth of the cost of living index in the low-income employee group.<sup>119</sup>

Currently, there is a new Concept of the Social Insurance Reform in the SR which was presented for public discussion by the Ministry of Labour, Social Affairs, and the Family of the SR in autumn 1999. The new concept observes the starting points laid down in the basic concept of the social security transformation from 1990 to 1992 that were subsequently elaborated in the Concept of the Transformation of the Social System in the Slovak Republic, of 1996, whereby emphasis was laid on the enforcement of the basic principles of social solidarity, targeting of the benefits granted, while observing the citizen's participation in the enforcement of his/her rights and the enhancement of the citizen's personal responsibility for his/her fate.

It interprets social insurance more broadly than the present state of law and includes all the state-regulated monetary benefits paid out on the basis of paid insurance premiums or contributions. Social insurance will be composed of the following:

- sickness insurance that rests on an obligatory, basic pillar of short-term benefits (presently, sickness insurance benefits) and optional pillar of supplementary short-term benefits (non-existent at present);
- pension insurance that leans on a mandatory system of long-term benefits that will consist of the obligatory pillar No. I financed by a PAYG system of

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<sup>118</sup> The Act of the National Council of the SR No. 125/1998 Coll. on subsistence level and the setting of amounts for the purposes of state social benefits.

<sup>119</sup> The subsistence level amounts will be, as a rule, adjusted at July of the current calendar year. As of July 1, 1998, the subsistence level per adult was set to SKK 3,000. For the purposes of this Act, low-income level households are deemed households the income of which does not exceed the upper limit of the income of the first twenty percent of all the households, arrayed in an upward fashion by the reached net monetary income per inhabitant. The crucial period, for which the cost of living growth in low-income level households is monitored, is a period between the month of April of the previous calendar year and April of the current calendar year.

funding (currently, pension security benefits) and an obligatory capitalization pillar No. 2 (non-existent at present);

- supplementary pension insurance based on an optional pillar No. III of long-term benefits (presently, supplementary pension insurance benefits);
- accident insurance based on a mandatory system of accident benefits (presently, only a fragment of it exists, having the form of the indemnification of occupational accidents and occupational diseases).

A new approach to social security was inevitable, especially for reasons specified below:

- the current system is costly, demotivating, and inequitable; hence, there is a need for a diversified system of multi-source funding. The current system, especially pension security, will become insolvent in succeeding years and incapable of ensuring the citizen's claims enshrined in the law;
- the amount of the social insurance benefit ought to be appropriate to the arisen social situation and at the same time, have regard for the financial tolerability of the system;
- The current system is discriminatory, because for the same insurance premium, various benefits and allowances are granted to some categories of citizens and it does not take due account of the relationship between the payment amount and the benefit amount and the function of tax is mixed with obligatory insurance, which allows for concealing the high tax burden in the Slovak Republic.

The new concept of social insurance not only gives the reasons underlying the drafting of a new concept, but it also defines issues on which consensus must be reached and simultaneously, sets forth the basic principles supporting a new system of social insurance. Among the basic principles are:

- a) obligatoriness (compulsory participation of each and everyone);
- b) universal nature (by its nature, it covers/resolves the most common social situations);
- c) uniformity (at meeting the given conditions, each individual is entitled to equal claim);
- d) non-profit nature of organizations that are to provide social insurance;
- e) public nature of an institution that administers the obligatory part of social insurance and its management based on a tripartite model;
- f) state guarantee of a specific scope of the claims of the parties to the obligatory parts of the social insurance system;
- g) functional and independent state supervision over the administration of social insurance.

Similarly to other advanced countries and those in transition, it is essential to seek:

- a) a compromise between the amount of actual pensions provided by the basic social insurance system and the amount of contributions paid into the system;
- b) rules for a gradual addition to age for the claim to an old-age pension;
- c) a transfer of a portion of the obligations related to pensions to systems based on the principles of individual saving schemes and capitalization.

### 8.3 Pension Security

As was mentioned above, the new concept of social insurance has identified three pillars of pension insurance. The first pillar – obligatory pension insurance – financed by a „Pay As You Go“ system of funding, corresponds with the current system that will be partly preserved. A second pillar was added to the new concept, and it was inserted by the drafters between the basic and supplementary insurance. This will involve obligatory capitalization (on the citizens' personal accounts) that should be ensured by the Social Insurance Office and even a supplementary pension insurance office. The third pillar – optional supplementary pension insurance – operates based on the employer-employee principle. The basic difference between pillar III and commercially-based insurance is that in the supplementary pension (welfare) insurance companies, it is only the insured taking part in the appreciation, whereby in a commercial insurance company, it is the shareholder.

TABLE 1: The Pillars of a Future Pension Insurance

Pillar	Type of Funding	Pension Share in the Wage	Institutionally Ensured By
I.	PAYG	30 to 35 %	Social Insurance Office
II.	Obligatory Capitalisation	20 to 25 %	Social Insurance Office, Supplementary Pension Insurance Offices
III.	Optional Supplementary Insurance	20 to 25 %	Supplementary Old-age Insurance Offices
IV.	Individual Commercially-Based Insurance	Unlimited	Commercial Insurance Companies, Investment Companies, Commercial Banks

The amount of coverage of pension claims relative to the gross lifelong income, in percent.

Source: [www.employment.gov.sk](http://www.employment.gov.sk)

The advantage of a PAYG system of funding is the inter-generation solidarity, which, however, leads to an intertemporal financial redistribution and, under certain conditions (the decline of the share of economically active population), is a growing burden on the economically active population. Among the risks of the social system may also be the demographic risk which arises if the

contributor-beneficiary proportion drops below a certain level (as a rule, below 2:1). It is assumed that in the year 2000, this proportion will be 1.4:1, and in 2020, only 1:1.

The above data corroborate the fact that the reform of pension security has to be implemented without delay. Arguments about the current alarming economic situation which is unfavorable for a successful transformation of the system, do not hold. Realistically, the postponement of the reform would be of a much greater burden to the social sphere, and, consequently, the entire economy.

TABLE 2: Anticipated Development of the Proportion of an Average Monthly Number of Economically Active Insureds and an Average Monthly Number of the Paid-out Benefits

Year	1998	2000	2010	2020	2030
Pesimistic Scenario	1.69	1.38	1.25	1.00	0.86
Optimistic Scenario	1.69	1.40	1.30	1.05	0.90

Source: The social reform concept, Ministry of Labour, Social Affairs, and the Family of the SR

The advantage of capitalization is that the deposited funds are held on personal accounts, which enhances the target-oriented nature and convenience of the system of creation and disbursement of the funds of the insureds. By pooling the funds, these are made available for use in long-term investments in the economy. The disadvantage of the capitalization system of funding is its sensitivity to the stability of the economic and financial environment and also the time necessary for the pooling of funds. Another drawback is that the price of the transformation must be paid – during the transitional period, both systems must be operated which results in increased costs.

It is envisaged that the transition from pension security to pension insurance will take some twenty-five years. Despite a gradual transition to a new system, the architects of this concept are aware of the shortage of funds necessary for paying out regular old-age pensions. Therefore, to cover these, it is suggested that the income from privatization (i.e., the Polish example) or the bonds of the National Property Fund of the SR be used.

## 8.4 Sickness Insurance

Only recently, discussions were held concerning the transfer of a portion of the means from the sickness insurance fund into health insurance, or, merging these two funds. This, in fact, is a scenario that was proposed back in 1994, which was also a time of serious financial problems for the health sector. This scenario leans on the experiences of some West-European countries, in which the systems

of health and sickness insurance are interconnected. The arguments supporting this merger point to the necessity to meet the condition underlying the eligibility of benefits (i.e., sickness); hence, treatment costs are correlated with the costs of the compensation of income in sickness. The proponents reason that once both systems are interlinked, a motivational factor of a speedy and efficient treatment with an objective to economize on sickness insurance will be introduced into the system.

The counterarguments of the Social Insurance Office point to a different nature of these insurance schemes. Social insurance, including sickness insurance, is based on individual merits, whereby health insurance is based on the principle of full solidarity. Subordinating sickness insurance to health insurance would result in a continuous growth of claims upon insurance funds which would not be limited merit wise, and in the event of their insolvency, these claims would have to be honored from the state budget as the guarantor of the Insurance Office. Independent insurance systems, thanks to a merit-based concept of sickness insurance, exert some pressure on a more cost-efficient use of health insurance funds. By merging the funds, money would be simply be transferred from one fund to another.

A new concept of social insurance gives a clearer picture of the direction of the sickness insurance reform. Sickness insurance makes a distinction between a short-term (initial) disability and a long-term disability. The short-term (initial) disability (within the 15<sup>th</sup>, or, 8<sup>th</sup> day) will be compensated by the employer, whereby the rate (percentage) of the payments of the contributions to sickness insurance will be proportionally reduced. After implementing the social insurance reform, this portion of the present sickness insurance will no longer be part of social insurance. The insurance of long-term disability (from the 15<sup>th</sup>, or, 8<sup>th</sup> day onwards) will be part of the system of short-term benefits within the framework of social insurance. It will be implemented through the obligatory pillar No. I of short-term benefits and funded from the contributions of employers, employees, and self-employed professionals; it will be administered by the Social Insurance Office. The State will regulate the system and guarantee its funding.

## **8.5 The Creation of the Social Security Resources**

The management of pension security and sickness insurance funds falls under the authority of the Slovak Insurance Office as a public institution. Its income is derived from the payments of insurance contributions by employees, employers, and self-employed professionals. The National Labour Office (NLO) pays contributions instead of the unemployed kept on the records of labor offices, and the State pays contributions in favor of selected groups of citizens (children,

soldiers, students, etc.).<sup>120</sup> According to statistical data, the average number of the insureds in the Social Insurance Office(1997) was reported to be 3,063,706 persons in sickness insurance, and 3,159,891 in pension security.

TABLE 3: The Management of Funds by the Social Insurance Office in the Years 1996-1998, (in billions of SKK)

	1996	1997	1998
Current Income	58.96	62.06	67.93
- Sickness Insurance Fund	7.31	9.58	9.82
- Pension Trust	50.93	51.5	56.3
- Other Income	0.72	0.98	1.81
Current Expenses	54.95	61.40	68.17
- Sickness Insurance Fund	7.39	8.12	8.98
- Pension Trust	46.09	51.00	55.88
- Administrative Fund	1.47	2.28	2.31
Fiscal Deficit	4.01	0.66	-0.24

Source: Suda, 1998

Back in 1998, the Social Insurance Office had a higher fiscal deficit than was anticipated in the 1998 budget draft. The original budget assumed a deficit of SKK 0.08 billion, and, effectively, a deficit of SKK 0.24 billion was reported. For 1999, a deficit of SKK 4.08 billion was projected, including expenses in which the raising of old-age pensions was not reflected.

There are several factors that put the income side of the Social Insurance Office at risk. A notorious, recurring example are insufficient payments of the State in favor of selected groups of citizens that are not transferred in amounts set forth in the law; on the contrary, annually, the State Budget Act sets ever-lower contributions. Other outstanding liabilities to the Social Insurance Office are due to the drafting of the rehabilitation act. Companies, lured by a vision of being included in the rehabilitation regime, cut payments into public funds. Another risk is the ever-growing unemployment (refer to the chapter on the labor market).

In 1997, the Social Insurance Office receivables totaled SKK 18.2 billion, and in 1998, SKK 37 billion. Among the biggest debtors are transformed state enterprises, medical facilities, and agricultural cooperatives.

## 8.6 Social Security Expenditures

Until January 1994, social security had been funded from the state budget. By introducing social insurance, the funding of social security was separated from the state budget and transferred to the Social Insurance Office. The major objective of

<sup>120</sup> Section 14 of the Act No. 274/1994, as amended.



this separation from the state budget was to narrow down the dependence of the running of social insurance on political decision-making, and increase the transparency of its management. At the same time, health insurance was separated from the state budget for similar reasons. However, social insurance, despite this separation from the state budget, as well as health insurance, continues to be largely dependent on it. This is largely due to the already mentioned payments of insurance premium by the State in favor of selected groups of citizens.

### 8.6.1 The Running of the Pension Fund

Over the past ten years, social expenditures have gone up in nominal terms; for instance, the sum of pension security benefits was SKK 19.05 billion in 1990; in nine-years time, in 1998, it almost tripled to SKK 57.4 billion. In spite of that, the actual value of paid-out benefits did not reach the 1989 level.

TABLE 4a: Pension Security Benefits (in millions of SKK), Current Prices

	1980	1990	1992	1994	1996	1998*
Paid-out Benefits, Total	11.560	19.051	28.013	37.145	47.391	57,421
Of Which: - Old-age Benefits	6.059	11.610	17.499	23.051	30.034	37,554
- Disability Benefits	2.864	4.116	6.035	7.889	9.761	12,084
- Widow's/Widower's Benefits	2.158	2.957	4.170	5.156	6.546	7,206

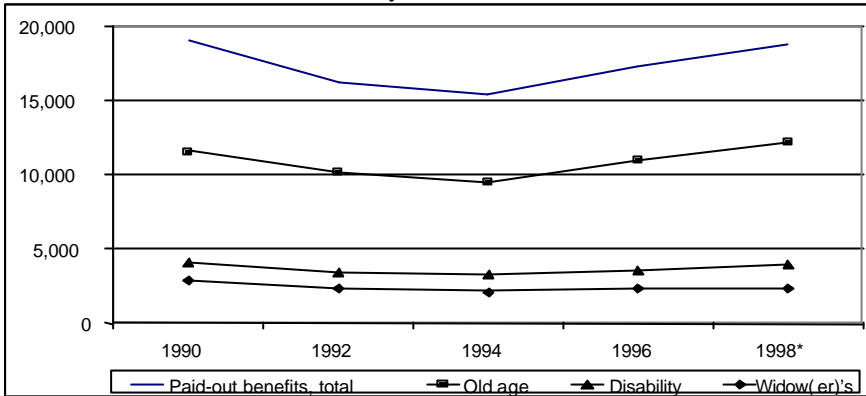
TABLE 4b: Pension Security Benefits (in millions of SKK) 1990 Fixed Prices

	1990	1992	1994	1996	1998*
Paid-out Benefits, Total	19,051	16,220	15,392	17,380	18,742
Of Which: -Old-age Benefits	11,610	10,132	9,552	11,014	12,257
- Disability Benefits	4,116	3,494	3,269	3,580	3,944
- Widow's/Widower's benefits	2,957	2,415	2,136	2,401	2,352

Source: 1995, 1998, statistical yearbooks, Statistical Office of the SR \* - Ministry of Labour, Social Affairs, and the Family of the SR

Several reasons account for the nominal (and partly real) growth of social security expenditures; in addition to inflation and a dramatic drop in the standard of living in the first transformation stage, it is the emergence of new situations that call for social protection, specifically unemployment. The fact that up until recently, the criteria for the eligibility to social benefits had been fairly soft, resulting in a higher number of ill-founded claims, and, consequently, in an increase of social security expenditures.

CHART 1: Paid-out Pension Security Benefits.



1990 Fixed Prices, (in millions of SKK). Source: Statistical Yearbook of the Statistical Office of the SR

The largest portion of Social Insurance Office expenditures are pensions. In 1998, pensions accounted for eighty-two percent of the overall current expenditure of the Social Insurance Office. By late 1998, pensioners had accounted for 21.1 percent of the population, whereby the share of old-age pensioners was 13.7 percent. In the past ten years, the number of pensioners has been steadily growing; however, considering the size of the population, one cannot speak of a dramatic increase in the number of pensioners. Therefore, it cannot be claimed that an increase in the number of pension beneficiaries accounted for an overall increase in the amount of the paid-out pension security benefits. Despite this, it should be noted that there exists an extensive group of disabled pensioners which has been reporting a moderate increase.

It is clear from Table 6 that the degree of demographic dependence (the proportion of the number of the post-working age population and the working-age population) in the countries of Central and Eastern Europe is comparable with the OECD countries (this indicator, in fact, is somewhat more favorable in the former group of countries than the latter). A statistically more favorable situation in the countries of Latin America and Asia has been conditioned by long-term demographic trends that vary dramatically from the demographic development in the majority of advanced economies. The indicator of social tolerability of the pension system (i.e., the degree of the system dependence) is rather unfavorable for the Slovak Republic, and the development in the past years has burdened the system tolerability even more.

TABLE 5: Number of Pension Beneficiaries, Number of the SR Inhabitants

	1990	1992	1994	1996	1998*
Number of Pension Beneficiaries, Total (thous.)	1,087	1,156	1,178	1,173	1,140
Of Which – Old-age Benefits	506	548	556	561	741
Disability Benefits	223	243	256	249	279
Widow's/Widower's Benefits	275	283	288	292	
Number of Inhabitants (thousands.)	5,311	5,314	5,356	5,379	5,393
No. of Pension Beneficiaries to No. of Inhabitants in %	20.46	21.75	22.0	21.8	21.1
Old-age Pension Beneficiaries, in %	9,5	10,3	10,4	10,43	13,74

Source: 1995, 1998 statistical yearbooks, Statistical Office of the SR\* - Ministry of Labour, Social Affairs, and the Family of the SR

TABLE 6: The Old-Age Pension System (1<sup>st</sup> and 2<sup>nd</sup> obligatory levels) in Transitional Economies and Selected Economies

Country	Retirement Age For Men <sup>1</sup>	Degree of Demographic Dependence <sup>2</sup> (%)	Degree of the System Dependence <sup>3</sup>	Old-age Pension Expenditures as a Percentage of GDP in the Relevant Year
Bulgaria	60	37	87	8.0 – 1995
Czech Republic	60	32	42	9.1 – 1995
Estonia	60	32	52	6.7 – 1995
Hungary	60	36	59	10.3 – 1994
Latvia	60	33	51	9.8 – 1995
Lithuania	60	30	53	4.8 – 1994
Moldova	60	26	-	4.1 – 1994
Poland	60	28	49	14.6 – 1995
Rumania	60	29	62	6.5 – 1993
Russian Federation	60	31	46	5.5 – 1993
Slovakia	60	32	42	9.9 – 1995
Slovenia	60	29	54	13.7 – 1994
Ukraine	60	36	-	8.0 – 1995
Eastern Europe, the				
Baltic States, CIS	60	30.	48.3	7.3
Asia	55.5	15.3	11.4	1.9
Latin America	60.8	14.9	21.0	2.0
OECD countries	64.4	32.9	39.2	9.2

<sup>1</sup> 1991 data. <sup>2</sup> Proportion of the size of the post-working age population and the working-age population. 1990 data. <sup>3</sup> Proportion of the number of the pension system payers to the pension beneficiaries. 1990 data.

Source: Transition Report 1996, EBRD

By comparing the development of the pension security benefits and the demographic development, the following may be stated:

- the share of the number of pension beneficiaries in the total population has not reported any marked changes (moderate increase); however, the paid-out pension security benefits in the monitored period dropped in real terms (the growth of nominal benefits did not offset inflation) and the benefits did not reach the 1990 (1989) level;
- after an initial drop in the years 1990-1992, but since 1993, there has been a growing trend in the paid-out benefits (overall, as well as monthly benefits per person);
- the most significant growth was reported in the number of old-age pension beneficiaries (they accounted for 13.7 percent share in the population in 1998 as opposed to 9.5 percent in 1990), whereby the total old-age pension benefits reported the most dynamic increase among the selected indicators (the real 1998/1990 index is 105.6 percent).

TABLE 7: Average Monthly Pension and Average Monthly Wages in the National Economy

	1990	1992	1994	1996	1998*
Old-age Pension	1,550	2,058	2,852	3,479	4,490
Disability Pension	1,413	1,940	2,714	3,305	4,132
Widow's/Widower's Pension	825	1,118	1,431	1,734	3,142
Average Monthly Wages	3,281	4,543	6,294	8,154	10,003
Proportion of the Average Old-age Pension and the Average Wages in the National Economy (in percent)	47.24	45.3	45.3	42.66	44.88

SKK, current prices. Source: 1998 Statistical Yearbook, Statistical Office of the SR

\* Ministry of Labour, Social Affairs and the Family of the SR

TABLE 8: Average Monthly Pension and Average Monthly Wages in the National Economy

	1990	1992	1994	1996	1998*
Old-age Pension	1,550	1,192	1,182	1,276	1,466
Disability Pension	1,413	1,123	1,125	1,212	1,349
Widow's/Widower's Pension	825	647	593	636	1,026
Average Monthly Wages	3,281	2,630	2,608	2,990	3,265

SKK, 1990 fixed prices. Source: 1998 Statistical Yearbook, Statistical Office of the SR

\*Ministry of Labour, Social Affairs and the Family of the SR

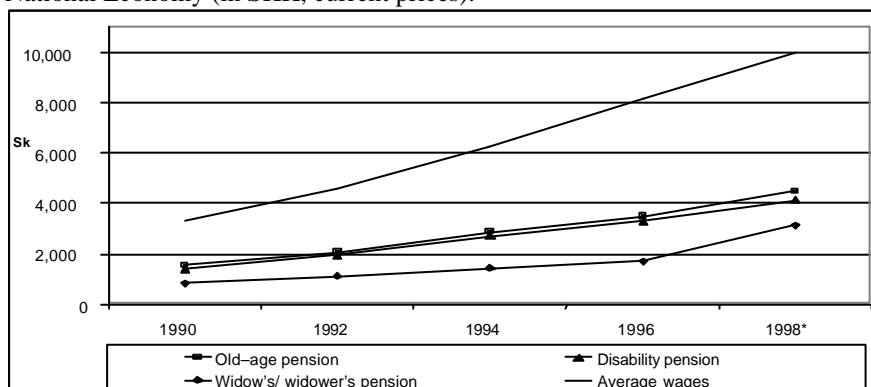
TABLE 9: Average Monthly Pensions and Average Monthly Wages in the National Economy

	1990	1992	1994	1996	1998*
Old-age Pension	100.00	76.88	76.24	82.31	94.55
Disability Pension	100.00	79.50	79.59	85.78	95.45
Widow's/Widower's Pension	100.00	78.47	71.87	77.08	124.31
Average Monthly Wage	100.00	80.17	79.49	91.14	99.51

Indices, 1990 = 100. Source: 1998 Statistical Yearbook, Statistical Office of the SR  
\*Ministry of Labour, Social Affairs and the Family of the SR

In 1998, real pensions, similarly to real wages, did not reach the level of 1990 pensions, save for widow's/widower's pensions in which a significant increase was reported in 1998. During the transformation stage, the proportion of the average wages and old-age pension reported a stepwise decline at the expense of pensions.

CHART 2: Increase of the Average Monthly Pensions and Average Wages in the National Economy (in SKK, current prices).



Source: 1998 Statistical Yearbook, Statistical Office of the SR and Ministry of Labour, Social Affairs, and the Family of the SR

Chart 2 indicates the “opening up of scissors” between the average monthly pensions and the average monthly wages. While in 1990, the proportion of the average old-age pension and average wages was 47.2 percent, in 1996, it was only 42.6 percent. In 1998, this proportion improved to 44.8 percent due to cost of living adjustments.

The real level of pensions has reported a dramatic drop in almost all countries undergoing transition. In the Czech Republic, the proportion of the old-age pension and gross wages was 50.4 percent in 1989; in 1996, 43.5 percent; in 1997, 45.3 percent. The proportion of old-age pension and net wages was 63.8 percent in

1989; in 1996, 56 percent; in 1997, 58 percent. In Croatia, the average pension dropped relative to average wages from 64 percent in January 1992, to 49 percent in December 1996. In Hungary, where old-age pensions are subject to taxation in the event a pensioner is employed, and, hence, disposes of a supplementary income on top of old-age pension, the average old-age pension was 59 percent of the net average income, and 39 percent of gross average income in 1996.<sup>121</sup>

Likewise, the data for the Czech Republic indicate a growing wage differentiation (from 34.2 percent in 1989 to 57.6 percent in 1996), while the differentiation in old-age pension deteriorated (a decline from 28.7 percent in 1990 to 17.6 percent in 1997). Although similar data are not available for the Slovak Republic, the above figures may serve as an indicator of global development trends. In the past, it was income that was dramatically leveled off. Currently, the trend is just the opposite – differentiation of wages and the leveling-off of pensions.

At the 1<sup>st</sup> and 2<sup>nd</sup> levels of pension insurance, the new concept of social insurance assumes coverage of pension claims equivalent to 50-55 percent of the real gross lifelong monthly wages. The third level is be conceived in such a fashion that the coverage of pension claims reaches 20-25 percent of the lifelong monthly wages.

If, according to the Statistical Office, the cost of living has increased by no less than ten percent, or, the average wages in the economy have gone up by no less than five percent no later than three months of the date of the last increase of pensions, pensions can increase. The word “can” is used deliberately, as pensions increase will take place only if the financial position of the Social Insurance Office allows for it. The pensions increase is set by a fixed amount with regard to cost of living increases, and percentage wise with regard to the increase of the average monthly wages in the economy of the SR. Pensions went up by twelve percent in 1996, ten percent in 1997, and eight percent in 1998.

TABLE 10: Increase of the Consumer Price Index, Increase of the Average Monthly Wages, and Pension Adjustments, Annual Changes (in percent)

	1995	1996	1997	1998
Increase of Consumer Price Index	9.9	5.8	6.1	6.7
Increase of Average Monthly Wages	14.3	13.3	13.1	8.4
Pension Cost of Living Adjustments		12	10	8

Source: Statistical Yearbook of the Statistical Office of the SR

<sup>121</sup>Source: Human Development Report for Central and Eastern Europe and the CIS, Chapter V: Alternative Social Policies, UNDP, 1999, p. 52-65

## 8.6.2 The Management of the Sickness Insurance Fund

Over the past ten years, sickness insurance, similarly to pension security, has reported a dramatic increase in terms of the paid-out benefits. The expenditures of the sickness insurance benefits totalled SKK 8.973 billion in 1998 (Table 3), which accounted for a 10.6 percent increase as opposed to the year before. Sickness benefits accounted for the largest portion of expenditures, 82.6 percent.

The growth of sickness insurance expenditures recorded in 1998 was due to both the increase in the number of the beneficiaries of sickness benefits and an increase in the amount of this benefit. In June 1998, the daily sickness benefit increased from SKK 300 to 350 in employees. In 1999, the maximum daily sickness benefit dropped to SKK 275, the objective being an improvement of the management of sickness insurance funds.

TABLE 11: Social Insurance Benefits (in millions of SKK, current prices)

	1980	1990	1992	1994	1996	1997
Total	2,783	4,352	4,922	5,652	7,379	8,113
Of Which – Sickness Benefits	1,899	3,147	3,823	4,368	6,043	6,685
Family Care Benefits*	195	441	321	314	366	388
Maternity**	689	764	778	958	970	1,040

\*Benefit associated with the care of a family member. \*\* Pecuniary assistance in maternity.  
Source: 1995 and 1998 Statistical Yearbooks, Statistical Office of the SR

TABLE 12: The Development of the Correlation between the Average Daily Sickness Benefit and the Average Daily Wages

Year	Average Monthly Wages, SKK	Average Daily Wages, SKK	Average Daily Sickness Benefits in SKK	Correlation between Average Daily Sickness Benefit and Average Daily Wages, in %
1989	3,141	103	-	-
1990	3,278	107	72	67
1991	3,770	124	77	62
1992	4,543	149	92	62
1993	5,379	176	101	57
1994	6,294	206	122	59
1995	7,195	236	122	52
1996	8,154	267	149	56
1997	9,226	302	162	54

Source: Social Policy, 1998

Ever since 1989, the proportion of the average daily wages and the average sickness benefit has been deteriorating, at the expense of the sickness insurance benefit. In the future, the situation should be remedied by a new structure of sickness insurance which is presented in the Social Insurance Reform Concept of the Ministry of Labour, Social Affairs, and the Family of the SR.

## 8.7 Conclusion

This chapter has presented an overview of the system of funding and functioning of the social security system. The authors have demonstrated that within the framework of the entire social security system, its deficit is growing due to the deteriorating demographic conditions (i.e., a drop in the share of the working-age population, increase of the share of the post-working age population, and high unemployment). The paid-out pension and sickness benefits disregard the insurance system of their collection (i.e., benefits do not correspond with the insured's contributions); hence, the entire obligatory public system has been actually changed to a kind of additional taxation. This system is both unequivocal, given the deteriorating demographic situation, and no longer sustainable.

For reasons mentioned above, the social system in Slovakia is expected to go through sweeping concept changes in the near future. Postponing social system reform may have a very negative impact upon the country's economy, as it may disturb the social and political balance. In addition, a well-functioning social system is among the preconditions of long-term sustainable development in the quality of living for inhabitants.

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## 8.9 Supplements

TABLE 13: Size of Economically Active Population, Number of the Unemployed, Average Wages and Old-age Pensions, 1989-1995

Indicators	1989	1990	1991	1992	1993	1994	1995
Size of Population	5,287,663	5,310,711	5,295,877	5,306,539	5,336,455	5,336,207	5,363,600
Economically Active Population.			2,102,529	2,118,808	2,047,106	2,045,000	2,430,840
Unemployed		39,603	301,951	260,274	368,095	371,481	365,316
Old-age Pensioners	628,622	654,153	688,637	712,056	724,601	733,048	738,847
Average Monthly Income	3,089	3,205	3,776	4,490	5,350	6,339	6,600
Average old-age Pension	1,459	1,578	1,912	2,086	2,395	2,876	2,879

Source: Social Policy of the SR, Ministry of Labour, Social Affairs and the Family of SR, Bratislava 1995. Statistical report on the basic development trends in the economy of the SR in 1995.

TABLE 14: Development of Nominal and Real Wages in 1989-1998

Year	Average Nominal Wages in the Economy of the SR, in SKK	Wage Increase Index	
		Nominal, %	Real, %
1989	3,142	100.0	100.0
1990	3,281	104.4	94.4
1991	3,770	120.0	69.6
1992	4,543	144.6	75.7
1993	5,379	171.2	72.8
1994	6,294	200.3	75.0
1995	7,195	229.0	78.2
1996	8,154	259.6	83.8
1997	9,226	298.6	89.2
1998	10,003	318.4	

Source: Statistical Yearbooks of the Statistical Office of the SR, Bratislava



## 9 Industrial Policy

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This chapter deals with industrial policy in Slovakia during the 1990's transition decade. During this period, the government's official industrial policy goals were not reached. Many tendencies that the policy makers regarded as negative were actually strengthened. Some responsibility for this has been due to institutional aspects of governing the transition, particularly in the frequent policy changes and the inability of policy-makers to adjust to the changing Slovak economic environment. The Slovak economic environment can be characterized by rapidly increasing marketisation and by the effective weakening of the government's executive branch.

Many objectives included in the policy documents of the time were contravened indirectly by statements found within the same documents. Many other major government actions during the decade were not a part of the official industrial policy framework yet had a significant impact on industrial structure. This occurred even though they usually contravened the officially proclaimed objectives and favored tendencies that were officially considered to be negative. The combination of these factors significantly contributed to economic developments in the Slovak industry throughout the 1990s.

At the beginning of 1990s, the Slovak environment was extremely distorted with regard to prices, property rights, internal and external trade, etc. A sequencing of steps that either removed these distortions or preserved some of them and the overall macroeconomic policy became the most important tools of the government in influencing the industrial structure. Slovakia could not avoid having an industrial policy. It could have had a conscious industrial policy or an industrial policy by default. It could have had an industrial policy that preserved the past industrial structure by retaining or increasing existing distortions, or an industrial policy that removed these distortions and automatically contributed to the change in the industrial structure. As this chapter shows, most government actions contributed to the preservation or increase of existing distortions and this helped preserve the industrial structure that had been created during the communist period.

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## 9.1 Introduction

Industrial policy, unlike monetary or fiscal policy, does not have a clear and unambiguous definition. The term is very recent and nearly all the works on the subject have been published since 1975. (Zloch-Christy, 1998, p. 188) Many authors provide no definition and the others do not contrast their definition with that of other scholars. (Blaise, 1986, p. 3) Disappointment with government intervention in the economy has recently led many economists and policy-makers, with Organization for Economic Co-operation and Development at the forefront, to re-evaluate the usefulness of the very term 'industrial policy' and to push for a new term with a new content - 'industrial competitiveness policy'. (Gassmann, 1997, p. 37) However, this introduction will argue that in the Slovak context, the use of the term 'industrial policy' is relevant even when the proponents of 'industrial competitiveness' reasoning is taken into account.

Definitions of industrial policy range from very broad and ambitious ones to more narrow ones. The first point to be raised is whether or not the industry in question means the whole economy, a secondary sector of the economy (mining, energy sector and manufacturing) or manufacturing itself. There are examples available for all three definitions, (e.g., Watson, 1983, Pinder et al., 1979, Blaise, 1986) but the predominant trend leans toward limiting the definition to manufacturing. This chapter will focus on manufacturing, but it will also consider the energy sector and, to a limited extent, mining.

More variety evolves around the definition of what industrial policy's role is in relation to industry. Approaches can be divided into two groups. The first group looks at government policy in general and can be represented by OECD's definition of industrial policy in the 1970s: "Industrial policies are (policies) concerned with promoting industrial growth and efficiency." (OECD, 1975, p. 7) Most researchers prefer a more focused approach. A good example is one by Blaise: industrial policy is "the set of selective measures adopted by the state to alter industrial organization." (Blaise, 1986, p. 4) The latter point of view will also be used in the chapter, albeit in an altered form. The definition used here will be:

***Industrial policy is a set of any measures adopted by state that has a significant and an uneven impact on various industrial sectors and thus, knowingly or not, alters industrial organization.***

During late 1980s and particularly during the 1990s, there was a growing body of opinion that believed industrial policy, in the form of selective government intervention, was counterproductive (Gassman, 1997, p. 37). Some scholars, particularly those specializing in East Asia, (e.g., Ha Joon-Chang, 1996) disagree. A recent OECD paper argues: "In the past, many OECD governments pursued policies to expand industrial production in specific sectors in order to foster

national or regional economic development, expand or protect employment, improve the balance of payments or stimulate technological innovation. During the extended period of low economic growth that began in the mid-1970s in most OECD countries, disenchantment with this traditional approach set in for a number of reasons." (OECD, 1997, p. 1) Most of the policies were related not only to globalization, but also to the decreasing faith in the government ability: "Partly because they often failed, 'government knows best' policies became too costly as government budgets were squeezed. By and large, governments are not good at 'picking winners'." (ibid.) That is why OECD is promoting the term 'industrial competitiveness policies', and focusing on "improvement of the country's framework conditions for industry." (Gassman, 1997, p. 37)

This dichotomy is, in some respects, irrelevant for an economy in transition. Slovakia of the 1990s does not represent cases of governments choosing or not to selectively interfere in the economy and has little to do with debates on the merits of government intervention and the distortion of the free market. There was no free market in Slovakia in 1989, and there was no way to switch to one immediately. In 1989, the government owned the whole economy. The public sector share of GDP in Czechoslovakia was 99.3 %. (Kornai, 1992) On January 1, 1993, when Slovakia became independent, the share of private sector in GDP reached only 32.4 %. (Miklos, 1997, p. 118)

Slovak governments have had to make crucial decisions on both the general and the sector-specific level in several capacities. As owners, they have had to decide on whether to privatize or to preserve state ownership. They made the decision to privatize in the overwhelming majority of cases. They also had to make decisions, as the privatization agency, on who the future private owners were going to be, what to sell first, and how to set a price, etc. During the pre-privatization period, governments needed to make short-term to medium-term managerial decisions regarding investment decisions of the enterprises prior to the sale. In a few cases where the decision was to preserve state ownership, they needed to formulate and implement their long-term plans. As a regulator in a transition economy, they had to make choices concerning what approach to take to correct distorted prices and determine priorities. Fourthly, they had to decide as a banker (owner of the most important banks in the country) on the loan policy to enterprises. In all of these capacities, governments influenced the developments, even by their passivity, so there was no truly *laissez-faire* option. The best example is their reluctance to liberalize certain socially sensitive prices that preserved some distortions over the whole decade. Similar arguments are also true for privatization or solutions to banking sector problems.

Analysis of the Slovak industrial policy has to examine explicit government industrial policy documents and the programs included in them. A thorough

analysis also needs to focus on seemingly unrelated government actions. This chapter aims to show that:

- The official goals of industrial policy documents were generally not reached; on the contrary, many tendencies considered negative by policy-makers were strengthened.
- Part of the responsibility lies in the institutional aspects of governing the transition, primarily in frequent policy changes and the inability of policy-makers to adjust to the changing Slovak economic environment. It was an environment characterized by rapidly increasing marketisation and by the effective weakening of the government's executive branch. Many objectives in the policy documents were often contravened indirectly within the same documents.
- More importantly, other major government actions during the decade, that had not been a part of the official industrial policy framework, had a significant impact on industrial structure. These usually contravened by the officially proclaimed objectives and favored tendencies that were officially considered to be negative.

## 9.2 Slovak Industry in 1991

In the April 1991 Program Declaration, the government of Prime Minister Jan Carnogursky identified the following phenomena as the principal causes of low Slovak competitiveness: "Analyses have shown that (our industrial) sectors, in comparison with their counterparts abroad, can be characterized by a high level of obsolescence of production assets, low share of final and sophisticated production and high level of energy inputs and raw materials. They are also presenting environmental problems." (Carnogursky, 1991, p. 11)

During the 1990s, the individual policy generally stayed within the framework of the original analysis. To fully understand the industrial policy efforts of Slovak governments, it is necessary to look at what was meant by Carnogursky and his successors.

First of all, let us look at two issues that gradually disappeared from the government's top agenda:

1. Environmental problems. It is not surprising that the industrial pollution was a priority in the early transition policies (e.g., Vavro, 1992, pp. 19-20 and Cernak, 1992, pp. 18-28) and a major target of both government and enterprise expenditure. Closing several of the worst polluters, establishing new legal standards, and developing extensive environmental programs resulted in the gradual decline of industrial pollution as a priority agenda item. There were timetables for solving the remaining major problems. In the 1994 policy document, Magvasi (1994) still mentions what it calls the

'environmental debt,' but it is evidently no longer a top priority. (Magvasi, 1994, App. 1, pp. 10-12) Industrial policy approved by the government and the parliament in 1995 mentions only 'respecting requirements for environmental protection' as a criterion within one area of government objectives. (Meciar, 1995, p. 4)

2. Obsolete production assets. Cernak (1992) notes that in 1989, the last year of the centrally planned economy, the average age of industrial machinery was 10.7 years. (Cernak, 1992, p. 12) As OECD (1991) explains, this was due to a decreased investment during the 1980s in favor of consumption (OECD, 1991, p. 9). There was also over-investment in the construction part of the investment. (Cernak, 1992, p. 13)) The former trend continued to worsen during the early years of transition due to the depression-induced decrease in investment (*ibid.*, p. 13). This problem did not really disappear. Instead, it became merged, in the minds of policy-makers, with the general issue of low industry sophistication and competitiveness. Investment showed a significant upswing in the second half of 1990s. This meant that it had ceased to be feasible to make generalizations about the state of machinery and buildings.

The two remaining issues gradually became the most crucial ones:

3. High level of energy inputs and raw materials. This issue was directly related to the problem of undesirable industrial structure that required what the policy-makers considered to be excessive energy and material inputs. All the policy documents viewed it as a crucial problem and always mentioned that decreasing the level of consumption of energy and raw materials by industry was a top priority within the restructuring framework. (e.g., Vavro, 1992, p. 10, Cernak, 1992, p. 4, Magvasi, 1994, p. 1, Meciar, 1995, p. 4 and Meciar, 1997, p. 1) This goal was not achieved. On the contrary, it will be seen that governments made decisions that went directly against this priority. The reasons and the consequences of such a situation will be explored below.
4. Low level of sophistication and final production. This has been considered the most important and persistent problem. It has not been solved over the period, and has become worse in several aspects. Individual documents interpret the general term differently - e.g., as a low level of knowledge- and innovation-intensive production, (Vavro, 1992, p. 3) insufficient competitiveness on the world markets and consequent low export potential of the industry (Cernak, 1992, p. 4) and a low share of value added in industrial production. (Magvasi, 1994, p. 1) What brought them all together was a realization that the Slovak industry has competed on both the international and domestic markets primarily with intermediate products based on the simple processing of raw materials. Their competitiveness was based on low



prices, and required a cheap workforce and subsidized energy prices. (as detailed in Meciar, 1995).

TABLE 1. Structure of Slovak Industry in 1991, in %

	Employment	Export	Production	Sales
<b>Mining</b>	5.1	0.9	2.7	3.3
CA + CB Mining	5.1	0.9	2.7	3.3
<b>Energy</b>	5.8	0.8	9.5	15.4
E Electricity, Gas and Water Supply	5.8	0.8	9.5	15.4
<b>Basic Industries</b>	26.7	65.6	44.1	41.9
DE Manufacture of Pulp, Paper and Paper Products; Publishing and Printing	3.4	11.7	5.9	10
DF Manufacture of Coke, Refined Petroleum Products and Nuclear Fuel	1.3	10.2	6.3	5.3
DG Manufacture of Chemicals, Chemical Products and Manmade Fibers	5.7	4.8	2.8	2.7
DH Manufacture of Rubber and Plastic Products	2.2	2.5	3.7	3.3
DI Manufacture of other Non-metallic Mineral Products	5.5	22.2	13.7	11.5
DJ Manufacture of Basic Metals and Fabricated Metal Products	8.6	14.2	11.7	9.1
Investment Goods	33.3	9.8	12.8	10.7
DK Manufacture of Machinery and Equipment N.E.C.	18.2	4.3	4.8	4.3
DL Manufacture of Electrical and Optical Equipment	9.1	3.3	5.9	4.6
DM Manufacture of Transport Equipment	6	2.2	2.1	1.8
<b>Food</b>	8.5	5.7	18.3	17.4
DA Manufacture of Food Products; Beverages and Tobacco	8.5	5.7	18.3	17.4
<b>Light Industry</b>	20.6	16.4	12.8	10.9
DB Manufacture of Textiles and Textile Products	9.8	6.8	4.7	3.8
DC Manufacture of Leather and Leather Products	4	3.7	2.1	1.9
DD Manufacture of Wood and Wood Products	3	1.5	1.8	1.5
DN Manufacturing N.E.C.	3.8	4.4	4.2	3.7

Source: author's calculations based on the Statistical Office of SR

The reasons for this structure can be traced through the communist past of Slovakia. Before the communist take-over of 1948, the economy had been dominated by agriculture. During the following forty years of central planning, it was largely industrialized. As Smith (1998) argues: "This (industrialization) represented an extensive regime of accumulation - fast growth in output was secured by the expansion of the forces of production through the forced industrialization of previously 'backward' agricultural economies." (Smith, 1998, p. 72) Smith goes on to demonstrate that the industrial sectors most favored with investment during this period in Czechoslovakia and the ones that recorded the greatest increases in output were oil, energy, engineering, metallurgy, and chemicals. (Smith, 1998, p. 71) However, engineering was not a market- or consumer-oriented one; it was associated with armaments production. In the 1980s, armaments production accounted for 32 % of the total engineering output in Czechoslovakia. (Financial Times, November 2, 1993, p. 16) Slovakia dominated the heavy segment (tanks, armored personnel carriers, etc.) However, it is not the aim of this chapter to trace the detailed reasons for the policymakers' struggle with the industrial structure during 1990s, only to point out that the problems were a natural result of past policies pursued by communist governments. Let us now look at more detail regarding the resulting industrial structure

### **9.3 Structural Issues at the Beginning of Transition**

In order to describe the issues facing the Slovak policy-makers, we will begin with a simple structural analysis of the industry. Table 1 depicts the share of individual industrial sectors in production, sales, employment, and exports in the first year of economic reform - 1991. The table shows that in 1991, production of light industry was of negligible importance. On the other hand, basic industries dominated, particularly manufacturing of metals, oil products and chemicals. This structural dependence on heavy industry is particularly pronounced if one looks at exports, where basic industries had a 65.6 % share. The information from table 1 can be supplemented with information on Slovak export structure and comparative studies on small Western European economies. This is based on SITC classification in the following table:

TABLE 2. Commodity Structure of Exports of Small Western European Countries and Slovakia, 1993, in %

Country	Group of Exports (SITC classification)				
	0+1	2+3+4	5	6+8	7
Austria	3.3	5.2	8.3	43.9	38.9
Sweden	1.6	11.3	9	34.3	42.7
Belgium	10.6	6.1	14.4	37.7	27
Netherlands	20.4	15.1	18.9	23.2	23.7
Spain	14.3	6.4	7.7	27.8	43.1
Portugal	7.1	9.8	4	57.2	21.6
Slovakia	7.6	5.8	12.2	51.9	22.5

Source: Meciár (1995), p. 21, except for Slovakia, where Statistical Office of SR (1994)

The table indicates that even at the beginning of the transition, Slovakia had to rely primarily on the export of intermediate products and simple final products (SITC 6+8). The share of more sophisticated manufacturing products (SITC 7) was significantly less than in other small Western European economies, with the exception of Portugal and Netherlands. Chemicals (SITC 5) were also very important. This picture is confirmed if one looks at table 3. It shows the revealed comparative advantage data for trade with Western Europe in 1991

TABLE 3. Slovakia's Revealed Comparative Advantage in Trade with Western Europe, 1991

SITC Group	1991
0 Food and Live Animals	3.1
1 Beverages and Tobacco	-1.2
2 Crude Materials	2.7
3 Fuels and Related Products	0.9
4 Animal and Plant Oils, Fats and Waxes	0
5 Chemicals and Related Products	-1.9
6 Intermediate Manufactured Products	31.9
7 Machinery and Transport Equipment	-39.2
8 Miscellaneous Manufactured Articles	3.8
9 Other Commodities and Products of Trade	0

Source: author's calculations, based on the Statistical Office of SR

A more detailed analysis was completed by OECD (1991) and OECD (1996) and those analyses confirmed that Slovak exports were dominated by intermediate products primarily from basic industries. The top ten export articles in 1995 were: steel and non-coated iron, petroleum oils, textile yarn, steel and iron coated, rubber

tires, simply worked wood, furniture, cement, paper and paperboard, men's clothing. These products accounted for 31.4 % of exports. (OECD, 1996, p. 86)

Such an analysis is supported by Havlik (1996), who calculated correlation of x-factor intensities with revealed comparative advantage (RCA) values in trade of various Central and Eastern European countries with the European Union. This analysis helped to uncover patterns of emerging trade specialization. In 1993, the first year for which such calculations were done for Slovakia, it had the highest correlation of RCA with energy intensity and the smallest correlation with labor intensity from all the countries surveyed (Czech Republic, Slovakia, Slovenia, Hungary, Poland, Bulgaria, Romania). Slovakia was also the only country to have a positive correlation of RCA with capital intensity. (Havlik, 1996, p. 33)

There are five principal reasons why this structure of manufacturing, particularly regarding exports, might be considered a problem and why it was seen as problematic by Slovak policy-makers:

1. In 1990, Slovakia covered only 70 % of its electricity consumption from domestic production and had to import most other raw materials for energy production. (Meciar, 1990, p. C9) Dominant industries, however, were very energy intensive and energy consumption per unit of GDP was extremely high - approximately three times as high as in the European Union. (MH SR, 1999, p. 23) Economic growth of these industries' sustained dominance further increased this imbalance and required significant investment into the energy production sector by drawing resources from other sectors of the economy. It also distorted the economy for reasons detailed below.
2. The low level of sophisticated production meant that approximately half of Slovak exports consisted of highly price-sensitive products. (OECD, 1996, p. 87, the data is for 1995) Miklos (1996) conducted an analysis of Slovak exports' competitiveness based on quality vs. price, using Aiginger's methodology. (see Aiginger, 1995) Export articles are ranked depending on the extent to which their competition in the world markets is based on price or quality. Miklos looked at 50 of the most important Slovak export articles. These comprised 67.1 % of Slovak exports, and he treated them as being representative of overall Slovak exports. He found that 58.3 % of them are in the group termed as "low quality competition, high price competition" and only 17.3 % are in the "high quality competition, low price competition." (Miklos, 1997, p. 121) Their competitiveness was based on the costs of inputs, particularly wages and energy. The need to preserve competitiveness would limit the scope for sustainable medium-term wage growth. This, in turn, would limit a possible increase in the standard of living.
3. Slovak energy prices have been regulated by government, significantly lower compared to Western Europe and, in general, lower than those of its Central

European neighbors. Since the government has owned most of the energy sector, the amount of actual subsidy this represents is difficult to estimate due to non-transparency. The government has admitted that this was an important factor in the competitiveness of Slovak manufacturing. (Meciar, 1995, p. 1) From the welfare point of view, further investment in the energy infrastructure would have distorted the situation. There have also been other indirect government subsidies that were related to other utility prices and wage regulation.

4. Much of the Slovak export production was subject to dramatic demand swings in international markets. Calculations by OECD (OECD, 1999, p. 27) show that import cycles in the OECD area for the major export items of Slovakia can be quite significant - with annual growth rates varying from -10 % to +30 % within 2 years (this example is from years 1993-1995). Such variability presents significant problems in achieving sustainable and stable growth, particularly when one factors in the importance of exports to the Slovak economy.
5. The structure of the Slovak manufacturing sector was very capital intensive. From a welfare point of view, preservation of such a Communist legacy was far from optimal, especially considering Slovakia's high unemployment, cheap labor and scarce capital.

## **9.4 Developments in 1990s**

### **9.4.1 General Developments**

This analysis examines changes in the structure of Slovak industrial production, sales, exports, employment and profits from 1991 till 1998 (1997 in the case of exports and profits). Individual sectors were grouped into the clusters previously used for the year 1991. Transport equipment is not included in the analysis due to its distorting statistical influence – reasons are explained in a separate section dedicated to this sector.

Changes in industrial production and sales show that tendencies considered negative by policy-makers became even more pronounced after 1991. Basic industries strengthened their dominant share and the importance of the energy sector in the economy also increased. Light industry was further weakened, while investment goods made a gradual turnaround, regaining some ground after losses at the beginning of the transition period.

Export data shed further light. The picture for investment goods and light industry is the same as for production and sales. What is more intriguing is that the export performance of basic industries, after gaining an even more prominent role during the 1990s and reaching an apex of 66 % share in exports in 1993, sharply

weakened from 1996 onwards. The reason was a sharp downswing in demand in OECD countries for these commodities. (OECD, 1999, p. 27) This fact confirms the danger of relying on these industries for growth and export earnings. The export of these sectors decreased not only in relative terms, but also absolutely - by 20 % in 1996 and then stagnated in 1997. On the other hand, the export of investment goods increased steadily since 1995: by 10.6 % in 1995, 4.6 % in 1996 and 19 % in 1997. The exports of the light industry cluster either stagnated or fell during the whole 1990s, even though this masked a mediocre performance by some sectors and a very poor one by others. Another important measurement is the persistent increase in energy exports.

These swings influenced employment as well. Again, the energy sector and basic industries kept increasing its share - in 1991, energy, mining and basic industries accounted for 39.9 % of industrial employment. In 1998, it was 46.5 %. Share of employment in food industry slightly increased but both investment and light industry went down. Investment goods were particularly hard-hit in the early 1990s, but the employment has leveled off since 1994.

Analysis of profits in individual industrial clusters complements the picture by demonstrating that energy and basic industries were able to utilize the opportunities presented to them by the transition environment. They preserved or increased their profits. But, industries producing consumer and investment goods were unable to reap profits even from the economic boom of 1994-1998 period, and they slipped further and further into the loss. This point is very important because most of the Slovak industry has been financed from retained earnings. (see Magvasi, 1994 for analysis)

The point of this aggregate analysis is to show that the structural problems of the Slovak industry increased throughout the 1990s even though Slovak policy-makers considered it very negative as early as 1991. The conclusion is that the industrial policies pursued by various governments failed. The analysis, in the last part of the chapter, will show how the governments' action actively contributed to this failure.

## **9.4.2 Developments in Basic Industries and Investment Goods**

Due to their importance, a more detailed analysis of two sectors – basic industries and investment goods – follows.

### **9.4.2.1 Basic Industries**

These industries experienced a sustained drop in sales in the 1991-93 period due to the loss of domestic and, in the first years, export markets (in the USSR and elsewhere in the former CMEA area). In this situation, they resemble other industrial sectors. They differ from the rest of the economy due to their ability to

find new export markets during the transition recession and the fact that they consistently place a higher percentage of their production there. If we exclude the manufacture of basic metals and fabricated metal products, then basic industries began the process of transition with less shares of export in sales than sectors producing investment goods and light industry. However, basic industries were then able to sharply increase this share and are consistently shown as leading the other two industries by 6 to 7 percentage points.

A demand crisis in export markets has hit these sectors since 1996. This can be attributed to the downturn in the OECD area. Two types of industries are notable based on their reaction. One - consisting of manufacture of pulp, paper and paper products, publishing and printing, manufacture of chemicals, chemical products and manmade fibers and manufacture of rubber and plastic products - was able to withstand it relatively well, in the sense that their exports stagnated, but did not fall. On the other hand, manufacture of other non-metallic mineral products and manufacture of basic metals and fabricated metal products experienced a sharp decline in exports since 1996.

It can be said that some of these sectors were reactive in their activities (particularly the metal and mineral industry) and took advantage of export possibilities during the upturn. These sectors were unable to use the income stream from exports to upgrade production or to find further markets. Other industries, primarily paper and chemical, were not deterred by recession. These industries also exhibited higher productivity growth and made more profit than the reactive industries.

It is worth noting that, with respect to change in employment, this cluster can be also divided into two groups. One experienced only a mild overall decrease in employment - industries producing paper, rubber and plastic and metals - ranging from 4 % to 14.8 %. On the other hand, petrochemicals, chemical industry and mineral-producing industry went through much sharper employment contractions of 33.6 % to 40.3 %. This roughly corresponds to divisions based on sales and profitability - industries with higher sales growth were generally more able to preserve the previous employment. This was reflected in mixed productivity growth and lower ability to make profits.

#### **9.4.2.2 Investment Goods**

Two sectors that produce investment goods are included in this section. They present a strikingly divergent picture. On one hand, the machinery and equipment production sector was unable to transfer its export markets from East to West because much of the exports were arms (see section on military production). That sector experienced a sharp decline in sales, an even greater decrease in employment and huge losses. It was only in the second half of 1990s that it

managed to switch to export-led growth. That action was accompanied by further labor-shedding and increased labor productivity. On the other hand, manufacture of electrical and optical equipment was, after the initial transition recession, among the industrial sectors that managed to capture new markets, avoid downsizing, and rapidly increase labor productivity.

Both sectors have been consistently losing money with different magnitudes of losses. In the manufacture of machinery and equipment, the losses are paramount and the whole industry is unable to get back into profit. The production of electrical and optical equipment is a different matter. Based on specific enterprise data (Trend June 16, 1999, TOP 100 section), it can be inferred that the latter is a mixture of profitable firms with a certain percentage of sick corporations. The reasons why these companies are not washed out of the system is that there are several exit barriers in the Slovak economy (Miklos, 1997)

Borgula (1999) reports that the general competitiveness problems of the Slovak industry extend to production of machinery and equipment: "The final production is... below its capacity, and the (sector) is more geared towards intermediate consumption and... focused on productions dependent on less sophisticated technologies, productions with a less sophisticated processing, with a lower value added, lower rate of skilled manpower, and the use of scientific and technological knowledge. According to some analyses, as much as 70 percent of the Slovak engineering exports are dependent on the products of such manufacturing branches." (Borgula, 1999)

## **9.5 Analysis of Three Specific Sectors**

### **9.5.1 The Volkswagen Factor– Production of Transport Equipment**

In analyzing structural changes in the Slovak industry, it is important to keep in mind the 'Volkswagen factor.' The German carmaker came to Slovakia in the early 1990s, but its production began to increase rapidly only in the second half of the decade. In 1998, sales reached SKK 56.7 billion (USD 1.6 billion) and exports represented 99.5 % of sales. Volkswagen was the second largest corporation in Slovakia in terms of sales and its largest exporter in 1998. (TREND, June 16, 1999, TOP 100 section) It was first in both categories in 1999. Therefore, its presence severely distorts available industrial statistics. The statistics otherwise show a remarkable shift in Slovak industrial structure in the 1996-1998 period away from chemical, metal and other heavy industries towards transport equipment production.

This shift is partially an illusion in the sense that much of it is caused not by any changes in the Slovak industry, but only by the increases in production, sales and exports in a single Bratislava plant. Its real importance for the country's



economy is also overstated by these figures, because much of its operation still consists of labor-intensive parts of car completion from components imported from Germany. This is reflected by the fact that while transport equipment accounted for 7.9 % of industrial production in 1997, it accounted only for 4.4 % of the value added. On the contrary, in 1994, when Volkswagen was a minor player, the two values were much closer - 3.7 % in value added and 3.9 % in production.

The Volkswagen plant has also been, to a large extent, an export enclave resembling Mexican maquiladora, with very limited local linkages. Its import content is reportedly above 80 %. Despite its impressive rise during the decade (in 1998, it accounted for 75 % of sales in its sector and 11.3 % of manufacturing sales), it employs only 5250 workers, 19.9 % of employment in its sector and 1.3 % of manufacturing employment.

During 1999, there were signs that the pattern might be altering. Changes noted was the opening of new workshop producing car bodies, planning for an industrial zone in Bratislava where producers of components would be working, and planning for the new production of a luxury model in Bratislava. However, the point of this analysis is not to criticize or praise Volkswagen, but to show:

- why it was necessary to exclude transport equipment from our previous analysis;
- why the remarkable rise of Volkswagen has not yet exercised such a change in the state of Slovak industry as some statistics would lead us to believe.

### **9.5.2 Energy**

Due to industrialization patterns in Slovakia that preferred energy-intensive sectors and low efficiency of energy use, Slovakia has one of the most energy intensive economies in Europe. Its energy consumption per unit of GDP (purchasing parity) has oscillated between values 2.5 and as high as 3 times the European Union average. It is also important to note that Slovakia has the highest energy consumption per unit of GDP from the group of Central European countries - 15-30 % higher than Czech Republic, Hungary and Poland. (MHSR, 1999, p. 24) The energy prices have also been lower compared to these countries. (OECD, 1999, pp. 120-122)

Governments acknowledged that cheap energy prices were an implicit and important subsidy to some industrial sectors (Meciar, 1995, p. 1) - particularly those such as metal and chemical industry that were able to bring in export earnings. In fact, a study by Hughes and Hare (1992) uncovered the fact that in the presence of world prices, these sectors would not be competitive. They calculated value added by individual sectors in transition countries in 1988, as if inputs and outputs were purchased and sold using world prices. It found that in Czechoslovakia, chemical and oil industry was actually destroying value and

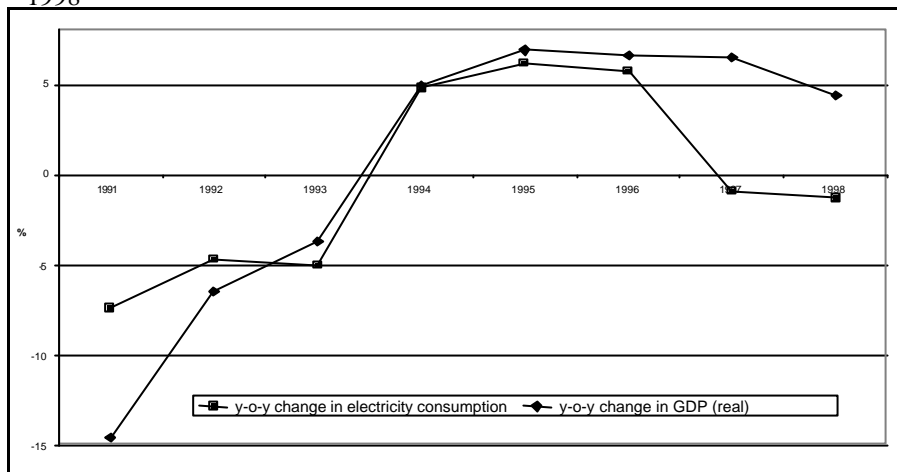
metallurgy was using enormous resources to produce its value added. (Hughes and Hare, 1992, pp. 463-464)

Understandably, governments were reluctant to bring energy prices to the global level and use other instruments to encourage efficient energy use. In the words of the Ministry of Economy: "Measures taken so far concerning prices in the energy sector have not motivated the industrial companies... to make a serious increase in efficiency of energy consumption." (MHSR, 1999, p. 23)

Such a high energy consumption, coupled with a low level of available domestic energy resources, has resulted in a high level of imports of energy raw materials, particularly from Russia. In 1990, Slovakia could domestically produce only 70 % of its electricity consumption. (Meciar, 1990, p. C9) Despite pledges to decrease consumption, successive governments decided to solve the problem by finishing nuclear and hydro plants that had been started during the communist period and to build more new ones. Water dams were constructed along with the first two blocs of the nuclear plant Mochovce. After the first bloc of Mochovce was finished in 1998, Slovakia generated sufficient electricity for domestic use. After the start of the second bloc, Slovakia was expected to become a net exporter because the production significantly outstripped consumption. (SME Daily, July 29, 1999, p. 16)

This approach was accompanied by persistent government involvement in the energy sector and the effective preservation of government monopoly and regulation of prices. These factors prevented any calculation of resource allocation efficiency. There are indicators of low efficiency of production and a preference for the creation of new electricity-generating capacity. This was indicated by the massive investments in large producers. (see Trubiniová, 1996, pp. 129-130) A significant portion of government resources available for loan guarantees and industrial restructuring was consciously used in the energy sector, primarily to set up new electricity production. (see Cernak, 1992, Magvasi, 1994, Meciar, 1995) The following chart depicts annual change in electricity consumption and GDP in the 1991-1998 period.

CHART 1. Year-on-year change in the real GDP and electricity consumption, 1991 – 1998



Source: IEA, OECD

It shows that for most of the 1990s the electricity consumption closely followed the GDP. This proves that there were no substantial increases in efficiency of electricity use. In the last two years - 1997 to 1998, the pattern changes and electricity consumption stagnated while GDP still grew. On the other hand, this has only balanced the opposite development at the beginning of the transition. At that time the electricity consumption decreased much less than GDP. In 1998, the electricity consumption was by 3.5 % lower than in 1990, while the GDP was by 2.2 % higher.

The other part of energy sector, not closely examined here, is the transport and storage of oil and natural gas that Russia sold to Western Europe. This sector has also remained state-owned and has undertaken substantial investment. Due to government control, distorted prices, and cross subsidies, it is not possible to make a welfare or efficiency analysis. (see Jurzyca, 1998)

Overall, as table 4 demonstrates, the energy sector significantly increased its sales and profits, however with decreasing labour productivity indicates that monopoly rents and distorted prices affected this outcome. (see Magvasi, 1994)

TABLE 4. Some Indicators for the Energy Sector, 1991-1998

	1991	1992	1993	1994	1995	1996	1997	1998	Total
Sales		-10.3	-8.1	49.3	13.3	-0.4	-0.4	18.6	61.4
Export		45.8	-32.3	1614.5	1.4	10.4	4.9		1,889.1
Export/sales	1.3	2.1	1.5	17.7	18.3	17.9	18.8		17.5
Employment		-1	12.9	2	-2.4	1.2	2.2	3.1	29.4
Lab. productivity		0.3	-18.3	13.7	-0.1	3.6	-3.9	-6.9	-15.6
Profit		9.191	10.172	26.178	23.385	25.651	19.638	15.695	129.910

Source: Statistical Office of Slovak Republic. Note: annual change in %, except for profits, where yearly level in millions of SKK

All governments were concerned with the high level of energy consumption per unit of GDP in Slovakia but the situation has not significantly improved over the decade. The government has poured enormous resources into building new electricity production (and into infrastructure for energy transit), while keeping energy prices below the levels of Western Europe and even neighbouring countries. Available data indicate that there has been no significant increase in efficiency of electricity consumption per unit of GDP and that the energy sector has seen decreasing labour productivity while reaping enormous profits. These facts, when linked which together with complete government control, indicate that cross-subsidisation of most of the energy sector is taking place based on transit rents from oil and natural gas transit to Western Europe. After massive price hikes in 1999 and 2000 and the announced of privatisation, the situation began to change substantially. The results have not yet been observed.

### 9.5.3 Arms Production

During 1980s, Czechoslovakia was one of the top military producers in the world - 7th in 1987. (This description is based on Smith, 1998) Slovakia dominated production of heavy weapons, particularly tanks and armoured vehicles. The principal markets for heavy weapons of the Warsaw Treaty Organization, the Communist equivalent of NATO. The demand for these products declined during late 1980s due to changes in the geopolitical situation, and this sector gradually lost its markets. Another cause for this demise stemmed from its specialisation. It was unable to follow its industrial counterparts in shifting export markets from the East to the West. Plans were made, even before the fall of the Communist regime in 1989, on how to convert the sector from military to civilian production and preserve its share in the industry. As the section on industrial development in 1990s demonstrated, these plans did not succeed. The new production lines did not find markets and the overall output, exports, and employment of the sector significantly declined.

'Conversion' programs were part of all industrial policies. They preceded industrial policies and were coupled with continuing government ownership of the former arms companies. Significant resources from the Czechoslovak federal government until 1993 and even by the Slovak government in 1993 and 1994 were used to fund the conversion switch. The total costs in the transition period of 1991-1994 were SKK 2.2 billion of direct financial assistance, SKK 3.8 billion in loan write-off and an unknown level of government loan guarantees for new production lines. (Meciar, 1997, p. 57) In 1995, a new government-owned holding company, DMD Holding, jsc., integrated most of the sector's state-owned enterprises in the sector and the relationship between the government and enterprises assumed a new form.

Despite the assistance and integration, most of the enterprises were unable to recover and continued to produce enormous losses. They lost more than SKK 22 billion during the 1991-1998 period for the whole sector, and this was seen as development unparalleled in any other sector. This loss indicates the true amount of government subsidy. The loss and the funds mentioned above resulted in non-performing loans from state-owned banks. Arrears in payments of taxes and insurance payments to government agencies were also a result.

The reasons for the failure were threefold. First of all, the speedy transformation of an arms industry into civilian production is generally a very difficult task. The financial resources available to the government were significantly lower than those planned for the programs. This resulted in the cancellation of some programs or the under funding of others. (Meciar, 1997, pp. 57-58) This was partially a result of Czechoslovakia's split and the limited fiscal options of the independent Slovak government. Most important, the most significant result were the institutional problems associated with continued state ownership. Long delays in approval of projects, (ibid.) politically inspired changes, personal clashes within enterprises, proliferation of rent-seeking activities and the lack of clear direction all contributed to the ongoing decline of this government-dominated sector. (Smith, 1998, pp. 317-318)

Borgula (1999) enumerates sub sectors where the engineering is competitive - these are precisely those that had not been associated with military production: "According to the revealed comparative advantage, of the twenty-six engineering production branches, only five production branches are competitive in the discriminating (OECD) markets in the following order of priority: shipbuilding, ship and boat repair; bearings manufacture, transmission and control elements, motor car parts and accessories and motor engines; train locomotives and carriages, engineering metallurgy."

There has been a clear mismatch between the aims and the results of military production conversion. The aim of governments was to preserve plants and

companies previously producing weapons and to restructure them towards civilian production. The expected result was a preservation significant levels of output and employment. In reality, the policy results resembled policies towards some of the 'terminally mature' industries in other countries, where government aims to ease the pain of phasing out industries that are doomed. During 1990s, crucial plants employing tens of thousands of workers in central Slovakia gradually reduced their employment until it reached a small fraction of the previous numbers.

## 9.6 Industrial Policy Documents

Six documents will be analysed in this section. Five of them bear the name 'Industrial Policy.' They were chosen even though only some of them were officially approved by the government and the parliament. The remaining ones were also officially submitted by the Ministry of the Economy to the government's Economic Council or parliamentary Economic Committee, but they never received the official government's and parliamentary consent. The reason was that due to elections and subsequent changes, they became 'out of date' even before the approval. Many programs were kept from one policy document to the next and there is a significant measure of continuity. What is more important is that these policy documents are not used here as a tool of political agenda – in the sense “this is what government promised and did not keep” - but are used to gain insight into how policy-makers thought and approached the issue of Slovak industry and its structural change. With the exception of the third Meciar government that had two documents, one policy document was chosen for each government in the 1991-1998 period. The combined documents run over 1000 pages, so this section focuses strictly on a few chosen aspects:

- What objectives did they set for the industrial policy and what instruments did they envision to achieve these objectives?
- Were the documents internally consistent?

Vavro (1992) – submitted in April 1992, bears the name of Anton Vavro, the Carnogursky government's Deputy Prime Minister for the Economy. That government was in power from April 1991 to June 1992. It is the only document that is not called Industrial Policy, but, deriving from the German tradition of *Strukturpolitik*, is entitled the “Structural Policy of the Slovak Republic.” This policy proposal focuses on only a few selected sectors. These are sectors where it sees a significant government role because they should be either 'winners' or 'losers.' Within industry, it sets objectives for the energy sector as a “strategic industry” (p. 10) and for the 'losers' – are the mining industry and metal production:

- the processing of iron ore and non-ferrous metals has only a “limited comparative advantage” (p. 13) and is import-, energy- and environmentally-

intensive. (ibid.) A significant portion should be phased out and the rest upgraded towards more sophisticated products. The preferred tool would be higher prices of energy and payment of 'real costs' for environmental damage and consumed natural resources.

- in the energy sector, the principal "structural shift will be in consistent preference of more efficient use of energy to creation of new energy sources." (p. 10)

In some respects, this is the least specific material because it sets forth only directions and does not quantify them. However, it should be said that apart from this, it is the most specific policy document from all presented. It sets the general structural shift that it wants to achieve (from less sophisticated industries and large enterprises to more environmentally and energy friendly ones) and then it does not refrain from saying that it will mean closing down some industries. It also states that it will use government subsidies and taxes to effect this change. Therefore, it is not a blanket policy for supporting all industries by all means.

After the June 1992 elections, the new government of Vladimir Meciar (1992-1994) came into power and gave the new Minister of Economy, Ludovit Cernak, a task of submitting an industrial policy. Cernak completed this task in November 1992 (Cernak, 1992). This 'Industrial Policy of Slovak Republic' is the first to contain government plans for all industrial sectors. It also contains short-term and long-term objectives, (Cernak, 1992, p. 5) which are vague, but consistent with what was said about desires of Slovak policy-makers: to phase out "non-efficient" enterprises, decrease energy and raw materials consumption, decrease steel production and consumption together with environmental damage caused, increase value added in the industry together with sophisticated and exportable production. It pinpoints the dominance of heavy industries and the low sophistication of industrial sectors. (ibid., p. 4)

One might expect significant support towards sectors that fulfil the wishes of policy-makers. That is not the case, based on Appendix 2 – 'Proposals for Government Programs of Industry Development in Slovak Republic,' which envisions investment projects for the following decade. The structure of proposed investment is in table 5, and is calculated on the basis of data provided in the document.

TABLE 5. Government Programs of Industrial Development for Selected Sectors, 1992

Selected Industrial Sectors	Proposed Investment (mil. SKK)
<b>Mining</b>	5 066
<b>Light Industry</b>	3 145
DB Manufacture of Textiles and Textile Products	862
DC Manufacture of Leather and Leather Products	383
DD Manufacture of Wood and Wood Products	1 900
<b>Basic Industries</b>	62 055
DE Manufacture of Pulp, Paper and Paper Products; Publishing and Printing	12 970
DF Manufacture of Coke, Refined Petroleum Products and Nuclear Fuel	13 739
DG Manufacture of Chemicals, Chemical Products and Manmade Fibres	3 995
DI Manufacture of other Non-metallic Mineral Products	2 111
DJ Manufacture of Basic Metals and Fabricated Metal Products	29 240
<b>Investment Goods</b>	16 917
DK + DM Manufacture of Machinery and Equipment N.E.C., Transport Equipment	15 300
DL Manufacture of Electrical and Optical Equipment	1 617
<b>Energy</b>	142 100
Total for Selected Sectors	229 283
<b>TOTAL</b>	251 400

Source: author's calculations, based on Cernak (1992), Appendix No. 2

Apart from the overwhelming dominance of basic industries and the energy sector (81.2 % of total), closer analysis of projects within basic industries reveals that they are in the heavier, less sophisticated part of the spectrum, even though they usually aim to upgrade or modernise it. In other words, this is a strategy of preserving the capital- and energy-intensive basic industry by technological modernisation, rather than a strategy of structural shift.

The next Industrial Policy was proposed by Peter Magvasi (1994), Minister of Economy in the interim Moravcik government (March – December 1994). It differs significantly from its predecessor in one respect. Where Cernak included all investment projects of all enterprises, Magvasi sought to focus the government's attention on those areas that he thought should have priority, and where he believed government should be involved. The overall price tag of the industrial projects is less than half of Cernak's, despite a cumulative inflation of approximately 30 % between the two policy proposals. It also clearly stated how the government would fund the priorities. The first group are "projects of macroeconomic importance,"



(Magvasi (1994), App No. 2, p. 7) where the government should take on loan guarantees. Members of the other group are “restructuring projects of regional and sector importance,” where the government would also take on loan guarantees linked with partial reimbursement of interest costs. (ibid., p. 15) The first one deals primarily with infrastructure investment.. Industrial spending included SKK 24.8 billion for the electricity sector and SKK 32.6 billion for gas and oil industry. The second group is divided into sectors. Again, basic industry and energy sectors dominate. Basic industries account for 50.1 % of proposed spending and the energy sector for 18.3 %. What distinguishes Magvasi’s policy from Cernak’s is that Magvasi explicitly acknowledges the need for continuing support of basic industries: “Energy, metal processing and chemical industries... have a high share in GDP and export that we cannot replace by production of other sectors and if their products lose competitiveness, insoluble economic problems might arise.” (Magvasi, 1994, p. 19) The dominance of these industries in the government’s proposal for restructuring is testimony to the fact that this analysis was to be borne out in policy-making.

After October 1994 election, the third government of Vladimir Meciar came into power (1994-1998). It passed and submitted Industrial Policy to parliament in 1995 (Meciar, 1995) and its Revision in 1997 (Meciar, 1997). These documents can be characterised as ‘all things for all sectors.’ Both policies contain a long list of micro priorities in individual sectors, strongly reminiscent of old communist plans (see the section on institutional problems for more detail). As in Magvasi (1994), there is also a long list of minor policies with negligible impact and funding. The only major proposals are in sector-specific policies. Again, the preferred approach is government guarantees for bank loans and the structure of sector-specific spending favours basic industries. The production of metals and chemicals accounts for 49.2 % of proposed spending, with light industry and electrical and optical engineering accounting for 1.8 % and 1.5 % respectively. The only major change is a financial shift towards engineering – 42.5 %. (all data from Meciar, 1995, p. 121). Two separate laws passed during this period should also be regarded as a part of the industrial policy. The Strategic Companies Act and Revitalisation Act need to be considered because the policy documents relied on them and they were to be directly involved in the government’s industrial policy. (More on these laws in the chapter on privatisation and restructuring.) The last policy, passed by the new government of Mikulas Dzurinda, is described and analysed in more detail in the conclusion.

## **9.7 Analysis of Government Influence on Industrial Restructuring and Investment**

Developments within the industrial structure are closely tied to investment, particularly since the Slovak industry is relatively capital-intensive. It is not surprising that a significant part of the explanation of the changing structure of Slovak industry is related to the availability of investment capital in Slovakia for individual industries and companies. Government actions that shaped these areas can be roughly divided into two areas - privatisation and government fiscal and investment policy. The other part of the explanation as to why industrial policy failed is related to government's institutional characteristics, particularly its inability to adjust to the changing environment and its ineffectiveness attributed to frequent policy turnarounds.

### **9.7.1 Privatization**

Private vs. public ownership of certain sectors is one of the basic instruments of the classical industrial policy. In Slovakia, the situation was different from advanced market democracies, because the state owned the whole economy prior to transition. The privatisation of most of the economy was considered one of the principal aims of the economic reform package approved in 1990 and implemented in January 1, 1991. (MSPNM SR, 1999, p. 1) (More on the issue in the chapter on privatisation.) This section will argue that the privatisation method of direct sales chosen during the 1995-1998 period was important in determining investment and production structure in the Slovak industry. It gave incentives to large companies in basic industries that allowed them to invest on a level significantly above their already high share of industry.

Slovakia has undergone two waves of privatisation of large enterprises. One was implemented in the 1991-1993 period, the other occurred during the 1993-1998 period (it should have been officially over by 1996, but some sales continued even afterwards). The core of large privatisation occurred in 1992 which was considered the first wave. The 1995-1998 period was considered the second wave. Sales took place between the two periods, but their book value amounted only to SKK 25.7 billion out of property with the book value of SKK 226.7 privatised during the 1991-1998 period in large privatisation. (calculations based on MESA 10, 1999 and Reptova and Polonec, 1999, p. 460)

The voucher method dominated the first wave - enterprises with a book value of SKK 79.7 billion were privatised through the voucher method and enterprises worth only SKK 12.7 billion were privatised via direct sales. In the words of one of the architects of this wave: "(Voucher method was used) because the speed and extent of privatisation were considered to be crucial and there was lack of available investment capital." (Miklos, 1996, p. 90) The vouchers were distributed to the

population and they could then exchange them for shares. This achieved the objective but there are divergent assessments of its effects on corporate governance and restructuring. (e.g., Djankov and Pohl, 1997, Meciar, 1997, MSPNM SR, 1999)

On the contrary, during the 1995-1998 period, the voucher privatisation was cancelled and enterprises with book value of SKK 109.2 billion were sold via direct sales. (Reptova and Polonec, 1999, p. 460-1) The aim was to sell enterprises to those 'strategic' buyers who would be able to rejuvenate them - usually management or domestic investors. However, this method was mired in non-transparency, allegations of corruption and political cronyism. (e.g., see OECD, 1996, Miklos, 1995, 1998, Miklos and Zitnansky, 1996, 1997, Reptova and Polonec, 1999, MSPNM SR, 1999). This section will demonstrate that both methods influenced the industrial structure – the voucher privatisation indirectly together with expansive fiscal policy and direct sales directly, particularly through investment requirements that were often a condition of the sale.

First of all, table 6 demonstrates that a highly significant number of large enterprises, particularly in basic industries, were privatised during the 1995-1998 period. The table is based on data on the 100 largest companies in Slovakia compiled by the economic weekly *Trend* for year 1998. It is not surprising that companies from basic industries and investment goods are over-represented in the list of large corporations, together with mining. The food industry has also large firms – 8 are on the list. On the other hand, companies from light industry are generally not present. What is more interesting is that large enterprises from basic industries were clearly much more likely to be privatised in the 1995-1998 period than their counterparts from the sector of investment goods. All large food companies were either sold before 1995 or are subsidiaries of foreign multinationals, so none of them were privatised during the period. In addition, corporations active in basic industries and sold during the 1995-1998 period generally dominate the overall sales of their respective sectors.

TABLE 6. Large Enterprises Privatised by Direct Sales in 1995-1998 and Their Importance for Industry Sales

Sector	Companies in TOP 100 in 1998	Companies in TOP 100 privatised during 1995-1998	Their share in sales by TOP 100 companies in their sector	Their share in overall sales of their sector in 1998	
Mining	CA	4	4	100	36
	+CB				
Food	DA	8	0	0	0
Light Industry	DB	1	0	0	0
	DC	0	0	-	-
	DD	0	0	-	-
	DN	7	3	51.7	34.1
Basic Industries	DE	1	1	100	95.2
	DF	11	6	44.2	39.8
	DG	2	0	0	0
	DH	2	2	100	13.5
	DI	7	4	83	54.6
	DJ	3	1	51.8	15.3
Investment	DK	4	1	19.6	6.1
Goods	DL	5	2	8.7	7.8
	DM	0	0	-	-

Source: author's calculations based on Trend TOP 100, Privatisation Register from MESA 10 data, Ministry of Privatisation of SR data and Statistical Office of SR data

Consequently, it can be inferred from the table that whatever specific requirements were set during the privatisation process in the 1995-1998 period would tend to influence large enterprises in basic industries and their respective sectors much more than other sectors. There were several peculiarities to the privatisation process during this period, most relevant being the investment requirement. Prices for companies were set at a significantly lower level than done previously – for direct sales in the 1992 – 1993 period, the price was on average 105.9 % and 106.7 % of the accounting value of a company, but it was only 28.2 % and 18 % for the years 1996 and 1997. (MESA 10, 1999) The price was often made conditional on investment to be carried out in following years or allowed for such investment to be later written off from the purchase price. This meant that for every crown that was invested within the limit, a crown was deducted from payment. Unless the marginal value of investment was a very unlikely zero, it paid off for new owners to invest even if the investment was not necessary or efficient from the welfare point of view. (Jurzyca, 1999)

To analyse the incentive structure of investments, we will analyse incomplete data on direct sales during the 1995-1998 period available in the Privatisation

Register compiled by a private think tank in Slovakia, MESA 10. If we look at the 35 largest companies in Slovakia by sales in 1998, 9 are private corporations in services and construction. The remaining 26 are industrial companies or state-owned utilities. There are 8 state-owned utility companies ranging from the Slovak Gas, Slovak Electricity through electricity distribution networks to Slovak Rail, Slovak Telecom, and Slovak Mail. It has already been described how government channelled investment into these corporations, particularly in the energy sector.

This analysis deals only with the remaining 18 large industrial companies not completely owned by the state. Out of these 18 enterprises, exactly half were privatised during the 1995-1998 period and have data on the book value, price, and investment requirements available. These firms were obliged to invest at least SKK 27.2 billion following the privatisation, which is more than 59.8 % of the total investment required by the government during the period from privatised enterprises - SKK 45.8 billion. Shares in these largest firms sold during the period constituted book value of only SKK 26.1 billion - 23.9 % out of total book value of enterprises sold during the period. Thus, government motivated new owners of these firms into investment spree that was dramatically above their share in the industry. All of these firms were relative behemoths from basic industries: petrochemicals, chemicals and metal industry. There is also individual anecdotal evidence that same condition applied to large enterprise in basic industries sold shortly before the fall of the second Meciar government in March 1994, particularly in the chemical and pharmaceutical industry. (Reptova and Polonec, 1999, pp. 460-1)

Consequently, by its choice of which enterprises to privatise by direct sales and high, but selective investment requirements, the government was providing a very powerful investment incentive for the largest companies in those sectors that it officially wanted to lose share in the economy. These were also industries, as already mentioned, which had been hugely favoured in access to investment during the communist period. On a sub sector level, these were generally companies in the more basic and heavy part of their sectors - usually processing oil and ore.

## **9.7.2 Fiscal and Investment Policy**

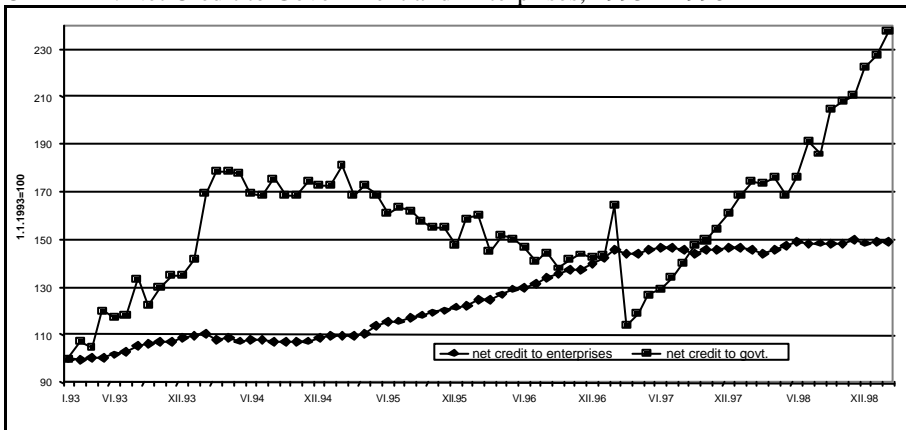
The government's fiscal and investment policy during 1990s underwent several dramatic changes, which had an important impact on the structure of industrial investment in Slovakia. (Those interested in the details of fiscal policy should refer to chapter 3.) The decade can be roughly divided into three periods. Until January 1, 1993, it was a fiscal policy of a regional government governing a region in a deep crisis. From 1993 to 1995, the government had to simultaneously cope with the additional burden of establishing a new state together with the loss of previous transfers from the Czech Republic. It managed to do so and still reduced

the looseness of its fiscal policy. From 1996 through 1998, the fiscal policy was an aggressively expansionary one, aimed particularly at infrastructure construction.

1991 and 1992 can be characterised by the emergence of hard budget constraints for enterprises and the loss of government subsidies. The general government's overall fiscal policy was relatively restrictive to prevent the emergence of a Polish-style hyperinflation. The tight stance was based on the need to stave off inflation pressures arising from the liberalisation of prices, devaluation and other external shocks. It was successful – after growing by 61.2 % in 1991, inflation declined to just 10 % in 1992, the lowest level in all transition countries.

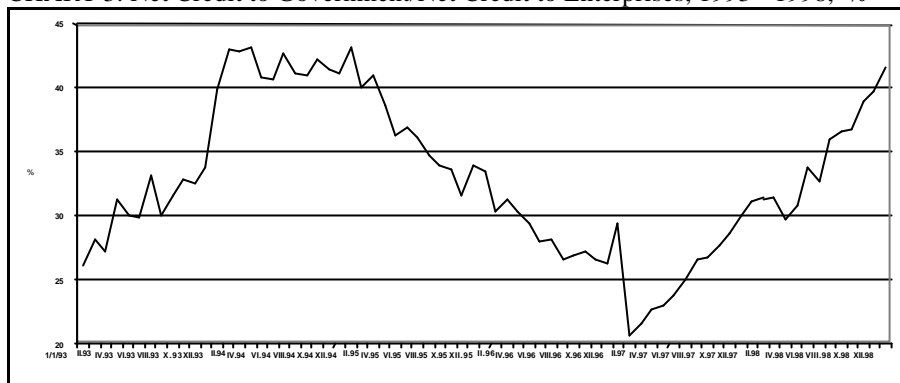
Data available for Slovakia since 1993 paint a picture of a consistently conservative monetary policy, which meant that Slovakia has enjoyed the lowest inflation among transition countries, together with the Czech Republic. This meant that a crowding-out effect occurs quite easily in the Slovak domestic loan market as there has been no great credit expansion. As consumer loans have not played a significant role so far, the interplay is generally between government and enterprise credit. Chart 2 depicts development of credit to government and enterprises with January 1, 1993 as the starting point.

CHART 2. Net Credit to Government and Enterprises, 1993 – 1998



Source: NBS

CHART 3. Net Credit to Government/Net Credit to Enterprises, 1993 - 1998, %



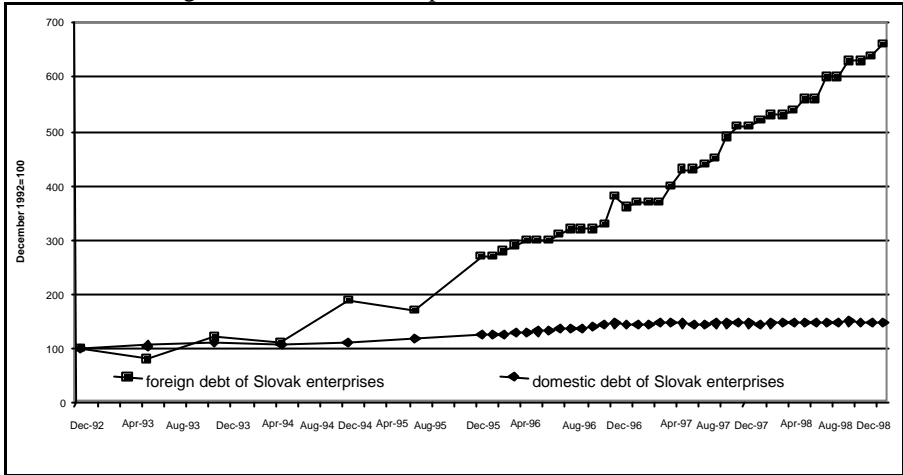
Source: NBS

Chart 3 supplements the picture by showing the ratio between domestic credit to government and to enterprises from 1993 until 1998. Three phases can be easily discerned. During the first year, loss of Czech transfers, continuing economic downturn, expenses of building a new state together with a relative lack of fiscal discipline meant a high budget deficit accompanied by an increase in the government borrowing at the expense of enterprises. In 1994, economic growth and increased fiscal discipline meant that government borrowing stagnated and began to decrease. Enterprises finally gained more access to loans and the fast growth in their debts lasted until end of 1995. In 1996, two developments coincided. The government began an ambitious infrastructure spending, while the central bank, afraid of overheating the economy and mounting current account deficit, tightened the monetary policy. From 1996 to 1998, the government made huge investments in energy' infrastructure and road construction. The result was that it went on borrowing and significantly crowded out private investment for the remaining 3 years. (Note: the sharp fall in government credit at the end of 1996 was a result of an accounting change, which wrote off the controversial debt of the Slovak government to the Czech Republic. Without this change, the sustained increase in government borrowing can be observed from mid-1996 on.)

Without available domestic credits, enterprises began to increasingly turn abroad, particularly as the stability of Slovak crown seemed to indicate the advantages of low-interest deutschmark or dollar loans. Due to the strong growth of the Slovak economy, international lenders were now more willing to lend to Slovak companies. (OECD, 1999, p. 9) The result - shown in Chart 4 - has been a strong growth in foreign loans versus domestic loans since 1995. At the end of 1995, foreign loans to enterprises were only 29.6 % of domestic loans to enterprises. In November 1996, it was still only 33.2 %. During the following two

years this ratio more than doubled to 74.6 % by December 31, 1998. This development is important for industrial structure for three reasons.

CHART 4. Foreign and Domestic Enterprise Debt, 1993 - 1998



Source: NBS

First of all, a significant proportion of these loans were government-guaranteed credits to state companies building the nuclear plant in Mochovce and water dams in Gabčíkovo and Zilina. The government credit guarantees amounted to SKK 100.4 billion by the end of 1998 and were generally taken during year 1995-1998. (OECD, 1999, p. 9) What is more important, only large companies could, for obvious reasons, tap international financial markets and secure foreign loans. This seems to be reflected in the investment patterns of 1996 and 1997, when large enterprises had a hugely disproportionate share in investment compared to value added, as table 7 demonstrates.

The form of privatisation chosen in the previous period (voucher privatisation) caused that even enterprises already privatised required a significant volume of capital for investment as the privatisation itself had not brought any. This only reinforced the consequences of the fiscal and investment policy of the government in the 1996 – 1998 period (see also chapters on privatisation and restructuring).



TABLE 7: Breakdown of Value and Investment in the Economy, by Size

	Value Added		Investment	
	1996	1997	1996	1997
Enterprises by Number of Employees				
0 – 9	13.2	14.5	11.3	8.6
10 – 19	3.6	3.8	3.0	2.3
20 – 49	4.7	5.2	4.4	4.4
50 – 249	13.2	14.7	17.9	23.0
250 and more	46.8	42.0	63.4	61.7
Tradesmen	18.5	19.8	-	-
TOTAL	100.0	100.0	100.0	100.0

Source: Statistical Office of SR. Note: tradesmen not included in investment statistics

The last important factor is the development of foreign investment, particularly FDI. The inflow had been very low for the whole decade and was considered highly unsatisfactory by all policy-makers. Successive governments held key to two principal reasons for the low inflow. First of all, they decided to privatise in favour of domestic buyers, either through voucher privatisation or direct sales even though privatisation has proven to be one of the best and the fastest ways to attract FDI to a transition country. In case of voucher privatisation, this is only a part of the truth, as many industrial enterprises in which a foreign investor was interested were excluded from it and sold to the foreign bidder instead. As already noted, foreigners were completely excluded from privatisation in the 1995-1998 period. The other principal reason for low influx of capital was low stability, nationalist stance and negative perception abroad of most Slovak governments headed by Vladimir Meciar.

The result of this policy mix was high investment in the state-controlled sector (dominated by energy) and in large private enterprise, particularly those in basic industries. The government actions reinforced industrial structure identified by official government policies as negative.

### 9.7.3 Inability to Adapt to the Changing Environment

Another group of reasons, why the government industrial policy targets were not achieved and why the government policy was not effective, is the inability of institutions to adjust to the new post-communist environment, which has been undergoing rapid change ever since 1989.

The best example of the inability of bureaucracy and policy-makers to adapt to the new environment is the continuing inclusion of a sweeping range of both specific projects and vague pronouncements into the industrial policy documents.

In the case of the former, it was understandable in 1992, if one part of the proposed Industrial Policy was dedicated to "Proposals for government programs to develop industry in the Slovak Republic." (Cernak, 1992, App. No. 2) It is a 29-page long document containing a list of 120 projects to be supported by the government, ranging from finishing the construction of a nuclear plant to production of microwave appliances. (ibid., pp. 1 and 8) Even though such a list could be rightfully criticized as mechanical continuance of communist planning, it had a logic stemming from the fact that the government was still owner of at least controlling stake in enterprises considered in the proposal. The same logic applies to vague pronouncements liberally sprinkled through the policy paper about "increasing efficiency of production, savings in fuels and energy sources, increasing sophistication and quality of production." (Cernak, 1992, p. 11) This example is about the metal industry and the government still owned the metal industry in 1992. Consequently, such pronouncements, which, together with specific projects, make up a large part of the policy documents, can be perceived as showing direction in which the owner - government - is going to move.

However, as more and more of the industry were privatised, it became less and less understandable, why should such proposals be part of an industrial policy, but they continued to be included. Finally, the last industrial policy ("Revision of Industrial Policy in the Slovak Republic"), submitted to the government and to the parliament in the second half of 1997, still contained a list of what it called "development projects." (Meciar, 1997, p. 60) This similarly worded mixture of vague pronouncements and specific investment projects was ridiculous because it concerned largely private companies without specifying how the government proposed to influence or support such activities (e.g., "production of ammoniac in Duslo Sala, jsc." (ibid., p. 66), a company where the government did not hold a share any more). This is not an exception - in 1997 - 73 % of Slovak industrial output was produced by the private sector (Miklos, 1998, p. 336) and if government ownership of the energy sector is discounted, the figure would be even higher. Going through the list, one sees one fully private company after another. The truth is that the companies reported innovation and restructuring projects they were going to implement or hoped to implement and the Ministry of Economy proudly included them into the policy document to have a list of activities, which it did not have to financially support.

Two other examples of government inability to adapt are the act on strategic companies and revitalisation act. The first one, passed in 1995, was supposed to preserve government share and influence in key enterprises. The second one, passed in 1997, was supposed to aid in revitalisation of viable companies by stopping the usual debt collection and bankruptcy proceedings. Neither of them really worked – many companies that were not supposed to be privatised under the

former law, were sold and no company ever went through revitalisation. Both laws are analysed in more detail in chapters on privatisation and restructuring, so let us only briefly look at reasons for their failure.

The reason why the government strategy failed seems to be its inability to adjust to the new environment. Slovakia, over the 1990s, can be characterized by the creation of a market economy, rule of law and democratic political system, which mean, inter alia, that the effective power of state and particularly the executive to influence the economy becomes much more limited. Limitations are caused not only by the division of power within the state (both laws were pronounced unconstitutional at least in their parts by the Constitutional Court), but also by the fact that the new environment is based on universal rules, which even the government can bend only at its peril and where the government is only one of many actors in the economic arena. In the previous regime, the government effectively had no equals, only subordinates. In the new reality, refusal of other actors effectively meant end of a policy. The government and particularly the executive branch were also unable to take fiscal limitations into account in their planning, so many plans could not have been implemented.

## **9.8 Conclusion**

This chapter dealt with industrial policy in Slovakia during the transition decade of 1990s, concentrating on years from 1991 to 1998. In this period, official targets set out by government documents on industrial policy were not reached. On the contrary, many tendencies considered negative by policy-makers had been strengthened. Part of the responsibility lies in institutional aspects of governing the transition, primarily in frequent policy changes and the inability of policy-makers to adjust to the changing Slovak economic environment, which can be characterised by rapidly increasing marketisation and by effective weakening of the power of the executive branch of the government. Many objectives included in the policy documents were often contravened indirectly within the same documents.

Many other major government actions during the decade, which had not been a part of the official industrial policy framework, had a significant impact on industrial structure, but usually contravened the officially proclaimed objectives and favoured the tendencies officially considered to be negative. A combination of these factors significantly contributed to developments in Slovak industry over 1990s.

It should be stressed that the Slovak environment at the beginning of 1990s was extremely distorted with regard to prices, property rights, internal and external trade etc. It was the sequencing of steps that removed these distortions (or by a decision to preserve some of them) and the overall macroeconomic policy that

became the government's most important tools in influencing the industrial structure. Therefore, Slovakia could not avoid having an industrial policy, it could only have had a conscious industrial policy or an industrial policy by default, it could have had an industrial policy preserving the past industrial structure through retaining existing distortions or their deepening, or it could have had an industrial policy removing these distortions thus automatically contributing to the change in the industrial structure. As this chapter shows, actions of most governments contributed to preservation of existing distortions or even their deepening and thus helped preserved industrial structure created during the communist period.

In October 1998, the new government of Mikulas Dzurinda came to power and passed a new industrial policy document (MH SR, 1999b). This policy differs from its predecessor by explicitly emphasising the following principles:

- moving from isolationism to openness;
- moving from selective interventions towards systematic improvement of the economic environment;
- moving from making declarations to real actions;
- moving from support of the weak and punishment of the efficient towards the creation of an environment that supports the efficient and pushes out the enterprises with long-term lack of efficiency (ibid., pp. 10-11).

The policy concentrates on the creation of an environment conducive to economic development and explicitly identifies as key issues some of the distortions caused by the government that this chapter analysed as well. Despite these changes for the better, the policy involves two principal risks:

*Excessive reform ambitions.* The previous policies have been too ambitious regarding the extent of support programs, the fiscal resources available and institutional capabilities of the state. This policy has a different problem – it proposes a set of reforms, about which there is no consensus within the government or society or which require conditions that the state cannot guarantee. An example of the former can be the declared tendency to radically increase labour market flexibility (ibid., p. 37) or to decrease the corporate income tax to 20 %. (ibid., p. 36). An example of the latter is the required cooperation of the private agents in the program of data collection on quality of assets and liabilities without making clear what should lead private agents to cooperate in this venture. (ibid., p. 30)

*Insufficient change in the ministry itself.* Even though this policy makes clear that its writing was overseen by people with reform ambitions, its content indicates that this was not necessarily shared by all authors. The policy contains a significant volume of redundant information and remnants of previous policies, which indicates that individual writers of the policy continue in their old way of thinking.

The new government, however, made a series of bold steps in 1999 and early 2000 that will undoubtedly influence the industrial structure. Swift price deregulation, particularly regarding utilities, and the preparation for privatisation of utilities began to remove some of the accumulated distortions. Lowering of the fiscal deficit and preparation for bank and enterprise restructuring began to create conditions under which not only large enterprises can find debt sources of financing. The data for 1999 indicate that the industrial structure began to gradually change. Real results, however, will begin to show only in the early years of the 21<sup>st</sup> century.

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## 10 Economic Competition

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Competition policy pursues goals that do not have a universal understanding, much like the modes used to meet them. In transitional economies, competition policy is a very broad and complex problem. In addition to standard legislation (The Act on the Protection of Economic Competition) and institutional backup, other legislative norms are needed to achieve the equality of opportunities (e.g., public procurement, license-granting, natural monopolies regulation, state aid). There is also a need for active participation in eliminating regulatory barriers to competition. The independence of an antimonopoly authority and its status need to have a solid legal and financial backing.

An antimonopoly institution is expected to be active in areas where competition can be distorted by the Government. It also needs to be more active in public advocacy of competition policy. An anti-monopoly institution needs to present itself as an independent, competent institution that uses quality analytical tools. In addition to a formal framework, informal rules, i.e. competition advocacy, also have a profound effect.

The mutual influence of formal and informal rules, coupled with a combination of internal and external pressures, will determine the future of competition policy and competition conditions in the Slovak Republic. The future development of competition policy and its enforcement will be directed towards a greater flexibility of rules and strengthening their multinational nature. It will also be marked by a shift from control of “conventional” anticompetitive practices to the control of the regulatory intervention of public administration, state aid, and the enhancement of the strength and influence of informal rules.



## 10.1 Introduction

Generally speaking, the goal of competition policy is to protect economic competition. There have been debates going on, as to what the economic competition should serve, that is, the decomposition of this general objective. Is it economic efficiency in its static or dynamic meaning, consumer welfare, or other than economic goals - social, for instance? This question leads to the problem of mutual compatibility of these partial goals. Another issue that remains open is how the goals are to be met. In conjunction with this, debates arise on the degree of the prescriptiveness needed from rules. One option is to lay down clear-cut and straightforward rules, which calls for an *ex ante* formulation of all the current and prospective situations acting against competition, or, to maintain the flexibility of rules. In this case, it will be necessary to analyze and evaluate each and every case individually. This presupposes quality in an entity enforcing the rules. Another problem concerns the incorporation of competition policy into the context of an overall economic policy, which may conflict with commercial and industrial policies. Initially, competition rules were intended to protect competition on the part of entrepreneurs. Later, it became apparent that competition could also be restricted by the State. This creates a problem in determining who can intervene in such cases and in choosing the method of intervention. This is related to the informal rules and an overall competition culture. The globalization of business relations calls for the harmonization of competition rules and procedures at a multinational level, hence, its leading trends are conceived in the EU and the OECD.

## 10.2 The Context

### 10.2.1 The Substance and Goals of Competition Policy

Opinions on what the goals of the competition protection policy should be have been shaped by the economic development, theoretical views, and experiences with the antitrust implementation.<sup>122</sup> Goals may be identified either by researching the history of countries where antitrust legislation has been enforced (historical method <sup>123</sup>), or by analyzing the law texts and observing the changes and

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<sup>122</sup> The concept of antitrust is used in the USA; in Europe, it is competition policy. In the presented study, the concepts are used synonymously.

<sup>123</sup> The early competition rules were established over a hundred years ago in Canada and the USA. After World War II, they were exported to Western Europe, followed by the rest of the world. Currently, competition laws and institutions exist in all the advanced market and transitional economies.

trends in legislation (analytical method). Initially, understanding competition policy from the point of view of law, predominated. It was judged whether the practice corresponded with the practice prohibited under law. Economists became interested in this area later on.<sup>124</sup>

In the process of antitrust legislation enforcement, there have been several interpretations attempting to define the goal of competition protection. An increase in the economic efficiency, the elimination of the transfers between the buyers and sellers, or between companies having market power and consumers, and support of small and medium-sized enterprises are all examples of various interpretations. The enforcement of competition policy was also marked by political influences and motifs based on the idea that maintaining a fragmented structure was also a way of maintaining a democratic form of rule. Efforts were made to eliminate risks caused by economic concentration, which, as a rule, was conducive to political power. The goals of competition policy were to prevent economic power from being abused, and to protect consumer and producer interests. At times, the issue of plurality was overemphasized and resulted in the protection of small enterprises. In this context, a goal formulated in this fashion would be contradictory to economic efficiency and consumer welfare.

There are countries where legislation has not explicitly contained the issue of goals in the competition law. In others, the issue has been stipulated in broader terms or covered with several specific goals. The more recent legal norms attempt to stipulate the goals of economic competition. The most frequent goal listed is the preservation (or, protection, promotion) of competition (or, free/efficient competition). Some legal provisions contain more than just economic goals. For instance, competition policy in Great Britain is linked with the concept of public interest.

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<sup>124</sup> In the 1950s, especially the Industrial Organization School, the development was markedly influenced by R.H. Coase's famous article entitled *The Problem of Social Cost*. The economists began to analyze the economic relations and influence antitrust laws. G. Stigler introduced the concept of efficiency, i.e., welfare economics, which had a profound effect upon the nature of competition policy. R. Bork claimed that in the 100-year history of the enforcement of antitrust in the USA, its enforcement had been impacted by the non-specification of the goals of competition policy. This resulted in the courts prohibiting numerous beneficial market structures and practices. Especially detrimental was "egalitarianism", market fragmentation, and the protection of small enterprises. Bork outlined the objectives of competition policy as follows: "*The role of antitrust may be summarized as an effort to improve the allocation efficiency without lowering production efficiency so as not to lower consumer welfare.*" Defining several goals entails a problem of their mutual consistency or hierarchization. L. White identifies three possible goals of competition policy: economic efficiency, fairness for entrepreneurs, and the control of economic concentration.

In the past few years, the goal of competition policy has been identified with the achievement of economic efficiency. This is defined as a support to the allocation efficiency manifested by low costs, technological changes, and innovations. As a rule, the ultimate goal is the enhancement of consumer welfare. Globalization introduces the problem of national, or, multinational dimension of consumer welfare.<sup>125</sup> The issue of the so-called efficiency defense introduces the principle of balance in antitrust. The more recent laws explicitly contain this principle,<sup>126</sup> in others the balance method is manifested through their enforcement. The selection of goals is a political decision. Previous experiences abroad have shown that competition policy ought to be more focused on consumer welfare and economic efficiency rather than on the protection of individual competitors and the control of large, dominant companies.

Antimonopoly rules are a form of regulation. Even so, there are constraints to these interventions in a market environment. From a long-term point of view, the market would be able to cope with market failures that result from restriction of competition. The question that needs to be answered is whether a regulatory intervention can introduce balance more quickly. In my opinion, there is a need for such an intervention in transitional economies because intervention may accelerate the establishment of market conditions. A long-term viewpoint would suggest that the abandonment of such a form of regulation ought to be considered. The context described above is vital for understanding the competition policy in the SR.

The goal of competition policy was not stipulated in the Act No. 63/1991. Some legal formulations of the Act allowed for a contravening interpretation, which complicated the enforcement of the Act. In the Act No. 188/1994, the goal of the protection of economic competition is expressly stipulated in Article 1: *“The purpose of this Act is to protect economic competition in the markets of products and services (hereinafter only “goods”) against prevention, restriction or distortion (hereinafter only “restriction on competition”), as well as create conditions for its further development, in order to promote economic development and consumer welfare.”*

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<sup>125</sup> For instance, E. Fox and J. Ordover (1996), refer to the world welfare concept (an aggregate level of consumer benefit and producer profit in all countries).

<sup>126</sup> Canada (the Act of 1980) and France (1986) may serve as examples of countries in which the principle is laid down in their respective legislation. Initially, an opinion prevailed in France that anticompetitive agreements were bound to be negative because eventually they resulted in higher prices and inflation. Later on, the opinion was changed, and the 1986 Act contained the principle of balance (in anticompetitive agreements, abuse of a dominant position, and concentration control), whereby the possibility of outweighing the impacts on the competition by economic effects is contingent on the consumers' participation in welfare.

An objective formulated in this fashion reflects more recent trends according to which economic competition is increasingly understood as a means of achieving economic goals, especially economic efficiency and consumer welfare, rather than a goal in itself. Economic competition also directs attention to the establishment of competition conditions.

In the SR, the Act is based on the protection of efficient competition and the principle of balance. The protection of economic competition is not an end in itself and cannot be enforced in absolute terms. It is directed towards establishing economic conditions that will have a favorable impact on the consumer.

## 10.3 Achieving the Goals

### 10.3.1 Per se Versus Rule of Reason

There is frequent conflict between legal and economic approaches in regard to how the goals of competition policy are to be met. The disputes between lawyers and economists on antitrust have been around for some time.<sup>127</sup> Basically, one may speak of two camps: 1) the authors who wish to safeguard the prescriptive nature of competition rules and approach economic competition as a goal. They clamor for univocal prohibitions and detailed rules; 2) the authors who underscore the results and effects and approach economic competition as a way of ensuring an efficient economic development. They lay emphasis on the analytical nature of rules and advocate individual evaluation of each case.

The development of competition rules enforcement was initially based on the evaluation of individual cases based upon their legal merits. Experience led to setting up groups of similar cases and then imposing a blanket ban. Later on, there was a shift from the per se rule (where it suffices to give a proof of the case corresponding with the prohibition stipulated in the Act) to the rule of reason principle (which accentuates economic consequences, i.e., it does not suffice to establish that a practice is prohibited, it, too, must have a negative impact on the economy).<sup>128</sup>

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<sup>127</sup> In the SR, in the magazine *Právny obzor (Legal Horizons)*, in 1996 and 1997.

<sup>128</sup> In the USA, a shift from linguistic interpretation of Sherman's law to economic interpretation is evident. The precedent of per se rule was established; it sufficed to establish that the activities monitored clearly corresponded with prohibited practices, irrespective of their economic impacts. In 1911, the Chief Justice of the Supreme Court compelled the majority of experts that the Act needed to be interpreted in a "reasonable" fashion, and introduced the so-called rule of reason which was based on the assumption that the legislator could not systematically condemn all the practices prohibited under law and instead, they were to be viewed within the context of their consequences. A distinction was made between the so-called good and bad deals restricting competition (Clayton's Act of 1948). Later on, this approach was transposed to the national legislation of France and the EC, for

The Slovak law concept of economic competition protection is based heavily on the rule of reason. Economically, this concept is very acceptable, but is very demanding in terms of its enforcement. This concept calls for quality economic analyses of the individual cases and a sensitive weighing of their impacts. In transitional economies, and the SR is no exception, the above concept is confronted with the quality of human resources charged with the enforcement of the Act.

### 10.3.2 Where to Intervene

Competition policy is a type of regulation and its role is to correct market failures. A question arises whether it is expedient to correct these failures by virtue of intervention into the structure, or to intervene by conduct.<sup>129</sup> In the early days of antitrust, the structural approach predominated<sup>130</sup> and it was embodied in a ban on monopolization. It was later that attention was directed towards defining the prohibited conduct of entrepreneurs (agreements restricting competition, abuse of a dominant position). Rules controlling economic concentration (mergers, acquisitions) were adopted because it became apparent that the impact of the market structure on the conditions of competition was significant, and structure intervention allowed for some prevention.<sup>131</sup> At the same time, it should be noted that the entrepreneurs responded to the uncompromising sanctions imposed upon cartel agreements by establishing concentrations with looser control. A question may be posed as to whether or not this is not abandoning a stringent implementation of anticompetition legislation.

In principle, three areas concerning the instruments of competition policy were established: 1) concentration control; 2) prohibition of anticompetitive practices; 3) state aid control. The difference among them is that concentrations are not prohibited;<sup>132</sup> they are only subject to the control of antimonopoly institutions. On the other hand, anticompetitive practices are prohibited and sanctioned. Economic competition may also be distorted by the interventions of public administration, and this has resulted in seeking the instruments of response to them. In the EU, regulations on the state aid control have been introduced, and this area has recently become dominant in the EU.

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instance.

<sup>129</sup> Based on the S-C-P paradigm of J.M. Clark. Refer to Sherer and Ross (1990).

<sup>130</sup> Well-known are cases of Standard Oil Co. (1911), American Tobacco (1911), Alcoa and AT&T.

<sup>131</sup> In the EU, since 1990 (Regulation No. 4064/1989).

<sup>132</sup> This would be an action against an efficient development of companies via their external growth.

In the SR, the legislation covers the above areas, i.e., it stipulates the control of concentrations, anticompetitive practices, and it even provides some limited room for a response to competition restriction on the part of public administration (Article 18 of the Act). The issues related to the state aid control need to be addressed separately. In 1999, the State Aid Control Office was established, and in September 1999, the Act on State Aid was passed (Act No. 231/1998 Coll.). The latter went into effect on January 1, 2000.

## **10.4 Formal Rules**

In line with a new institutional economics, institutions need to establish formal rules (legislation, institutions) and informal rules (attitudes, customs, ethics, behavioral patterns). In the SR, the protection of economic competition had a sound basis. In the early years of economic transformation, a fundamental legislative and institutional framework was established in order to protect economic competition.

### **10.4.1 Legislative Framework of Economic Competition**

The Act No. 63/1991 on the Protection of Economic Competition introduced the rules of competition protection to the Slovak legal system.<sup>133</sup> The earliest amendment of the Act took place after it had been in force for over a year. The Act No. 495/1992 Coll. was especially focused on the sweeping state and legislative changes that were under way. It reflected the abolishment of the Federal Office for Economic Competition and transferred powers to national offices.

After the independent republic was established, the protection of economic competition was even enshrined in the Constitution (Article 155, Para. 2 of the Constitution of the SR). Despite that effort, enforcement of an economic policy distorted equality of opportunities in a number of ways.

A new Act No. 188/1994 Coll. on the Protection of Economic Competition was passed, because several weak points were found in the legal provision of the 1991 Act (the purpose of the act was not stipulated clearly enough, the scope of its jurisdiction was too narrow, vague substantive clauses on cartel agreements along with a dual regime of their judgement, inadequate definition of mergers, excess reporting duty of entrepreneurs at acquiring a monopoly or dominant position in the market, insufficient powers of the Antimonopoly Office (the Office) in gathering necessary materials and information, unsatisfactory legal provisions pertaining to administrative proceedings before the court, inaccuracies in

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<sup>133</sup> In the past, the Act No. 141/1933 Coll. on Cartels and Private Monopolies was passed in the Czecho-Slovak Republic in 1933. Later on, within the framework of a centrally planned economy, it was no longer viable.

terminology, a need to take account of the laws passed at a later date). The Act was focused on harmonizing the national law with the EU rules of economic competition. It was preceded by an extensive comparative analysis and a discussion with numerous foreign experts. In fact, it was among the earliest laws passed in the SR to be harmonized with the EU legislation and up until now, it has not caused any serious problems.

In accordance with the international commitments (Euroagreement effective as of February 1, 1995), implementing rules for the enforcement of competition provisions were adopted and became effective in 1997. Harmonization of legislation caused no specific objections concerning economic competition. The control of state aid and public procurement is of greater concern. Competition policy is still in the process of development, and the rules are being changed in the EU. This makes it important to monitor and analyze this development and respond to it appropriately.

Through the Act No. 240/1998 Coll. on Agriculture, an indirect amendment was forced through to grant an exemption for anticompetition agreements of entrepreneurs in agriculture.<sup>134</sup> The Antimonopoly Office of the SR was not given a chance to express its opinion on this bill. This is an example of how the government of that time disregarded the principles of competition. The Office submitted a legislative draft of the so-called little amendment of the Act that was intended to restore the original state of affairs. The draft was debated in the National Council of the SR in November 1999 and it was declined.<sup>135</sup> It is likely that this will induce a negative response on the part of the EU.

The Act on the Protection of Economic Competition can be listed as one of the crucial economic laws that, when enforced, assists entrepreneurs. In other countries, it is common practice to work with guidebooks. That was the idea behind passing the Act in 1994. The Act assumed the responsibility for publishing a generally binding provision in which the conditions of the Article 5 of the Act would be stipulated in greater detail.<sup>136</sup> This would assist the entrepreneurs with its enforcement. To date, such a provision has not been adopted. Instead, guidelines applicable to concentrations and agreements restricting competition were drafted. The Office drafted some internal methodologies, but failed to issue any generally binding provision or any guidelines.

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<sup>134</sup> Concerning milk, slaughter animals, oilseeds, cereals, sugar beet, vegetables, fruits, and potatoes.

<sup>135</sup> It was passed in the Parliament and was to come into force in 2003. On the initiative of the Antimonopoly Office of the SR, President of the SR did not sign it and referred it back to the Parliament.

<sup>136</sup> Compliance with the conditions under which the prohibition is not applicable to agreements restricting competition.

Currently, the Antimonopoly Office of the SR has drafted the so-called little amendment which is to introduce *de minimis*<sup>137</sup> doctrine, negative attest,<sup>138</sup> individual and group exemptions.<sup>139</sup> It has also invalidated the exemption of agricultural agreements from the jurisdiction of the Act. The Antimonopoly Office of the SR drafted the Legislative Plan of a New Act on the Protection of Economic Competition. The draft was approved by the Government on November 17, 1999. The proposed changes concern procedural and substantive aspects and these changes address the previous enforcement of the Act and the development of the EU competition rules. Efforts to enhance the prescriptive nature of the rules<sup>140</sup> and solidify the position of the Chairman of the Antimonopoly Office<sup>141</sup> are apparent. It would be most advisable to present this draft for a wider discussion.

### 10.4.2 An Overall Legislative Framework

The legislative framework of economic competition is also composed of other laws that ensure equality of opportunities in enterprise (for instance, access to essential facilities, state aid, public procurement, capital market regulation, banking supervision, the system of license-granting, ineffective bankruptcies). The lack of clear rules in the above areas allows for the competition distortion.

It is advisable to give an antimonopoly institution an opportunity to respond to drafting or amending such laws (*ex post* and *ex ante*). The Antimonopoly Office took active part in this process in the early period of its activity, but it was later assigned a more passive role. The Office is expected to review bills and other legal regulations. Its involvement in the legislative process is designed to prevent an uncontrolled adoption of new norms that may have a detrimental impact on competition. The position of the Office is not very solid. In passive legislation, the comments made by the Office on bills submitted by other ministries were only occasionally taken into account.<sup>142</sup>

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<sup>137</sup> The limits of unsubstantial restriction of competition which cannot appreciably affect competition conditions in the markets.

<sup>138</sup> The Antimonopoly Office opinion that the agreement of entrepreneurs does not fall under the prohibition within the meaning of this Act.

<sup>139</sup> Exemption from a prohibition of such agreements restricting competition that meet the criteria set forth in the Act and are deemed necessary for achieving efficiency. In addition to an individual exemption, there may also be a group of agreements that meet the criteria stipulated in the relevant legislative norm, for instance, agreements on specialization, research and development, if these agreements meet specified conditions.

<sup>140</sup> In our opinion, this contravenes the requirement for the flexibility of rules and it would be advisable to adopt guidelines, or, a generally binding provision, to stipulate these changes in greater detail.

<sup>141</sup> A requirement to enhance the independence of the Office is justifiable, however, it should be initially aimed at the enhancement of a collective decision-making.

<sup>142</sup> For instance, adverse opinion of the Office on the Act on Prices halted their adoption.



### 10.4.3 Aiding Economic Transformation

The Slovak economy is undergoing a stage of economic transformation that envisages the competition mechanism as a replacement for the administrative interventions of the State. Competition mechanism may be considered the most efficient instrument of market regulation; therefore, in this stage, an antimonopoly institution is required to enforce the following:<sup>143</sup>

- diminish administrative interventions of the State and enlarge areas exposed to competition pressure;
- intervene into the structure via privatization;
- allow free access to the market and the liberalization of foreign trade;
- make up for competition restriction on the part of public administration;
- encourage active competition advocacy.

Ever since it was established, the Antimonopoly Office has been actively enforcing the restriction of regulation and widening up the scope of competition conditions across the individual sectors of the economy. In the early years of its operation, the Office was an active vehicle of reform-oriented changes and was considered ahead of its time, to some extent.<sup>144</sup> For instance:

- It submitted a Bill that invalidated state monopoly in tobacco and salt enterprise. (The Act No. 63/1950). The Bill was carried in 1994. The Act established conditions for economic competition in the areas concerned.
- In order to introduce a competitive environment into the areas of products and services funded from the state budget, the Office initiated the adoption of the Resolution of the Government No. 640/1991 on Public Procurement. This was the first initiative of its kind in transitional countries.
- It repeatedly submitted a bill on the regulation of natural monopolies. To date, this bill has not been carried. The adoption of this norm is considered an essential precondition of a successful privatization and a constituent part of the restructuring of these areas of enterprise. Regrettably, the work on the regulation of natural monopolies was discontinued, and only lately, the problem has only recently been addressed anew.
- It submitted a draft of rules (as early as 1994), followed by a Bill on competitive license-granting. This Bill was turned down. Scandals, that have recently arisen in conjunction with license-granting in almost all the areas, indicate an urgent need to adopt such rules.

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<sup>143</sup> This is a more active position that is more prone to conflicts than the enforcement of the “conventional” antimonopoly policy on the part of antimonopoly institutions in advanced market economies.

<sup>144</sup> Considering the then period, the proposals made by the Office were much too advanced, and were not received positively.

- It made a proposal geared towards the improvement of the condition of competitive environment (by the Office taking part in the privatization process, identification and a continuous elimination of institutional, economic, and legislative barriers restricting economic competition, conducting analyses of the impact of system measures on competition).

In the years that followed, the Antimonopoly Office began to lose its position as an active market-oriented entity and was increasingly assigned a passive role. This role prevented its ability to dramatically affect the adopted measures of the economic policy. It did not even voice its opinion<sup>145</sup> on such relevant steps as the distorting of the principle of equality of opportunities in the Recovery Act, tax allowances for privatizing entities,<sup>146</sup> the exemption of some entities from the jurisdiction of the Act on Bankruptcy and Composition (for instance, strategic and rehabilitated enterprises), discharge of penalties for some entrepreneurs that defaulted on their tax liabilities, the introduction of import restrictions, or wage regulation. The Office declared an effort to partake in these processes more actively after the elections in 1998. However, too short a period of time has lapsed to judge whether or not these efforts have been achieved. This is also true of the Government's commitment to observe the principles of equality of opportunities and competition in the economic policy.

The privatization process also offered an opportunity to intervene in the establishment of competitive structures. The Office voiced its opinion on the concepts of the privatization of various sectors of the economy and the privatization projects of individual enterprises. The privatization process offered a unique chance, not only to create a favorable ownership, but also to create an organizational structure. The objective of expedient de-concentration and demopolization was to establish a competitive environment.<sup>147</sup> According to Article 19 of the Act on the Protection of Economic Competition, the Office is obligated to evaluate the drafts of a privatization project submitted by the founder pursuant to the Act No. 92/1991 Coll. on the Conditions of the Transfer of State Assets to Other Persons.<sup>148</sup> Later on, the privatization process became less

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<sup>145</sup> Or, it did not make a public statement or use arguments to influence public opinion.

<sup>146</sup> Discharge of income tax, discharge of the portion of the purchase price by the National Property Fund of the SR.

<sup>147</sup> The legislative framework of the powers of the Antimonopoly Office of the SR in the privatization process was composed of the Act on the Protection of Economic Competition and the Act No. 92/1991 Coll. on the Conditions of the Transfer of State Assets to Other Persons (the so-called Act on Big Privatization), as amended. According to these, the Office voiced its opinions on the drafts of a privatization project submitted by the founder from the point of view of the criteria of expedient deconcentration.

<sup>148</sup> For instance, in 1998, the Office issued decrees concerning 52 drafts of privatization projects.

transparent as public biddings were abandoned, and the equality of opportunities was distorted. The goal of competition policy is to establish competitive market structures, and this requires a close link with the industrial policy of the State. Conflicts occasionally may arise between them, usually revolving around the short-term effects. For instance, restricting import may balance-up the deficit of trade balance in the short-term, but also establish barriers to competition, lead to the deterioration of consumer welfare, and postpone the adaptation of enterprises to market conditions. Foreign competition is often the only one to exert competition pressure on domestic producers due to the size of the Slovak market.<sup>149</sup> Therefore, when protectionist measures were adopted (surcharge on import and extension of its effect), the Antimonopoly Office of the SR voiced a negative opinion. Although its view was usually disregarded, a debate on the medium- and long-term effects of such measures was invited and the pressure of domestic producers at the expense of consumers was at least partially outweighed.

#### **10.4.4 The Antimonopoly Office of the SR, Its Status and Powers**

The Antimonopoly Office of the SR is a central state administration body. It was established under the Act of the National Council of the SR in 1990. The Prime Minister appoints the Chairman of the Antimonopoly Office. In economic competition, the SR enjoyed a good starting position, and the Slovak Antimonopoly Office had been established prior to the Federal Office and the Czech antimonopoly institution.

Ever since it was founded in 1991, the Antimonopoly Office of the SR has gained recognition locally and internationally. Foreign contacts at bilateral and multinational levels were established (DG IV for economic competition in the EU, OECD, UNO). Later on, the situation was changed, and several foreign institutions began to refer to the strengths of this institution in the past tense.

The status of the antimonopoly institution was weakened largely due to the frequent recalling of its chairmen. At the same time, qualification criteria were lessened in favor of political criteria. The SR ranked first in the number of chairmen of the Antimonopoly Office in the Central European region. While in the CR, during the entire period of this institution's existence, there have been two chairmen, one in Hungary and two in Poland, the SR boasts a record of six

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<sup>149</sup> For instance, the analysis of the price development in selected groups of products conducted by the Office in 1994, indicated that the most rapid price increase was reported in sectors that were not exposed to the pressure of domestic competition and were protected from import (passenger cars, cigarettes, some groceries). On the other hand, a minimum price increase (below the inflation rate) was recorded in highly competitive sectors with non-existent import protection (textile and clothing, consumer machinery and electrical appliances).

chairmen. It was apparent that failure to ensure independent position was responsible for the frequent recalling of its chairmen.<sup>150</sup> The objective was to prevent any initiation of delicate cases and also to have the Office actively intervene into the privatization process through the control of concentrations.

Failure to understand the significance of competition principles in the economy resulted in approaching the Antimonopoly Office of the SR as a marginal institution under political control. Economic transformation calls for entering the economic policy in a much more active and go-ahead manner, therefore, this position needs to be void of any political and lobby group pressures. This method will establish a balance between the short- and long-term economic interests.

In fact, the establishment of a legislative and institutional framework is just the first step toward achieving efficient competition policy. The enforcement of the Act is contingent on the quality of human resources. A sensitive and economically justified entry into the economic environment of entrepreneurs and the ability to address the arguments used to set upon the anti-competition measures of the Government, calls for a quality and solid backup. After the initial excitement and numerous training courses held abroad, as well as conferences and workshops, preconditions were established to assure this institution's sound performance. Later on, filling in the post of chairman was politicized and an overall situation in the society resulted in numerous specialists leaving the Office. There is a marked shortage of specialists with a legal and academic background. Currently, the question is whether or not another group of experts on economic competition can be recreated. As a rule, it is easier to build an institution from the ground floor than to reorganize it later on.

## **10.5 The Implementation of Competition Policy**

### **10.5.1 The Scope of Cases Reviewed and Decisions Adopted**

Since the Office's establishment in 1998, it has issued 223 decisions on anticompetitive practices, of which 168 were cases of abuse of a dominant position in the relevant market, 55 were agreements restricting competition, and 135 were decisions on concentrations. According to the Act on the Protection of Economic Competition, the Office also reviewed other forms of competition restriction that were resolved by issuing a decree, or by ordering the relevant authority to remedy the state of affairs (46 cases of the enforcement of Article 18).

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<sup>150</sup> In 1994, the proposal to appoint the chairman of the Antimonopoly Office by the president of the republic for a term exceeding the four-year election term, was turned down.

Since 1991, the Supreme Court of the SR (SC SR) has reviewed 16 cases concerning the violation of the Act on the Protection of Economic Competition in total, e.g., ÖMV-Benzinol, Incheba, Slovnaft-Benzinol, cartel agreement of the Slovak cement producers. In ten cases, the Court upheld the decision of the Office.<sup>151</sup> Fines totaling over SKK 50 million were imposed. In the early years of its activity, the Office did not impose stringent sanctions because of the novel nature of this area, but rather focused on the clarification of competition protection to entrepreneurs. Later, sanctions were made much more stringent. To date, the highest fine has been SKK 100 million, and it was imposed on Slovnaft Inc. for abuse of a dominant position.

TABLE 1: Decisions of the Antimonopoly Office Issued in Individual Years<sup>152</sup>

Year	'91	'92	'93	1994	1995	1996	1997	1998	Total
Abuse of a Dominant Position	45	18	27	12	14	21	15	16	168
Agreements Restricting Competition	6	6	7	7	6	7	6	10	55
Anticompetitive Practices, total	51	24	34	19	20	28	21	26	223
Concentrations	11	8	8	6	9	27	17	49	135
Public Administration Measures, Article 18	-	-	-	8	19	2	7	10	46
Reviewing by Supreme Court	-	-	-	-	-	2	1	5	8
Fines, in thousands of SKK	-	-	-	21,937	2,180	5,287	6,510	14,142	50,056

Source: Statistics of the Antimonopoly Office of the SR, 1999

## 10.5.2 Anticompetitive Practices and Concentration Review

By law, the Office shall sanction anticompetitive practices (agreements restricting competition, abuse of a dominant position), control the process of

<sup>151</sup> In 1999, the Supreme Court upheld the decision of the Office in 5 cases.

<sup>152</sup> In our opinion, the figures give an idea of the overall scope of the activity of the Office, however, no trends, or, priorities of the Office may be projected on their basis. The number of cases across the individual categories was impacted by an overall economic policy (for instance, in concentrations), and the number of entities towards which the proceedings were directed may distort the figure. For instance, in 1998, of the total number of 16 decisions concerning abuse of a dominant position, in as few as 5 cases the Office decided that the dominant position in the market was abused.

economic concentration, and guarantee the establishment of competition conditions. The Office has carried out several investigations and adopted decisions prohibiting agreements and abuse of a dominant position.

#### **10.5.2.1 Abuse of a Dominant Position**

Pursuant to the Act No. 188/1994 Coll. on the Protection of Economic Competition, assuming the dominant position in the market is not prohibited, however, it shall not be abused. Abuse of a dominant position in the market may have several forms, namely: 1) enforcing disproportionate conditions in contracts; 2) tying contracts; 3) applying different conditions to equal or comparable transactions in individual entrepreneurs (discrimination).

In the event the Office is suspicious of abuse of a dominant position, it shall first define the relevant market (from the material, geographic, and even temporal point of views), determine if the entity concerned disposes of market strength, and demonstrate that abuse has occurred. If abuse is established, the Office shall issue a decree prohibiting such conduct of the entrepreneurs, and it may impose a fine equivalent to 10 percent of their turnover, even on a repetitive basis.

The politically sensitive nature of the cases is evidenced by the abuse of a dominant position by Slovnaft Inc. In 1998, the Office issued a decree in which the non-renewal of fuel purchase agreements with some entrepreneurs<sup>153</sup> was qualified as abuse of a dominant position in the relevant market, and the company was imposed a fine of SKK 100 million and ordered to remedy the state of affairs. Slovnaft appealed the Office's decision after the time for appealing had lapsed. In a special appellate procedure, the former chairman of the Office invalidated the original decision. In view of the fact that, according to the opinion of the Office staff, Slovnaft violated the law, the new chairman filed a petition with the Office of the Public Prosecution. In December 1999, the Office was served with a protest from the Chief Prosecutor of the SR. It was against the decision of the former chairman of the Office and the original decision was made void. The case is to be reviewed soon.<sup>154</sup>

#### **10.5.2.2 Agreements Restricting Competition**

Agreements, concerted practices of entrepreneurs, and the decisions of entrepreneurs' associations that result in competition restriction are prohibited because, through these means, the decision-making autonomy of entrepreneurs is restricted from gaining advantages at the expense of other entrepreneurs or consumers. These may be agreements between competitors (horizontal

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<sup>153</sup> Slovnaft refused to renew agreements on direct deliveries of fuels to some companies. Eight companies filed a petition with the Antimonopoly Office of the SR.

<sup>154</sup> After the time-limit for appealing, *Pravda* daily, November 20, 1999.

agreements), or between entrepreneurs that operate in ancillary markets (vertical agreements). In addition to written and verbal agreements of entrepreneurs, concerted practices are also prohibited, i.e., deliberate coordination of the conduct of entrepreneurs in the market cannot be referred to as a natural following of the competitor's procedures.

In accordance with the concept of an efficient competition protection, the applicable legal provision is not based on a universal prohibition of every agreement that restricts competition. It would be futile to prohibit agreements having no substantial influence upon competition (for instance, petty cartels), and also agreements that simultaneously restrict in-brand competition and promote out-brand competition (e.g., some distribution agreements). Therefore, the principle of balance is also introduced in agreements. To avoid any bureaucratization of this procedure, an increase of the entrepreneur's transaction costs, and tying the Office staff, mandatory notification of anticompetitive agreements was lifted.<sup>155</sup> This provided space for the Office to seek and review cases that are harmful to competition rather than just formally approving agreements that have no marked negative effects. The Office must take the initiative in finding leads to competition restriction. Generally speaking, this assumes quality analytical tools.

Among the most successful cases was a cartel agreement among the Slovak cement producers. This was examined by the Office in 1994 and resulted in a decision for prohibition and a fine of almost SKK 20 million.

### **10.5.2.3 Concentration Control**

Reviewing concentrations is a prevention and an intervention into the market structure used to prevent the emergence of entities capable of enjoying a powerful, dominant position through an external growth of companies. Concentration is a process by which an economic grouping of entrepreneurs is created through a merger, or amalgamation of previously independent entrepreneurs capable of assuming control over another entity. Assuming control is understood as the possibility to exercise decisive influence over an activity of another entrepreneur via ownership and user rights related to the enterprise. Especially important is the creation of influence over the set-up, voting and decision-making of the entrepreneur's bodies.

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<sup>155</sup> According to the previous provision, the Office was to be notified of all agreements, even those that had a minimal restrictive effect upon competition. These agreements were either approved or granted an exception. The only difference was that the approvals concerned less dangerous agreements and contained non-voicing of the opinion of the Office (acquiescence). Experience showed that entrepreneurs did not meet their obligations to notify the Office of the agreements to be approved. However, the enforcement of this obligation would not be advisable because they often may positively impact the economy and they would be approved by the Office upon notification.

Concentration is subject to the Office control, in the event: 1) the joint turnover of the parties to concentration is at least SKK 300 million, and at least two parties to concentration report a turnover of SKK 100 million respectively for the previous accounting period, or, 2) the joint share of the parties to concentration exceeds 20 percent of the total turnover in identical or substitute goods in the market of the SR.

In accordance with the concept of an efficient competition protection, the economic balance, i.e., judgement whether the harm to economic competition will be outweighed by the positive effects of concentration, is a vital criterion underlying the decision of the Office on concentration. Based on this concept, the Office may issue a decree on the concentration approval, prohibition, or tie its implementation to meeting some conditions. This allows for an economically prudent decision. However, some freedom in decision-making may be used for a politically-motivated decision.<sup>156</sup>

Concentration control is considered a sensitive area in the SR. The non-transparent privatization process has established vague ownership and capital ties that may result in an uncompetitive market structure. The entrepreneurs were obligated to notify the Office of a concentration exceeding the set limit. By law, the Office has the right to request all the relevant information in order to review economic ties and analyze their impacts on the competition conditions in individual markets. Pursuant to Article 10, Para. 2, the Office was authorized to prohibit a concentration which establishes or solidifies a dominant market position in the event that the parties to concentration fail to demonstrate that the harm to economic competition will be outweighed by nationwide positive economic effects of concentration. The Office may impose such a prohibition retroactively. It may also require that all things be restored to the original state. In several cases, notification duty was disregarded by entrepreneurs, fines in a few cases for failure to notify were imposed by the Office. In most cases, the Office consented to a concentration,<sup>157</sup> and in some cases, to the conditions of concentration (for instance, in Slovnaft – Benzinol case). The Office decided on the prohibition of one concentration in the case of vertical concentration between a dominant press publisher (Danubiaprint company) and a dominant press distributor (PNS company).

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<sup>156</sup> The question is whether a clear-cut formulation of this criterion would help, or if other ways of issuing a decision in line with the political requirements would be sought (e.g., via defining relevant markets). The enforcement of the Competition Act requires culture, observance of laws, and identification with the goals of this policy.

<sup>157</sup> It should be noted that the situation is similar abroad, e.g., in the EU. In the EU, however, concentration is much more extensively discussed with the DG IV staff well in advance so as to avoid a decision on the prohibition, and to prevent the parties to concentration from altering the operation to make it acceptable for the Commission.



The Legislative Plan of a new bill considers the introduction of the so-called concentration prenotification. This action is common in the EU and foreign investors are accustomed to it. Prenotification would allow the entrepreneurs to familiarize themselves with the opinion of the antimonopoly institution in the concentration plan's early stage. The investment risk of foreign investors, who have little trust in the enforcement and observance of the laws in our country, would be reduced. The potential risk of a prohibition of an operation in which their capital has been invested would be avoided.

The politically delicate nature is also evidenced by some decisions (for instance, in Slovnafit-Benzinol case) and the fact that a failure to notify concentration served as an argument for the invalidation of the agreements with the National Property Fund of the SR (e.g., Istrochem case<sup>158</sup>). Through concentrations, the enforcement of the Act on the Protection of Economic Competition may turn into an instrument of a retroactive revision of privatization decisions.

### **10.5.3 The Jurisdiction vis-à-vis the Public Administration**

According to Article 18 of the Act No. 188/1994 Coll. on the Protection of Economic Competition: 1) state administrative bodies and municipalities shall not, by their own decisions, apparent support, or in any other way, restrict competition; 2) the Office shall conduct oversight of the observance of Paragraph (1). Article 11, Para. 2 shall apply as appropriate;<sup>159</sup> 3) based on evidence and analyses, the Office may request the state administration bodies and municipalities to remedy the state of affairs.

The majority of cases reviewed concerned discriminatory action of the municipalities that observed the decrees of the Office as a way to remedy the state of affairs. A more complex and politically delicate situation arises if competition restriction is an outcome of a decision made by the central state administration body (for instance, a ministry). The table shows that the Office rarely intervened

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<sup>158</sup> In 1996, the Bratislava Chemical Works (CHZB) acquired 67 percent of Istrochem shares from the National Property Fund of the SR, for SKK 300 million, although their value was SKK 2.8 billion. In 1999, the National Property Fund of the SR withdrew from the agreement, and the argument it used was that CHZB did not notify the Antimonopoly Office of the SR of a concentration, and, hence, the privatization agreement was breached. The Antimonopoly Office of the SR, in its decision of November 18, 1999, corroborated the fact that CHZB did not violate the Act on the Protection of Economic Competition and the concentration was approved.

<sup>159</sup> Provision that entitles the Office to require background materials and information from entrepreneurs that are necessary for the operation of the Office.

into such cases, even though there have been numerous distortions of competition conditions occurring in recent years. The success rate of these cases was low.<sup>160</sup>

TABLE 2: Number of Reviewed Cases Pursuant to Article 18

YEAR	1991	1992	1993	1994	1995	1996	1997
No. of Cases	4	4	39	54	37	27	15 (7)*

(\*)\*- number of applications filed to effectuate redress. Source: Nižnanský (1998)

According to the chairman of the Antimonopoly Office of the SR,<sup>161</sup> the state is considered satisfactory in the case of municipalities. In almost all the cases, the municipalities responded positively to the findings of the Office. The decrees to eliminate the deficiency and remedy the state of affairs are observed. The situation is less satisfactory in cases where the central state administration bodies have been ordered to remedy the state of affairs. In several cases, the heads of these bodies did not even respond to the Office's warnings that the decisions issued violated the Act on the Protection of Economic Competition.

Regulatory barriers may be considered a big problem in transitional countries. These interventions, e.g., regulatory decisions on prices, wages, favoritism, administrative restriction of the market entry, exclusive rights, certificates, licenses, and other permits for enterprise, and also the non-existence of rules, selective access to information, may all impede or postpone the market entry and distort the principle of equality of opportunities. These interventions are distinct from the anticompetitive practices of entrepreneurs, but have not been thoroughly addressed. The basic characteristics of regulatory barriers are shown in Chart 1.

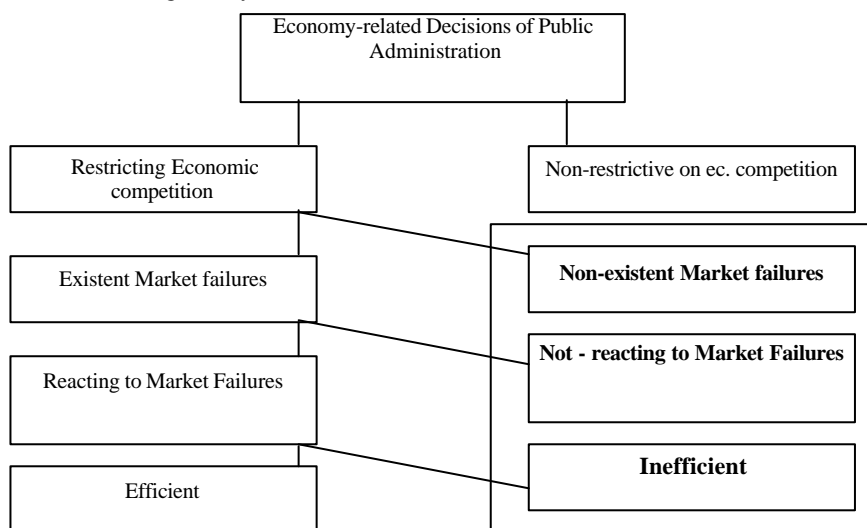
The chart illustrates that these are the decisions made by public administration, and that these decisions have an impact on the economy and the conditions of competition. Let us further assume that the intervention of the State in the economic environment is expedient only in cases of market failures. Market failures may be characterized by the market system's inability to ensure market

<sup>160</sup> For instance, the allocation of the funds of Pro Slovakia Fund which was given a broad mass media coverage. A Divisional director of the Antimonopoly Office of the SR was recalled from his position after he had instructed the culture minister to remedy the state of affairs pursuant to Article 18 of the Act No. 188/1994 Coll. on the Protection of Economic Competition, i.e., to stop the ministry from allocating funds from the Pro Slovakia State Fund to two periodicals (Slovenská Republika, Hlas ludu), to fund their supplements intended for national minorities because that created unequal competition conditions. The press made ironical comments on the non-transparency of the fund allocation as follows: "The funds of Pro Slovakia are a greater secret than defense spending".

<sup>161</sup> Nižnanský (1998).

assets. This can be caused by the market's unfitness, non-existence, or underdevelopment.<sup>162</sup> Regulatory barriers may be interpreted in active and passive meanings. Active failure means that the Government intervenes when it should not, or it intervenes in an inappropriate fashion. Passive failures means that the government does not intervene in areas where intervention is needed.

CHART 1: Regulatory Barriers



The Legislative Plan of a new bill contemplates the possibility of sanctioning the state administration bodies and municipalities for the non-observance of the Office's decree to remedy the state of affairs pursuant to Article 18. This, however, invites questions related to the status of the individual state administration bodies and their mutual subordination, and the responsibility of the Government for the enforced economic policy. In my opinion, it is more likely that the standard of informal rules that can resolve the problem.

<sup>162</sup> As a rule, the concept of market failure is used to describe situations in which the market output does not reach efficiency according to Pareto or Marshall. Ref. to Stiglitz (1197), Nemcová and Žák (1997).

## 10.6 Comparing with the Situations in the Czech Republic, Hungary and Poland

A questionnaire-based survey,<sup>163</sup> conducted in 1997, was focused on the perception of regulatory barriers by entrepreneurs in four transitional economies (CR, Hungary, Poland, and the SR). Comparison of the results indicated that the entrepreneurs in the SR were confronted with more restrictions in the area of public administration. Such a situation has numerous negative impacts on the economy:

- regulatory barriers may incur sunk costs in entrepreneurs;
- transaction costs of entrepreneurs rise;
- allocation efficiency, consumer welfare deteriorates;
- state interventions worsen the competitiveness of enterprises;
- entrepreneurs are focused on rent-seeking rather than profit-seeking.

Among the most detrimental regulatory barriers identified by Slovak entrepreneurs were the unequal privatization conditions, the protection of inefficient companies, and state restructuring aid. This indicates that in transitional economies, specific regulatory barriers are established that create unequal conditions for entrepreneurs. On the other hand, Slovak entrepreneurs were lenient with the discrimination of foreign entrepreneurs, and import restrictions. This alludes to a poor preparedness for globalization processes. The order of harmfulness is shown in table 3.

## 10.7 Informal Rules

The perception of economic competition and equality of opportunities was influenced by the novel nature of this area. In the early years of its existence, the Office was active in clarifying competition objectives and rules. In addition to the publishing of articles, workshops for entrepreneurs and lectures at universities were organized. Gradually, the entrepreneurs got used to the existence of competition rules, although one cannot speak of their full observance (e.g., the non-observance of notification duty at concentrations).

Selective policy on the part of the government, clientelism in privatization, public procurement, and license granting have all had negative effects. This effect was reflected in the perception of successful behavioral pattern. The process of remedying this situation will be both difficult and lengthy.

To date, few arguments have been used in favor of competition expansion on the part of consumers and their associations. For example, in the case of import restrictions, the effect upon domestic consumers is higher prices, and de facto

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<sup>163</sup> Conducted in 1997, on a sample of 155 respondents, refer to Zemanovicová (1998).

cross-subsidizing of foreign consumers is an outcome of an artificial export support. Currently, competition advocacy is non-existent in the SR, i.e., opposing government restrictions that restrict competition and can have deleterious effects upon consumer welfare. It cannot be assumed that the economic policy of the government is totally free from lobbying. This should be outweighed by the solid status and influence of institutions that advocate the nationwide economic interests and consumer welfare. The status of these institutions is still weak. This prevents the exertion of effective counterpressure by powerful and well-established affinity groups of entrepreneurs.

TABLE 3: The Order of Harmfulness in the SR

Numerical Order	Question	$\Sigma$
1	Unequal Privatization Conditions	285
2	Protection of Inefficient Enterprises	271
3	State Support of Restructuring	262
4	Legislation Enforcement	257
5	Advantages to Certain Companies	256
6	Non-existence of Rules	252
7	Exemption of the Scope of Legislation	252
8	Non-functioning Bankruptcy Legislation	249
9	Public Procurement	248
10	License-granting System	231
11	Allocation of Means from Public Funds	230
12	Price and Wage Control	221
13	Import Restrictions	211
14	Existence of Licenses and Permits	204
15	Limits, Standards, Restrictions	192
16	Discrimination of Foreign Entrepreneurs	189
17	Restrictions in Enterprise	170

Note: If all the respondents regarded the measure as: problem-free,  $\Sigma=100$ ; a barrier to competition  $\Sigma=200$ ; a significant barrier to competition  $\Sigma=300$ .

In transitional economies, a functioning legislative framework needs to be established quickly in order to avoid the distortion of rules in favor of narrow affinity groups. The transparency of procedures must also be observed, especially if the procedures are likely to substantially influence equality of opportunities.

In the early years of the Office's existence, it was common to inform the entrepreneurs and also the public at large of the Office's activity and its decisions. It was among the first public administration authorities to establish a tradition of annual reports containing an overview of activities and other relevant information.

This tradition has been kept.<sup>164</sup> Organizing press conferences continued, but the information presented avoided delicate topics and was non-responsive to government decisions, even when competition was harmed. The general public was denied information concerning the detrimental impact on competition. The disclosure of relevant information and the transparency of its activity began to deteriorate, and its decisions were no longer made official. It is common practice abroad that decisions of antimonopoly institutions and their commentary and explanatory notes are commonly made public. The purpose of this is to enable the entrepreneurs to anticipate the enforceability of the law. This information is also available on Internet. In the SR, the general public and even the professional public working in this field (lawyers, economists) were denied access to this information. A positive change took place after the elections in 1998. The Office<sup>165</sup> now makes public on a regular basis the information concerning cases under review and the decisions issued. This information is also accessible on the Internet ([www.antimon.gov.sk](http://www.antimon.gov.sk)).

## 10.8 Recommendations for the Economic Policy

A legislative and institutional framework has been established for the competition policy in the SR. Competition policy may be viewed in the light of costs and effects. It may be stated that the legislative framework has established preconditions for non-bureaucratic, economically rational procedures of the competition policy implementation. However, there is no effective instrument to halt administrative and regulatory interventions of public administration. It is these competition restrictions that may be regarded as relevant in the process of economic transformation.<sup>166</sup> It is advisable to solidify the position of the SR's Antimonopoly Office in the legislative process and also facilitate the adoption of economic policy decisions that restrict competition. Other factors are the initiation of legislative changes that are to eliminate artificial competition restrictions, or that will initiate the adoption of rules in this area that are vital from the point of view of equality of opportunities (e.g., license-granting). One may also consider the introduction of an obligation to consult the Office in the event measures are likely to have a detrimental impact on competition. Should the opinion of the Office be disregarded, measures need to be taken. An obligation to submit the opinion of the Office to the Parliament, together with the Bill and the necessity of informing the public should be set forth in a legal provision.

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<sup>164</sup> Reports on the activity of the Office are published annually in Slovak and English - accessible on the internet.

<sup>165</sup> Regular information of the Antimonopoly Office of the SR in *Hospodárske noviny* daily.

<sup>166</sup> For details, refer to Zemanovicová (1998).

In addition to the Act on the Protection of Economic Competition, there is a need to perfect rules in other areas as well, especially those having impact on equality of opportunities (regulation of natural monopolies, public procurement, license-granting, and the like).

Sometimes, the intervention of the Office is complicated by the environment which has inhibited the reform of some sectors. This situation impedes the enforcement of market-oriented measures. Therefore, progressing reform (e.g., of the health, social, and banking sectors, the capital market, natural monopolies) will continue to expand in areas that operate under competitive pressure. Reducing the number of redistribution processes will naturally narrow the space for regulatory interventions of public administration. Likewise, globalization and the harmonization of rules will be conducive to the establishment of a standard overall framework for enterprise.

The independence of an antimonopoly institution needs to be guaranteed in order to fairly implement competition rules and effectively respond to the implementation of regulatory barriers. The citizens ought to have access to information regarding the impacts of the restriction of economic competition. Hence, an antimonopoly institution should enjoy a degree of autonomy that allows it to present its arguments. If an antimonopoly institution is also expected to act as a competition solicitor, it must be regarded as a credible and competent institution. Its activities must be transparent and based on sound arguments and careful analyses of acclaimed experts viewpoints.<sup>167</sup>

Quality performance of competition policy is contingent on the quality of human resources. Given the high staff turnover and foreign experience, it is envisaged that external staff will be hired for some analyses, or, legislation drafting (for instance, the regulation of natural monopolies, state aid).

Generally speaking, the protection of economic competition, despite a successful start, was in a slump, especially in 1994. This was associated with an overall concept of the economic policy that was based on selectiveness rather than equality of opportunities. It may be considered a wasted opportunity that an institution that was set up with great enthusiasm and conceived in a modern fashion, was later politicized. After the 1998 elections, the Government stated their observance of the principle of equality of opportunities and the solidification of the

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<sup>167</sup> Oftentimes, a counterargument is used that attacking anticompetition regulation on the part of an antimonopoly institution is outside the scope of its powers. However, these are institutions that are to advocate public interest, and, hence, regulatory interventions harming the competition and consumers. For instance, Demsetz, H. (1991) in *Efficiency, Competition and Policy*, poses the following question: Why shouldn't the FTC (antimonopoly institution in the US) attack the ICC (Interstate Commerce Commission), if it attacks associations of entrepreneurs?

autonomy of this institution in its program declaration. The future will show how much the situation will change. Experience has shown that establishing a legislative and institutional framework does not alone guarantee effective implementation of competition policy. Informal rules play a significant role.

Harmony must be established between formal and informal rules. They cannot be too diverse or the former will have no vehicle and there will be no interest to enforce them. This can result in circumvention and distortion. In transitional economies, the following is necessary:

- active influence upon the public opinion (of professionals and laymen);
- cultivation of competition culture and transparency of rules;
- allies to enforce competition principles, equality of opportunities (the Government, MPs, entrepreneurs, mass media);
- balancing short-term objectives and medium- and long-term objectives;
- active involvement of an antimonopoly institution in information; dissemination, explanation of the impacts of the restrictions of economic competition on the economy and consumers, active response to regulatory interventions;
- in competition advocacy, independent non-governmental institutions may be assigned an important role because in contrast to other entities, they do not identify themselves with narrow sectoral interests in enforcing some regulatory interventions. On the other hand, they are not part of the government administration. This fact allows them to enforce independent professional opinions and to advocate for nationwide interests.

In transitional economies, competition restriction is often the legacy of the old economic system. The philosophy of equality of opportunities and the act of enforcing competition principles does not boast a tradition of long standing. It requires a much more rigorous approach to competition advocacy and also offers opportunities for the antimonopoly institution to take an active part in the process of the drafting of legislative rules, and the adoption of the economic policy measures that restrict economic competition. As a rule, regulation is advantageous for certain affinity groups, and, naturally, it has its adherents and lobby. Due to the limited time of their term in office, the government employees oftentimes are prone to prioritize solutions with short-term effects (often, via regulatory interventions). Therefore, it is necessary to override this propensity by for action conducive to achieving long-term effects upon the economy and consumers.

In view of the fact that a change of informal rules is time-consuming, the broader context must be taken into account. Political will is a must if a competitive environment and the observance of equality of opportunities are to be established. If there is no political will, the legislation designed to address the issue of competition restriction on the part of public administration will prove ineffective.



Passage of formal rules is relatively easy, but if they do not have their vehicle and lobby, they will be ineffective. For instance, such a lobby is naturally represented by entrepreneurs who are expected to take interest in fair rules.<sup>168</sup> In the SR, the situation is more complex because of past experiences that reinforced a belief that discrimination (e.g., in privatization, public procurement) is gainful. Hence, entrepreneurs have focused on advantage winning, i.e., rent-seeking rather than profit-seeking through competition.

Naturally, successful behavioral patterns and informal rules represent a broader historical and cultural problem. Such rules and behaviors are extremely conservative and change is a slow process. Changes to be implemented in formal and informal rules are shown in Table 4.

In our opinion, the following may be expected to take place in the economic competition in the future:

- shift to a greater flexibility which will require quality analytical work in competition policy. Therefore, the establishment of ad hoc analytical groups to address some situations may be expected;<sup>169</sup>
- in conjunction with globalization and integration processes, competition policy will be increasingly conceived at a multinational level. Therefore, it is necessary to monitor and analyze international trends and get prepared for them. The experiences of the associated countries in the first group of candidate countries testify to the complexity of the negotiation process;
- harmonization with the European law will require specialists on the EU competition law. In legislation, there will be a need to respond to the present state and changes in the EU, and methodologies will have to be drafted along with the explanations and guidebooks for entrepreneurs;
- within the national and multinational frameworks, a shift from “conventional anticompetitive practices” to the control of state aid and regulatory interventions of public administration is to be expected;
- reinforcing the weight and influence of informal rules and the public opinion pressure;
- the actions mentioned above will exert external and internal pressures on the implementation of an economic policy that has respect for equality of opportunities. The pressure of affinity groups and the weight of their political influence will act against this trend.

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<sup>168</sup> Cases have been reported abroad when entrepreneurs insisted on the establishment of a regulatory framework for natural monopolies and competition rules.

<sup>169</sup> I believe that the flexibility requirement will be applicable to the whole public administration and hence, flexible structures will be necessary.

TABLE 4: Changes in Formal and Informal Rules

Formal Rules	Informal rules
<b>Legislation</b>	Access of the Public to Information
- monitoring – ex post control	Alliances
- prevention - ex ante control	Public Opinion-leading
- remedy the non-existence of rules	Refinement of Competition Culture
- harmonization of rules	
<b>Institutions</b>	Activities of an Antimonopoly
- Antimonopoly Office of the SR: Independence,	Institution
Collective Decision-making, Human Resources	Activities of NGOs
<b>Overall Environment</b>	Activities of Consumer
- laws influencing equality of opportunities	Associations
- reform progression	Mass Media Influence
- law enforceability	
- integration	

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# 11 Privatization

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In a transition economy, privatization serves mainly as an inevitable condition of restructuring. With regard to the non-existing market and the mass of property to be privatized, the opportunity to apply the experience of developed economies was rather limited. Privatization was to a great extent an experiment.

Slovakia first relied on voucher privatization without the appropriate regulation of capital markets, protection of minority shareholders, institutions, and enforcement of law. Privatization continued with opaque sales to Slovak managers who lacked the necessary funding and know-how to achieve privatization. Restructuring was not perceived as the ultimate goal of privatization. At the same time, no emphasis was placed on privatization revenues, which later failed to alleviate the social impact of reforms. It was not fully recognized that privatization is a political process that provides a unique opportunity to acquire property and political influence.

Slovakia now faces two privatization tasks. First, it has to cope with the illegal privatization decisions taken in the past. Second, it has to prepare for the privatization of banks, large natural monopolies and the health care sector, which will be much more complicated than the bulk of the privatization processes to date. The government has to focus on acquiring international credibility by pursuing these two tasks.

In regard to the privatization of natural monopolies, the British rule applies here - the State must first of all favor competition. It is therefore necessary to separate monopolistic and potentially competitive activities of companies (horizontal and vertical dismantlement of monopolies) before privatization and prepare the regulator. Each sector (telecommunications, gas, electricity and water) should have its own regulatory authority in order to have a clear definition of responsibilities and prevent any conflict of interest. Privatization, which in itself is a technically complicated process, also imposes the need to amend several laws, e.g., those concerning debt collection.

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## 11.1 Introduction

The second half of the twentieth century is characterized by the privatization of state-owned companies.<sup>171</sup> On one hand, this process is based on the recognition that private companies perform better than state-owned ones. On the other hand, it is based on the generally changed perception of the role to be played by governments. Privatization requires that governments no longer act as entrepreneurs to develop a favorable business environment, and to monitor the enforcement of rules.

Low levels of performance, typical for state-owned companies, result from the conflict of state interests and weak corporate governance.<sup>172</sup> The conflict of interests can be explained by the fact that the State sets the legal definitions, and often the institutional definitions, for markets where it concurrently acts as an entrepreneur that competes with private companies. Poor governance is the consequence. The citizens (the electorate) therefore attach low significance to specific entrepreneurial activities of the government within the entire range of its activities. Private ownership then becomes preferred over state ownership because the shareholders can evaluate managers solely based on the performance of the respective company.<sup>173</sup>

The governments of various countries were unable to use their position as owners to ensure the performance of their companies or to regulate them in a failing market. Government attempts to conduct business led to a superfluous bureaucratization, a lack of identifiable responsibilities at different levels of management, corruption<sup>174</sup> and soft budgetary restrictions.<sup>175</sup> This resulted in a deformation of prices and behavior of consumers and companies.

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<sup>171</sup> Cf. Yarrow (1986) and Armstrong et al. (1995).

<sup>172</sup> Estrin (1996) differentiates three areas, giving priority to private ownership over state ownership: goals of the company, market structure, corporate governance.

<sup>173</sup> From the extensive empirical studies to be mentioned Claessens et al. (1997) who showed the positive influence of privatization on productivity growth in seven transition economies.

<sup>174</sup> According to the *Financial Times* (1996) the opportunity costs of American investors in 1996 amounted to USD 20 billion when the contracts were concluded by other investors due to corruption. *The Economist* (1996, July 13-19) mentioned selected cases of corruption and fraud in France, which in some instances ended with the arrest of former ministers.

<sup>175</sup> The terms soft and hard budget restrictions were defined by Kornai. Hard budget restrictions “... is a synonym for total financial self-reliance of a company and real bankruptcy risk in case of insolvency. A soft budget describes a situation in which state bureaucracy helps state companies (for example by subsidies, preferential tax treatment, soft loans, setting low administrative costs) and in which such companies are shielded from financial bankruptcy. In such cases the survival and growth of a company depends more on

Ownership, however, does not guarantee improved efficiency if there is not detailed legal frameworks guaranteeing the rights of owner control and courts willing to enforce laws.<sup>176</sup> Moreover, private ownership cannot significantly enhance the performance of companies if soft budgetary restrictions prevail and the new owners hamper access to more competitive external funding.

In this paper, we focus on the development of privatization in Slovakia and analyze its causes. The structure of this chapter identifies the failures and successes of privatization in Slovakia and gives recommendations for further privatization policy. The second section summarizes the dilemmas faced by the government at the outset of the privatization process. The third section describes in chronological order the policies pursued by individual governments while analyzing the main expressions and consequences. The fourth section contains a summary and recommendations.

## 11.2 Privatization Dilemmas

Privatization in transition economies is aimed to achieve multiple goals. First, it seeks a change of ownership as an inevitable condition for adapting companies to market mechanisms. Second, it seeks to protect against a reversion of the reform process. Third, it must provide a signal to gain credibility for the new economic policy. Specific problems related to achieving these privatization goals can be summarized in the following basic points:

- Speed of privatization. Fast privatization<sup>177</sup> is synonymous with the success and irreversibility of the reforms. Simultaneously, the period in which both new private companies and strong state-owned companies interact on the

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*its ties with bureaucracy than on market success.*" (1990, p. 140).

<sup>176</sup> Yarrow (1986) argues that an environment of competition and regulation is more important for efficient operation of the companies than the very change of ownership form. Brom (1997) documented clearly that the transfer of ownership in transition economies does not always guarantee a corresponding transfer of control. The description of corporate governance in socialism is cited by Brada (1996). Managerial bonuses depended on the completion of tasks set by a central plan, but the plan itself was formed according to the information of the managers. Apart from the founding Ministry, which replaced the owner, other stakeholders interfered with the activity of managers, for example the Communist party and local authorities.

<sup>177</sup> Cf. theoretical reasoning for a direct relation between the privatization speed and success of the reform in Aghion (1993) and van Wijnbergen (1992). The opposite was claimed by Dewatripont and Roland (1992). According to Collin and Rodrik (1991), potential foreign investors considered political instability, uncertainty related to economic policies and lack of legal protection of private property the most important restrictions to investment in Eastern Europe and the former Soviet Union. A fast privatization was to convince them that the countries are capable to guarantee enhancement in all three areas.

market is reduced.<sup>178</sup> To achieve irreversibility of the reforms, a critical number of companies have to be privatized.<sup>179</sup>

- Privatization methods.<sup>180</sup> Mass privatization enables fast privatization. However, creating diffused ownership without defining protection for minority owners does not lead to fast restructuring. Restitution is the least problematic issue from the point of view of change in ownership. Lengthy litigations that hamper the manipulation of property is a problem. Public auctions are applicable only to sales of smaller companies or specific assets. Public tenders and direct sales require a costly assessment of asset market value and significantly slow down privatization. However, they result in concentrated ownership that will more likely lead to better company management. Sales to foreign investors appear to be the best form of privatization.<sup>181</sup>
- Impact on unemployment growth. Privatization should result in restructuring that addresses excessive and redundant labor. Even so, the development of privatized companies should inevitably create new jobs. A government goal to keep unemployment below a set rate can therefore substantially slow down privatization.
- Privatization sequence. Privatization of natural monopolies is more complicated than the privatization of companies in competitive industries. This factor can therefore delay privatization and risk the need to maintain distorted prices that may significantly impact all other prices in the country.<sup>182</sup> At the same time, it encourages the government to use natural monopolies that are inefficient, that increase costs for consumers, and hinder the development of the monopolies themselves. For example, privatization of banks is a complex and sensitive issue. Maintaining state ownership there could result in soft budgetary restrictions for non-performing companies.
- Privatization restructuring. The experience of developed economies<sup>183</sup> shows that the horizontal or vertical dismantlement of monopolies and oligopolies is much easier and less expensive, as long as these are in state ownership. The

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<sup>178</sup> Murphy et al. (1992) explained with the model of supply and demand the collapse of production in Russia as a consequence of partial reforms, which did not do away with the restrictions of state companies and thus lead to an asymmetrical competition between state and private companies.

<sup>179</sup> Roland and Verdier (1992).

<sup>180</sup> Shafik (1994) mentions an excellent description of methods applied in the Czechoslovak privatization.

<sup>181</sup> Cf. e.g., Transition report (1995).

<sup>182</sup> At the same time poor quality of services and products might result.

<sup>183</sup> Tirole (1991), Vickers and Yarrow (1991).

privatization of local monopolies is easy and quick; however, without regulation it will reduce public welfare.

- Transparency. The voucher method is generally considered the most transparent method of privatization. It requires government direct sale approval processes to prevent corruption and arbitrary decisions of some clerks.
- Political benefit. Privatization is a political process, where the transfers of immense assets are followed by shifts in political power. Political parties have a unique opportunity to use the privatized property for obtaining the support of the business community.
- Public involvement. The involvement of the public in the privatization process can help to ensure the irreversibility of the reforms. There could be fears of transferring a majority of property to foreign investors. These fears are based more on political arguments than economic arguments. The government can win support for a privatization policy by involving people that have a personal interest in the reform and the new order..
- The use of privatization revenues. A precondition for privatization is the use of government revenues for the compensation of inevitable reform-related costs. For example, government revenues will likely be required for retraining the unemployed or for developing the missing infrastructure.
- Inadequate national funds. The lack of national funds can be handled in two ways - offering assets to foreign investors, and free transfer of property (voucher privatization).

### **11.3 Privatization Development**

Until January 1993, privatization in Slovakia was almost identical with privatization in the Czech Republic. Since the speed of privatization was an important goal of the federal government, the voucher method was used. A substantial disadvantage of this method was that it generated an excessively diffused ownership structure.

The privatization process in Slovakia began to deviate from the federal pattern. Privatization was significantly influenced by frequent changes in the government and the ministers of privatization. Since November 1989, there have been seven governments with differing approaches to privatization. The emphasis therefore began to shift towards creating a Slovak business community. This resulted in minimal privatization revenues for the government, delays in restructuring, and mingled political and economic power. The current government should efficiently privatize some natural monopolies and banks to enhance international credibility, and to obtain important funds.



### 11.3.1 The First Three Governments: 1989-92

The first government was formed by Milan Čič. He took office on December 12, 1989, to replace the last communist government and to prepare the first free parliamentary elections.

In the 1990 elections, a broad movement "Public against Violence" obtained the majority of votes cast and asked Vladimír Mečiar to form the second post-revolution government. Mečiar took office on June 27, 1990. Mr. Augustín Marián Húška was appointed President of the Office for the Administration and Privatization of National Property. The government of Vladimír Mečiar was recalled in April 1991. The third government was headed by Ján Carnogurský during the period of April 23, 1991 to June 24, 1992. The Ministry of Privatization was established based on the Act No. 347 Coll. of August 28, 1990.<sup>184</sup> Mr. Ivan Mikloš was appointed the first Minister of Privatization.

Privatization in 1990 was a revolutionary idea since 41 % of the population preferred the socialist regime, while only 3 % preferred capitalism and 52 % favored something between these two.<sup>185</sup> Dissatisfaction with the reforms grew mainly due to the first signs of liberalization of food prices and a factual devaluation of the currency.<sup>186</sup> Only 32 % of the population in 1991 considered the system better than the communist one.<sup>187</sup> The government initiated the small-scale privatization and began to prepare the first phase of large-scale privatization that were both based on federal legislation. The government hoped to win the support of the public with the voucher privatization, which started in May 1992 after the registration of the citizens and the investment funds in late 1991 and early 1992. This phase was concluded in December 1992 and the shares could have been distributed in February and March 1993. Finally, due to the split of the Czechoslovak federation, the shares were distributed as late as in May 1993.

#### 11.3.1.1 The National Property Fund

The National Property Fund (NPF) was established in 1991 according to Act No. 253/1991 as a legal entity. Its purpose was to assist the privatization of national property and clearly separate the administration of companies targeted for privatization and the privatization revenues from the government. The NPF consists of a Presidium and an Executive Committee that are supervised by a Supervisory Board. The Executive Committee is responsible for individual

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<sup>184</sup> The formal name of the Ministry of Privatization is Ministry for the Administration and Privatization of the National Property of the Slovak Republic.

<sup>185</sup> Source: Public Opinion Research Institute, Bratislava (1990).

<sup>186</sup> Valtr Komárek, main adversary of the reform, claimed: "*What is going on here is not an economic reform, but a cocktail of American recommendations for developing countries.*"

<sup>187</sup> Source: *Výber* (1991), No.32, p.19

sections. The Presidium has nine members elected by the Parliament. The Presidium decides, for example, on the sale of company shares and the property acquired through a withdrawal from a privatization contract. The Executive Committee has eleven members. The Supervisory Board has six members elected by the Parliament. The NPF assumes ownership of state property and, based on the individual privatization decisions, transfers this property to private persons. The NPF holds company shares, the resulting profits, and the privatization revenues. The use of the NPF-held property is decided upon by the Parliament. The NPF is politicized and very often operated with no control by the State.<sup>189</sup> Many sales were absolutely disadvantageous for the State.<sup>190</sup>

The largest liability of the NPF is the bonds<sup>191</sup> that replaced the second phase of the voucher privatization. Due to a lack of liquidity, the NPF had to borrow SKK 2.25 billion in 1998 to pay out the bonds to persons older than 70 years. At the same time, it did not pay its liabilities amounting to SKK 2.3 billion. The NPF-held property was used as collateral to guarantee its liabilities.

By the end of 1998, the NPF had assumed 1,487 privatization projects that included 2,625 proposals for privatization outputs amounting to a property book value of SKK 349.4 billion.<sup>192</sup> The NPF holds majority stakes and exercises the related rights, e.g., in Slovenská poisťovňa (insurance house), Slovenská sporiteľňa (savings bank) and Slovenské elektrárne (electrical energy); it also holds a significant stake in Všeobecná úverová banka (refer to Table 1).

At the end of 1998, the NPF received revenues from the sales of shares and assets amounting to almost SKK 48 billion. It has a realistic chance to collect further receivables in amount of SKK 18 billion (refer to Table 2). The total revenues of the NPF amounted to SKK 71 billion (refer to Table 3), however the loan of SKK 2 billion and the value of the bonds of SKK 8 billion have to be subtracted from this figure, since they are at the same time expenditures. The real revenues thus amount to SKK 61 billion.

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<sup>189</sup> According to the information of P67value of March 29, 1997, Brigita Schmögnerová said: *“Thus we came to a point where not only there are no external control mechanisms, because the Supreme Control Office is not allowed to control the NPF and actually the Parliament (NC SR) is not controlling the NPF either, but there are also no efficient mechanisms of internal control of the NPF.”*

<sup>190</sup> In early 1997, the NPF sold Slovnaft shares for SKK 230 million which is less than 25 % of their market value. P67value, April 14, 1997. The NPF approved the sale of 10.23 % of Slovnaft shares on February 19, 1998 with a loss of almost SKK 895 million compared with the market value. P67value, March 9, 1998.

<sup>191</sup> A total of 3,326,639 bonds were issued with a nominal value of SKK 33.3 billion. NPF (1999).

<sup>192</sup> The annual report of the NPF for 1998 states these figures, but the NPF (1999) reports the transfer of 1,531 state owned companies worth SKK 365.5 billion.

### 11.3.1.2 Small-Scale Privatization

The small-scale privatization based on the Act No.427/1990 began in February 1991 and ended in March 1994. The small-scale privatization allowed public auctions to sell or rent out small service facilities (e.g., hotels and restaurants), and small shops or industrial units were freed from old debt. A total of 9,500 business entities with a book value of SKK 12.3 billion were auctioned off at almost SKK 14 billion. SKK 12.1 billion of these non-budget revenues were transferred to the NPF according to the Act No.474/1990 and the rest was divided between the Slovenská záručná banka (Slovak Guarantee Bank) and the municipalities.<sup>193</sup> Foreign investors were not allowed to participate in the first round of the auctions.

### 11.3.1.3 First Phase of Large-Scale Privatization

Larger companies were privatized according to the Act No.92/1991<sup>194</sup> in two phases. The government adopted in its resolution No.443 of August 13, 1991 that listed the companies to be privatized. The first phase of privatization in the period of 1991-1993 saw the (partial) denationalization of property of 678 state-owned companies worth SKK 169 billion, mainly in the area of industry and services.<sup>195</sup> Some 1,500 projects were submitted for privatization. According to the Act, the government approved direct sales while other methods of privatization were to be approved by the Minister of Privatization.

Of the total privatized value, 48 % was privatized through vouchers, 28 % remained with the NPF, 12 % constituted the reserve fund and other funds, and only 7 % was sold directly (refer to Table 4). Here it is necessary to be aware of the fact that the market value of the assets differed from the book value. Therefore, it could be assumed that the share of direct sales was probably more significant than 7 percent.

### 11.3.1.4 Privatization Through Foreign Investors

In 1992, the government sold companies with a book value of SKK 0.8 billion for SKK 2.2 billion to ten buyers (refer to Table 5). From the point of view of the sales price, this was the richest year. In regard to the share in the book value of assets sold to foreigners between 1992 and 1998, the years 1994 and 1993 were most productive. In total, companies worth SKK 4.7 billion were sold to foreign investors for a sales price of SKK 7.7 billion.<sup>196</sup>

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<sup>193</sup> Source: Ministry of Privatization (1999a).

<sup>194</sup> This act was later amended 19 times.

<sup>195</sup> Source: Ministry of Privatization (1999a) and National Property Fund (1999).

<sup>196</sup> Author's calculations based on the public database of the Ministry of Privatization (1999b).

### 11.3.1.5 First Phase of Voucher Privatization

The voucher privatization was basically a free distribution of property using a simple procedure where the voucher prices - initially equal for all shares - progressively approach equilibrium prices due to the changing ratio between supply and demand. Each interaction reduced the total demand and the total supply of shares by shares with a balanced demand and supply. The volume on the supply side was given by the number of shares of companies to be privatized, while the number of unused vouchers determined the volume on the demand side. Five interactions were sufficient to achieve equilibrium.<sup>197</sup>

Based on the approved privatization projects, the shares of 503 joint stock companies with a total book value of SKK 86.9 billion (ca. USD 2.6 billion) were offered for the first phase of voucher privatization. In the individual rounds of this phase, the Fund sold shares worth SKK 79.8 billion of the above mentioned offer. SKK 7.1 billion worth of unsold shares were progressively sold by the Fund using standard methods. 2.6 million of Slovak citizens participated in the voucher method of privatization.

In comparison with the Czech scheme, the Slovak voucher scheme offered less property and property of poorer quality. The ratio of Slovak to Czech property was only 35:100 even though, according to the size of the economies, it should have been 50:100. On the contrary, the ratio of property to be actually privatized through vouchers was higher, 41:100.<sup>198</sup> Slovak companies were therefore privatized more through vouchers than through other methods. The weighted share of voucher ownership in a Slovak company was 74 % while it was only 64 % in a Czech company. The role of investment and privatization funds in Slovak companies was actually stronger when compared to the role of their Czech counterparts. The interest in Slovak companies, however, was generally smaller than in Czech companies. The ratio of used investment points for Slovak and Czech companies was only 27:100, even though Slovak companies were on average cheaper than Czech companies. The ratio was 23:34 investment points. In the last year before privatization, the ratio of total profits was only 23:100; the ratio of total debt was 31:100; the ratio of employees was 39:100.<sup>199</sup>

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<sup>197</sup> A more detailed description of the scheme is given, e.g., by van Wijnbergen and Marcincin (1995).

<sup>198</sup> Author's calculations according to the data of the Center for Voucher Privatization in Prague. There is a difference between the assets of companies included into voucher privatization (100 % shares), and the assets that were actually offered for exchange against vouchers (e.g., 80 % of shares). The difference was, e.g., sold to external investors even before the very voucher privatization, or it remained with the National Property Fund.

<sup>199</sup> Author's calculations according to generally accessible data from the Center for Voucher Privatization, Prague, 1993.

The major problem with the voucher method was that it created a too diffused ownership. Studies have analyzed the influence of voucher privatization on the price of company shares soon after their placement on the market. The studies actually established that a concentration of ownership improves the capital costs and performance of the companies.<sup>200</sup> Investment funds also acted as a major issue because dominant owners, due to missing legislation (protection of minority owners, definition of capital market and control), abused their position to expropriate minority owners. Marcincin and van Wijnbergen (1997) found out that after purifying the data of the selection bias, the investment funds appeared to be even worse issue than previously assumed.

### 11.3.2 Fourth Government: 1992-94

The Movement for a Democratic Slovakia (HZDS) won the parliamentary elections in June 1992,<sup>201</sup> and the government of Vladimír Mečiar took office on June 24, 1992. For almost one year, Mr. Lubomír Dolgoš<sup>202</sup> was the Minister of Privatization. His ministry was managed by Prime Minister Vladimír Mečiar. This government then changed the approach to privatization in the fall and emphasized the standard methods. The significant change was that the authority to decide on privatization was transferred back to the sectoral ministries. The privatization process then almost came to a halt. Act No. 60/1994, in force as of March 24, 1994, separated the functions of the President of the NPF and the Minister of Privatization. The President, Vice President, and members of the NPF board were elected by the Parliament. The amendment to the act also stipulated that the property held by NPF is not the property of the State, even though the use of this property is regulated by the respective privatization legislation.

The revival of privatization came during the period of February 15 to March 11 1994, when the NPF approved 44 privatization projects under the threat that the government would be recalled. The government of Vladimír Mečiar was recalled in March 1994.

The atmosphere in society is documented by an opinion poll from that year. Forty-seven percent of the citizens considered the current system a better one than the communist one while 42 % claimed the exact opposite. Seventy-two percent said that democracy did not meet their expectations, while only 23 % claimed the opposite. The then current economic situation, compared with the communist one, was better for 22 %, but worse for as much as 71 % of the population. Finally, 39

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<sup>200</sup> Cf. e.g., Laštovicka et al. (1995), Claessens (1995), Marcincin (1995), and van Wijnbergen and Marcincin (1995).

<sup>201</sup> HZDS obtained 37.3 % of votes and 74 of 150 chairs in the Slovak National Council

<sup>202</sup> From June 24, 1992 to June 22, 1993. Lubomír Dolgoš was recalled after criticizing the government for its unwillingness to continue with the privatization.

% preferred private ownership to state control of a majority of companies, while 53 % claimed the opposite.<sup>203</sup>

### 11.3.2.1 Investment Privatization Funds

The participants of voucher privatization placed their investment points independently into joint stock companies or into 429 investment privatization funds (IPF)<sup>204</sup> of which 169 were Slovak entities. While small investors acquired majority stakes in 244 Slovak companies (refer to Table 6), IPF acquired majority in 173 companies. As long as four IPF voted in conformity, they were able to control 110 companies (22 %) with a simple majority stake, or as many as 367 companies (73 %) with a real majority stake.<sup>205</sup> In comparison with the IPF, all other stakeholders in companies privatized through vouchers were negligible (refer to Table 7 with shares of non-voucher investors). Moreover, the IPF shares were in the portfolios of only a few investment companies. Seven largest companies owned 61 % of companies privatized through vouchers in Slovakia (refer to Table 8).

The number of IPF grew in 1994 to 311 due to the planned second phase of the voucher privatization that was never completed. In 1996, the IPF number fell to 36.<sup>206</sup> The IPF escaped the supervision of the Ministry of Finance through a re-registration as joint stock companies. Their shares often were not publicly traded.

The IPF were in the position of a strong shareholder and also, at the same time, a supervisor that was without supervision himself. Their shareholders, like small shareholders of the companies, did not have any chance to control and influence the management of the IPF. In an unregulated environment, the IPF managers were free to abuse their positions for enriching themselves at the expense of the shareholders.<sup>207</sup> Their position as owners in companies was complicated in 1995, when the authorized share of one IPF (and one investment company) in one company was reduced from 20 % to 10 %.

The IPF, in an unregulated environment, devalued the vouchers and also the shares of a majority of the participants in voucher privatization. Moreover, they undermined the Slovakian trust in collective investment. According to our

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<sup>203</sup> Source: Opinion poll organized by the United States Information Agency in 1993 in various countries of Central and Eastern Europe. *Economic Reform Today* 1/1994, p.10-13, 31.

<sup>204</sup> According to data of the Center for Voucher Privatization, the IPF acquired 72 % of all vouchers. Out of that IPF registered in the Czech Republic obtained 73 % and IPF registered in Slovakia 27 %.

<sup>205</sup> A precise calculation in Lastovicka et al. (1995). With real majority we mean the situation (simplified), where small investors are unable to unite their votes thus the minority owner of a stake can behave as a majority owner.

<sup>206</sup> More detailed paper on IPF by Olsson (1999).

<sup>207</sup> Anderson (1994) and Coffee (1994).

knowledge, there is no comprehensive study in Slovakia that has calculated the loss caused by the funds.

### **11.3.2.2 Second Phase of Large-Scale Privatization**

The second phase began in September 1993. The difference from the first phase lies in the emphasis put on standard methods (mainly direct sales) favoring Slovak managers, abandoning the voucher methods, and transferring privatization decisions from the government to the NPF. Fifty-eight percent of the total assets amounting to SKK 137 billion were privatized through direct sales (refer to direct sales of assets and shares in Table 9) and only 5 % were privatized through public tenders. According to economic theory, opaque direct sales and the advantaging of managers lead to delays in restructuring.<sup>208</sup>

### **11.3.2.3 Examples of Privatization Abuse**

On February 8, 1994, Matica slovenská signed a contract on the privatization of Neografia, valued at SKK 600 million for a symbolic SKK 1, against the promise to support HZDS.<sup>209</sup> The company Manager was founded on March 11, 1994 by the managers of Východoslovenské železiarne (VSŽ), on the day of the no confidence vote to the government of Vladimír Meciar. Three days after its foundation, it obtained approval for the privatization of 9.53 % of VSŽ's shares at SKK 200 per share, even though the market value at that time was three times higher.<sup>210</sup>

### **11.3.3 Fifth Government : 1994**

The government of Jozef Moravčík assumed office on March 15, 1994. Its task was to prepare for early parliamentary elections. Milan Janicina was appointed Minister of Privatization. The government planned the privatization of 174 companies with total book value of SKK 176 billion, out of which SKK 80 billion were to be privatized through vouchers. The total assets planned for the voucher privatization should have been higher, SKK 100 billion, since additional assets held by the NPF in the amount of SKK 20 billion were offered. These were not sold in the first phase of the voucher privatization. The government started to issue new voucher books and some 3.4 million people had their books registered at the end of November. That represented 92 % of the eligible citizens. The zero round was expected for early 1995. Thirteen approved privatization projects of the previous government were cancelled.

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<sup>208</sup> Aghion (1995), Blanchard and Aghion (1995), and Carlin et al. (1994).

<sup>209</sup> *Sme*, April 19, 1996, p.5.

<sup>210</sup> *Trend*, Oct. 11., 1995.

### 11.3.4 The Sixth Government: 1994-98

The government of Vladimír Mečiar assumed office on December 13, 1994, and Peter Bisák became its Privatization Minister. The first change in privatization was signaled by the adoption of Act no. 369/1994 with an effective date of December 21, 1994. That vested the NPF Presidium with the right to issue privatization decisions initiated by the Privatization Ministry or the NPF Executive Committee. Privatization decision-making powers held by the State were essentially assigned to a legal entity.<sup>211</sup> On November 4, 1994, the new Parliament passed Act no. 370/1994 intended to revoke 50 privatization projects approved by the previous government. On the basis of this law, actually twenty of these projects were repealed in December 1994, while the remaining thirty projects were repealed pursuant to a direct resolution of the government in February 1995. Act no. 370/1994 was repealed in May 1995 based on an adjudication of the Constitutional Court; nevertheless, in late November 1995, NPF continued in the privatization process of 27 companies.<sup>212</sup>

In its Policy Statement dated January 10, 1995, the government committed itself to develop new privatization techniques. Emphasis was supposed to be put on competitive forms of selling property to domestic investors<sup>213</sup> and payments for the purchased property was to be spread over a period of ten to fifteen years. The first payments usually were for 20 % of the agreed sales price.<sup>214</sup> NPF stopped providing information on privatization projects and selection criteria. In general, up to 50 % of the sales price could be waived, as compensation for the acquirer's investments, and concurrently be subject to favorable taxation terms.<sup>215</sup> The

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<sup>211</sup> Subsequently, the Supreme Audit Office declared that it cannot oversee privatization as according to this Act the government's role in privatization had been limited to entering the companies in the list of companies identified for privatization and to deciding upon applicable privatization methods. However, the government cannot be held responsible for privatization as such because the NPF alone decides upon the buyer, price and payment schedule. The Parliament could have had control over NPF but its majority was against it. *Národná obroda*, May 7, 1996, pg.1; *Práca*, March 4, 1996, pg.5; *Sme*, June 30, 1995, pg.4.

<sup>212</sup> *Trend*, Dec.13, 1995, pg.6B.

<sup>213</sup> The NPF Presidium Chairman Štefan Gavorník underscored that NPF's goal was to create a strong community of domestic businessmen. The only thing that mattered was "whom to will Slovakia belong" regardless of the sales price. *Hospodárske noviny*, Oct.24, 1995, pg.4.

<sup>214</sup> *Hospodárske noviny*, February 1996, pg.12 a 13; *Trend*, Nov.15, 1995, pg.6B a 8B. In the period from January through November 1995, NPF received SKK 6.7 billion out of the total agreed sales prices amount of SKK 35.2 billion representing some 20 %. Weighted average was approximately 15 % (author's calculations).

<sup>215</sup> Pursuant to the Tax Act amendment dated March 1996 acquirers are exempt from paying tax on the income incurred by them as a result of the waived payment for the acquired property.



voucher method was superseded by the bond method pursuant to Act no. 190/1995. The same Act empowered NPF to issue privatization decisions based on a recommendation of its Executive Committee instead of a recommendation of the Ministry, as used to be the case. On October 20, 1995, Vladimír Mečiar declared that privatization would be completed within eight months.<sup>216</sup> In June 1996, he stated that privatization came to a halt in December 1995 due to tension amongst coalition partners.<sup>217</sup> Act no. 210/1997 was the Parliament's reaction to the finding of the Constitutional Court. This Act gave the decision-making powers for direct sales back to the government. However, real possibilities of handling property at its discretion remained in the hands of NPF. In the period 1994-1996, the governments of Moravčík and Mečiar privatized 67 % of the property in terms of the sales price amount (refer to Table 10).

According to a 1995<sup>218</sup> opinion poll, only 29 % of Slovak citizens approved the government's privatization policy while an impressive 61 % disapproved of it. Direct sales were rejected by 61 % of the population, while merely 3 % found them to be just, and 12 % of the population could not decide. Existence of corruption, in the case of direct sales, was conceded by 69 % while only 8 % believed the opposite. A mere 11 % endorsed the statement that everyone would profit from the current privatization policy while 61 % disagreed. Only 14 % believed that the ruling coalition altered the privatization scheme for reasons other than strengthening their own political power.

#### **11.3.4.1 Bond Privatization** <sup>219</sup>

The bond method of privatization replaced the second phase of voucher privatization. The Privatization Ministry first withdrew licenses from certain large investment companies.<sup>220</sup> The Vice-Chairman of the government and Finance Minister, Sergej Kozlík, then made the statement, "*the chaps* [meaning the investment funds] *wanted to control hundreds of companies.*" The new Act no. 190/1995 amended the Privatization Act no. 92/1991 to supersede vouchers with bonds. In principle, the Constitutional Court sustained this Act in January 1996. Applicable enforcement provisions no. 134/1996 were promulgated by the government in March, and bond trading was launched in August.

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<sup>216</sup> *Sme*, Oct.21,1995, pg.2.

<sup>217</sup> *Sme*, June 28,1996, pg.5.

<sup>218</sup> Focus (1995).

<sup>219</sup> Source: *Hospodárske noviny*, April 18,1996, pg.D1-4; *Pravda*, June 3,1996, pg.2, June 6,1996, pg.2; *Profit*, June 1,1996, pg.1 a 2; *Sme*, June 27,1995, pg.4, Jan. 9,1996, pg.4; *Trend*, August 16,1995, pg.5B, May 15,1996, pg.17B, June 5,1996, pg.18B.

<sup>220</sup> The Ministry terminated trading in shares of VÚB Kupón (assets worth SKK 12.5 billion) on January 23,1995, and of PSIS Bratislava (assets worth SKK 7 billion ) at the end of March 1995. Source: *Sme*, July 18,1995, pg.4.

The essence of the actual procedure was that persons registered in voucher privatization received a bond with nominal value of SKK 10,000<sup>221</sup> maturing on December 31, 2000, and an interest rate equal to the discount rate of the National Bank of Slovakia. Prior to their maturity date, the bonds were to be used the following ways:

- 1) Any citizen could:
  - 1a) sell or donate his/her bond to a company that was a debtor of NPF;
  - 1b) sell his/her bond to banks selected by the government for restructuring;
  - 1c) use his/her bond for pension or health co-insurance;
  - 1d) in special cases use his/her bond for the purchase of an apartment;
  - 1e) use his/her bond for the purchase of shares available in NPF's portfolio for this purpose.
- 2) Selected acquirers of property could buy bonds from bond holders and use them for settling their debts with NPF at their nominal value.
- 3) Owners of apartments, communities as well as pension and health insurance houses and selected banks could buy bonds from bond holders and demand from NPF their payment prior to year 2000. These bonds may be redeemed by NPF, should it choose to do so, in volumes at its discretion. As bond demand was minimal, their price plummeted. Therefore, in March 1996, the government set "an average bond price" at above 75 % of the nominal value plus cumulative earnings.

Bonds constituted a potential problem both for NPF and the state budget. On one hand, NPF promised to pay SKK 33.3 billion plus yields. On the other hand, it sold assets at minimal prices, with payment schedules spread over ten up to fifteen years. Even in such cases, instead of cash, it received its bonds back. Should the liability of NPF not be considered a commitment of the State, it would be rather hard to imagine that the government did not implicitly guarantee NPF's liability.

By December 31, 1998, a scant one-third of the bonds were redeemed<sup>222</sup>, whereby 68 % of them were used for discharging due amounts of NPF's debtors<sup>223</sup> and 24 % were paid to citizens above 70 years of age.<sup>224</sup> Only 5 % were redeemed for shares of privatized companies.

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<sup>221</sup> That resulted in a shrinkage of the book value of the property earmarked by the government of Jozef Moravčík for the second phase of voucher privatization from SKK 100 billion to SKK 33.3 billion.

<sup>222</sup> FNM (1999): precisely 1,077,148 pieces of bonds were redeemed.

<sup>223</sup> Bonds could be used for discharging debts until the day on which the finding of the Constitutional Court dated June 24, 1998, was issued in the Collection of Laws – July 16, 1998.

<sup>224</sup> Pursuant to Act no. 322/1996 as of December 31, 1997.

### 11.3.4.2 Strategic Companies

The Act on Strategic Companies no. 192, dated July 13, 1995, deferred the privatization of selected companies with total assets value of SKK 150 billion.<sup>225</sup> It made them subject to a special privatization scheme that failed to be defined. This was a non-systemic step in the reform process as it facilitated the ownership rights of sectoral Ministries. The Act contained numerous unclear formulations that hampered its enforcement and induced a situation full of uncertainty.<sup>226</sup> The list of strategic companies included the following:

- 1) State enterprises operating in gas, power, post, telecommunications, heavy engineering industries, pharmaceutical production, transportation, agriculture, forest and water management, and stakes held by the State in the companies Transpetrol and Slovenské elektrárne. According to the Act, these entities were to be privatized based on special legislation.
- 2) Companies partially privatized in which the State wanted to maintain a special position. This category covered companies operating in oil production, mining and metallurgy, processing non-ore raw materials, machine engineering industries, chemical and consumer goods industry, transportation, agriculture and water management, pharmaceutical production and construction industry.

Arguments in favor of the Act adoption are summarized below:

- 1) The companies concerned were golden eggs. According to the Slovak Statistics Office, they generated 90 % of the total profits of the non-financial sector in 1994, i.e., one year before the adoption of the Act;
- 2) Postponement of privatization in the anticipation of better sales prices in the future;
- 3) Creating minimum profit chains. State control over vertically interconnected companies was expected to reduce output costs and provide funds earmarked for state development schemes;
- 4) Public usefulness of the companies;
- 5) Natural monopolies.

The first four arguments support the role of the State in an economy particularly during an ongoing economic reform - the objective of which is just the

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<sup>225</sup> That represents about 40 % of the size of privatized assets in Slovakia. Refer to Marcincin (1997) as well.

<sup>226</sup> The General Assembly of Slovnaft voted on the introduction of a golden share held by the State but NPF itself voted against it due to, as it claimed, an unclear definition in the respective Act. The wording in the Act that it referred to concerned the assembly of the shareholders that pursuant to this Act could not take decisions on matters “*that impact or may impact the strategic interests of the State.*” Source: *Trend*, Nov.29,1995, pg.3B. Quote from Act no. 192/1995, §6, section1b.

opposite. The last argument is sensible insofar that privatization of natural monopolies necessitates special attention of the government. Instead of underscoring this fact in the Act, the government could have invested more effort in preparing these monopolies for privatization. The Act was repealed in 1999.

#### 11.3.4.3 Examples of Privatization Abuse

On August 23, 1995, NPF sold 39 % of the Slovnaft refinery to the joint-stock company Slovintegra that was owned by Slovnaft's managers. The book value of the stake was SKK 6.4 billion, the actual total sales price was SKK 1 billion with the first installment SKK 100 million (1.6 % of the book value) and the remaining payments of SKK 900 million were spread over a period of ten years. The agreed price per share amounted to SKK 156 while the market share price exceeded SKK 800. Based on the market price of a share, the stake was worth SKK 5.1 billion and the State lost several billions of Slovak crowns. Slovintegra privatized additional 15 % of Slovnaft shares at a sales price of SKK 385 million on July 31, 1997.<sup>227</sup>

#### 11.3.5 The Seventh Government: 1998-

The government of Mikuláš Dzurinda assumed its office on October 30, 1998, and Mária Machová became its Privatization Minister. This government's premise was that *“two phases of privatization failed to provide for sound and effective company ownership.”*<sup>228</sup> In its Policy Statement, the government voiced its intention to privatize banks in order to lower interest rates,<sup>229</sup> conduct a court review of privatization decisions, pursue privatization by applying tender methods, redeem at least those bonds held by senior citizens aged sixty and above, foster bond trading in capital markets, ensure that the ownership rights of the State are exercised, and create conditions attracting foreign investors into the privatization process. What was unusual was its commitment to abolish bearer shares in order to facilitate transparency in the ownership of privatized property, to refrain from direct intervention in the operations of state natural monopolies, as well as its statement *“If the new owners of privatized companies fail to provide for the*

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<sup>227</sup> *Trend*, March 27, 1996, and author's calculations based on data of the Privatization Ministry (1999b).

<sup>228</sup> *“The first phase of privatization (voucher privatization in particular) was not supported by strong capital market regulations (strong protection of minority shareholder rights, rules on the provision of information and efficient supervision) and led to frequent stripping of assets (tunnelling). Similarly, results of the second phase of privatization (through direct sales in particular) were no better as most of the sales were driven by political interests.”* Office of the Government (1999c) and the World Bank (1999).

<sup>229</sup> Policy Statement of the Government (1998). *Cast Podpora podnikania a priemyselná politika.*

*prosperity of these companies for a number of years, for whatsoever reasons, the government shall seek the adoption of such measures that facilitate the recovery and restructuring of the companies.”*

The government began an effort to cut costs in strategic companies and to minimize corruption exposure and lack of transparency. It was considering “*to hire reputable managers and put them in charge of the management of these companies whereby their precisely defined compensation package would be derived from the achieved cost cuts, to privatize minority stakes with the company management rights [and] to sell majority stakes.*” The government was considering immediate “*commencement of the restructuring and privatization of Všeobecná úverová banka, Slovenská sporiteľna, Investičná a rozvojová banka and Banka Slovakia and [completion of] the process of privatization control as well as clear declaration of those companies the sale/purchase contracts of which shall be subject to a review.*”<sup>230</sup> Privatization is not mentioned among the short-term priorities of the government, probably by mistake,<sup>231</sup> because in the Government’s Set of Economic Austerity Measures (1999) are paid due regard.

The government’s effort to increase the transparency and effectiveness of privatization generated positive international recognition. The International Monetary Fund (IMF, 1998) stressed that “*Accelerated privatization of telecommunications and of other companies held by the State would convey an important message about the new government’s open attitude to foreign investors as well as it would boost the balance of payment...*” Concurrently, IMF recommended that prior to the privatization of the companies the state authorities “*closely monitor the financial performance and curtail their access to credits.*”

According to the Office of the Slovak Government (1999c), the government planned to privatize 1) the largest banks in 2000-2001, 2) power companies Slovenský plynárenský priemysel (gas), Slovenské elektrárne a rozvodné závody (electrical energy) – separating transmission and distribution – following the adoption of a number of acts after 2001, 3) Slovenské telekomunikácie (telecommunications) in the first half of 2000 whereby the proceeds would be used for the redemption of part of the bonds,<sup>232</sup> 4) health service facilities in 1999-2000, business units of Slovenská automobilová doprava (coach transport) by their concentration into seventeen business units in the second half of 2000, Vodárne a kanalizácie (water supply and sewage), and 5) state companies and residual interests in the sectors of agriculture, economy, construction and public works and environment by the first quarter of 2000 (refer also to Table 11).

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<sup>230</sup> Office of the Slovak Government (1999a).

<sup>231</sup> Office of the Slovak Government (1999b).

<sup>232</sup> Cf. recommendations of the World Bank (1999).

The government estimated that privatization would generate revenue streams of SKK 1.2 billion in 1999, SKK 27.5 billion in 2000, and SKK 70.8 billion in subsequent years. Concurrently, the Parliament repealed the Act on Strategic Companies no.192/1995 on September 16, 1999. An Act on natural monopolies is planned to be passed and an independent regulatory body is to be established prior to the actual privatization of natural monopolies.

## 11.4 Conclusion

Privatization of state companies in a transition economy is a primary prerequisite of restructuring. The associated incomes for the state budget are important during the transition period but not the most important aspect. Due to the absence of a market and the mass of privatized assets, the application of experiences of developed countries was rather limited. Privatization was to a great extent an experiment.

Slovakia's approach to privatization proved to be not very lucky. Voucher privatization was not supported with subsequent appropriate regulation of capital markets, protection of minority shareholders, institutions, and enforcement of law. Subsequent favouring of opaque sales to local managers lacked the necessary funds and know-how. In our opinion, restructuring was not perceived as the actual intended objective of Slovak privatization. At the same time, the emphasis not on privatization revenues failed to accumulate funds to alleviate social impacts of the reform process. Privatization is political because it represents a unique opportunity to acquire both property and political influence.

Slovakia is facing two privatization tasks. First, it must come to terms with past unlawful privatizations. Second, it must prepare for the privatization of banks, large natural monopolies and the health care sector. Such privatization is a much more complex exercise than prior privatizations. In the process of privatization, the government must bear in mind the need to build its international credibility.

Coming to terms with unlawful privatizations with the support of Slovak courts, in our opinion, can only be perceived as hypocritical. The tardiness of Slovak courts and corruption are well-known phenomena. Therefore, taking this avenue would be fueling nothing else than an accelerated stripping of privatized companies. An idea that appears worthwhile is a form of nationalization with an underlying obligation of prompt and transparent privatization.

In respect to the privatization of natural monopolies, a lesson can be drawn from Great Britain's experience that the State must first of all give its preference to competition. Only in areas clearly dominated by monopolies should an independent institution exercise regulatory control. This implies that, prior to privatization, monopolistic activities of companies need to be divided from their potentially competitive activities (horizontal and vertical dismantlement of

monopolies). It also implies that every sector (telecommunications, gas, electrical power, water) has its own regulatory authority to ensure that responsibilities are clearly defined and to prevent any conflict of interest. Privatization, technically complex as it is, necessitates an amendment of many acts, for example, those concerning debt collection. Slovakia would benefit from selections of buyers not tainted by scandals and buyers that are well-known foreign companies.

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## 11.6 Appendix

TABLE 1. NPF: Shares of Companies with Basic Equity > SKK 1 billion

Business ID	Name	Basic Equity	Property Participation (%)
34129421	DMD holding, Trenčín	4,949	1.65
31695426	CHEMES, Humenné	1,287	38.30
31318916	Investičná a rozvojová banka, Bratislava	3,000	11.71
31403450	Istrochem, Bratislava	4,279	24.63
31349111	Reštitučný investičný fond, Bratislava	2,047	1.05
34144790	Slovenské liečebné kúpele Piešťany	1,510	24.16
35705671	Slovenská plavba a prístavy Bratislava	2,545	48.72
151700	Slovenská poisťovňa, Bratislava	1,500	50.56
151653	Slovenská sporiteľňa, Bratislava	2,074	91.33
31380751	Slovenské elektrárne, Bratislava	41,804	95.72
31412742	Trnavské automobilové závody under liquidation	1,270	33.32
2216	VSS under bankruptcy proceedings, Košice	1,005	4.97
31320155	VÚB, Bratislava	4,078	34.86
30222524	Závod SNP, Žiar nad Hronom	5,789	29.71
31561187	ZVL Kysucké Nové Mesto under bankruptcy proceedings	1,104	2.73

Basic equity, in millions SKK. Source: National Property Fund (1999)

TABLE 2. NPF Collections Status as of December 31, 1998

Type of Receivables	Nbr. of Contracts	Sales Price Including Investments	Paid	Unpaid Part of Sales Prices
Sale of Shares	670	39,257	26,544	12,713
Sale of Property	735	38,434	21,197	17,237
Other				1,785
<b>Total</b>		<b>77,691</b>	<b>47,741</b>	<b>31,735</b>
Created Provisions for Receivables				13,890
Net Receivables				17,846

Prices, in millions SKK. Source: National Property Fund (1998)

TABLE 3. Revenues of NPF as of December 31,1998

Revenues	1992	1993	1994	1995	1996	1997	1998	Total
From Sales of Assets	5,971	4,040	7,484	8,817	7,954	3,419	4,534	42,219
From Dividends		21	412	602	368	246	172	1,821
Transfer from MP		7,000		1,000	3,000	500	600	12,100
Loans							2,245	2,245
Other Income	50	599	1,884	425	729	574	474	4,735
Financial Revenues	6,021	11,660	9,780	10,844	12,051	4,739		63,120
Income in Bonds					2,211	4,560	1,402	8,173
Total Revenues	6,021	11,660	9,780	10,844	14,262	9,299	9,427	71,293

Amounts, in millions SKK. Source: 1998 Annual Report of NPF

TABLE 4. Property in the First Phase of Privatization

Item	Nbr	Assets (mn SKK)	Assets (%)
A Companies Identified for Privatization	678	169,097	-
B Privatized Companies by	1,010	169,097	100
B1 - Sale of Assets	330	12,428	7
B2 - Free Transfers	116	2,086	1
B3 - Restitutions	7	19	0
B4 - Assets Deposit in to Joint-stock Company	557	154,564	-
B41 - Own Equity of Joint-stock Company	-	154,564	-
B411 - Basic Equity	-	134,705	-
B4111 - Sold Using Standard Methods	-	3,419	2
B4112 - Sold in Voucher Privatization	-	79,752	48
B4113 - Contribution into the Restit. Inv. F.	-	3,797	2
B4114 - Remaining in NPF's Ownership	-	47,737	28
B412 - Reserve and Other Funds	-	19,859	12

Source: Ministry of Privatization (1999a) and author's calculations

TABLE 5. Privatization by Foreign Investors

	1992	1993	1994	1995	1996	1997	1998	Total
Book Value (mn SKK)	806	1,163	1,314	522	78	61	724	4,668
Sales Price (mn SKK)	2,151	1,868	1,596	1,220	34	15	820	7,704
Sales Price/Book Value (%)	267	161	121	234	44	25	113	165
Number of Buyers	10	6	2	5	2	1	1	27
Book Value (%)	17	25	28	11	2	1	16	100
Sales Price (%)	28	24	21	16	0	0	11	100

Source: Ministry of Privatization (1999b) and author's calculations

TABLE 6. Ownership Interests of Voucher Investors

Investor	Czech Companies				Slovak Companies			
	50 %	30 %	20 %	10 %	50 %	30 %	20 %	10 %
Small Ind. Invest.	272	559	739	911	244	381	438	494
Investment Funds	334	631	787	876	173	305	365	406
Single Largest F.	0	9	102	747	4	27	81	363
Second Largest F.		0	7	482		0	3	203
Third Largest F.			0	217			0	81
3 Largest Funds	85	543	753	870	55	255	339	401
4 Largest Funds	196	605	769	873	110	276	349	402
5 Largest Funds	272	622	782	875	145	290	351	402
Total Vouchers	842	920	939	946	468	489	499	503

Notes: Data on a sample of 949 Czech companies are from 1993, while data on Slovak companies are from 1992. Table specifies the number of companies in which the respective type of investor holds more than  $x$  percent. The categories of largest funds specify the interests of  $n$  the largest funds, meaning largest stakes among funds in the given company. Source: Marcincin (1995)

TABLE 7. Ownership Interests of Non-voucher Investors

Investor	Czech Companies				Slovak Companies			
	50 %	30 %	20 %	0	50 %	30 %	20 %	0
Foreign	19	34	38	51	3	6	8	10
Domestic	16	28	38	58	11	14	22	31
NPF-tempor.	21	50	108	293	4	13	33	51
NPF-perman.	2	7	9	21	6	17	23	26
Banks	2	15	24	61				0
Restituents	2	5	7	52			0	8
Communities	1	1	4	181				0

Notes: Data on a sample of 949 Czech companies are from 1993, while data on Slovak companies are from 1992. Table specifies the number of companies in which the respective type of investor holds more than  $x$  percent. Data under "0" specify the number of companies in which the respective type of investor is present. For example, foreign investors hold stakes in 51 Czech companies out of which in 19 companies they represent majority shareholders. Source: Marcincin (1995)

TABLE 8. Seven Largest Groups of Funds by Republic

Slovak Republic		Czech Republic		Federation		% Points	
F.group	Nbr. of Shares	F.group	Nbr. of Shares	F.group	Nbr. of Shares		
SSK	6,008	CSP	20,210	CSP	21,376	950	15.6
SIB	5,541	IB	13,157	HCC	15,225	639	10.5
VUB	5,375	HCC	12,003	IB	13,594	724	11.9
SLP	3,995	KB	11,358	VUB	11,985	501	8.2
HCC	3,222	CP	7,623	KB	11,932	466	7.6
DI	2,249	VUB	6,611	SIB	10,987	333	5.5
CSP	1,166	SIB	5,446	SSK	7,708	169	2.8
7 IPS	27,556	7 IPS	76,408	7 IPS	92,807	3,782	62.1
∇ IPS	44,943	∇ IPS	131,037	∇ IPS	175 980	6 135	100.0

Notes: The groups of funds defined by founder, according to Mládek, Mejstřík and Marcincin. Number of shares quantified in thousands and specifies the number of shares gained by the fund in voucher privatization. Number of points quantified in millions. Data on the number of points spent by a fund for a company in individual republics were not available to us. The point percentages are calculated relative to points gained by all funds. The last line quantifies the total for all funds in voucher privatization. Source: Marcincin (1995)

TABLE 9. Property in the Second Phase of Privatization

Item		Number	Assets (mn SKK)	Assets (%)
A	Companies Identified for Privatization	610	136,804	-
B	Privatized Companies by	1,366	136,804	100
B1	- Sale of Assets	813	52,226	-
B11	- Direct Sale	645	45,072	33
B12	- Public Tender	155	7,140	5
B13	- Public Auction	13	14	0
B2	- Free Transfers	303	2,822	2
B3	- Restitution	16	22	0
B4	- Assets Deposit into Joint-stock C.	234	81,734	-
B411	- Basic Equity of Joint-stock C.	-	70,933	-
B4111	- Sold Using Standard Methods	-	36,041	-
B41111	- Direct Sale	-	34,801	25
B41112	- Public Tender	-	1,240	1
B4112	- Free Transfer of Shares	-	2,414	2
B4113	- Contribution into the Restit. Inv. F.	-	2,161	2
B4114	- Remaining in NPF's Ownership	-	30,317	22

Difference between assets deposit into a joint-stock company and the basic equity of a joint-stock company represents 8 % of the total privatized property. Source: Ministry of Privatization (1999a) and author's calculations

TABLE 10. Privatization Pursuant to the Register of Privatized Property

Year	Sales Price (mn SKK)	Sales Price (%)	Number of New Units	Average Sales Price Per Unit
1992	12,688	17	218	58
1993	4,062	5	69	59
1994	15,699	21	189	83
1995	18,617	25	480	39
1996	16,027	21	383	42
1997	3,839	5	168	23
1998	3,929	5	73	54
1999	14	0	2	7
1992-99	74,875	100	1,582	47

Data on 1,062 original companies. Source: Ministry of Privatization (1999b) and author's calculations

TABLE 11. Number of Companies Identified for Transformation and Privatization

Founder	Number of Companies	Book Value	Number of Employees
Ministry of Transport, Post and Telecommunications	44	4,215	14,164
Ministry of Economy	5	247	649
Ministry of Land Management	17	37,401	10,729
Ministry of Environment	1	19	24
Ministry of Construction and Public Works	1	133	41
Total	68	42,015	25,607

Ministry of Transport lists companies (business units) of the Slovak Bus Transport. Vodárne a kanalizácie (water supply and sewage) are included among the companies listed under the Ministry of Land Management. Book value as of December 31,1998, in millions SKK. Source: Ministry of Privatization (1999a)

## 12 Enterprise Restructuring

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The Slovak economy has been a puzzle. Its growth with low inflation and stable exchange rate has been followed by weak interest of foreign investors and a high unemployment rate. Later, it was shown that the Slovak growth was connected to the delay in price liberalization and structural reforms. The country was not able to adequately protect private ownership or enforce ownership rights through a corporate governance system and hard budget constraints. These were the reasons for the slow down in enterprise restructuring. New owners, in coalition with political parties, often robbed enterprises and searched for rents.

The Slovak government, since 1999, has had no clear vision of an enterprise-restructuring program. According to the report of the World Bank mission (1999), a restructuring program must contain four elements:

1. Restructuring and privatization of state banks. Private banks make budget constraints of enterprises strict enough to generate many changes in enterprise ownership.
2. Restructuring of bad loans in banks. Once again, ownership changes should be expected.
3. Improvement of the legal framework (bankruptcy act, commercial code, civic code, bank act and tax laws) and the judicial infrastructure.
4. Regulation and privatization of publicly beneficial enterprises. This primarily affects the top fifteen enterprises.

It is probable that the government will choose a de-centralized approach to enterprise restructuring. That method will allow creditors with the largest interest to recover their receivables, and to decide if the value of a bankrupted enterprise is higher through its restructuring or liquidation. This approach, however, assumes a significant change in the bankruptcy act and other legislation.



## 12.1 Introduction

Restructuring in a transition economy is usually implicitly understood as an act of adjusting enterprises to new market conditions. In literature, one can see different classifications of restructuring changes. Philippe Aghion's 1995 Transition report gives the best characterization of restructuring by using the terms reactive, strategic and deep restructuring. Reactive restructuring is a synonym for immediate changes extorted by external forces. An example would be a decrease in the labor force. Strategic restructuring denotes a change in markets, whether extorted by a split of CMEA, or by some new entrepreneurial activities of an enterprise. A deep restructuring describes changes connected to new investments that will significantly influence the future of enterprises.

Claessens et al. (1997) compared enterprise restructuring among various countries by applying three criteria. The first is sector-specific factors, which considers the initial level of productivity and inherited loans. The second is enterprise-specific factors, which considers structure of ownership rights, existence of external owners, progress made in the privatization of the economy, corporate governance, skills and motivation of managers to find foreign partners and new technologies, quality of banking services, and financial discipline. The third is external environment factors, which considers the rate of liberalization, macroeconomic stability, the financial system's viability, competition through imports, and the strength of the trade unions.

Companies typically undergo ongoing restructuring because they simply need to adapt themselves to immediate and projected market situations. When reforms of an economy do not proceed in the desired direction, i.e., towards creating the foundations for a market economy, the efforts of companies to adapt themselves is a waste of resources. Meaningful restructuring requires that the country focus on the goal of creating four basic pillars of a market economy. Mochrie et al (1998, p.2) states that they are: 1) Private ownership; 2) Clearly defined ownership rights that can be traded in and used to secure liabilities; 3) Legislation on contracts and bankruptcies, allowing rapid enforcement of agreements; and 4) A Commercial Code that requires companies to publish full and correct data on their financial state. These four basic pillars allow the acquisition of capital and the conduct of market-based business relations.

The restructuring of Slovak companies will be determined by the method of privatization and by the strong mingling of political with economic powers. The political situation must still address how to create a broad framework for corporate governance, how to cope with a lack of funding in soft budgetary conditions for selected companies, how to deal with non-performing loans in banks, how to deal

with the mutual debt of companies, and how to pursue the survival of loss-making companies.

In this chapter we focus on theoretical issues of restructuring and findings of important empirical studies. In the third section we consider studies on company restructuring in Slovakia that led to incorrect conclusions. The fourth section covers the main characteristics and elements of restructuring policies of various Slovak governments. The fifth section analyzes sector and selected company data. Foreign direct investment is analyzed in the sixth section. The seventh section contains conclusions and recommendations concerning inevitable changes in the economic policy of Slovakia and in the approach of the government's approach to the business sector.

## **12.2 Restructuring Issues**

In general, the restructuring of companies is not possible without a market economy, which again is not possible without private ownership. However, private ownership alone is not a sufficient guarantee for restructuring. Its successful adaptation of companies to global market conditions requires both private ownership combined with a good framework for corporate governance.

### **12.2.1 Privatization**

Privatization programs have provided the core of reforms in past transition economies. The final form of privatization was shaped by the interests of old managers, trade unions, political parties and bureaucrats in public administration. It was assumed that privatization would be a compromise between efficiency and satisfying the interests of these influential groups (e.g., Boycko and Shleifer, 1996). The consequent result of such assumptions was that privatization had to satisfy influential groups so that the government could receive sufficient support to enforce market reforms. A less efficient privatization would therefore result for the necessary restructuring. Thus, ownership and interest structures were created that negatively influenced the reforms and corporate governance. The support of old managers can be most easily acquired through their direct share in the privatization. A significant problem of such a privatization is the probable inability of old managers to manage companies in new circumstances and the impact of their reluctance to share control for obtaining new capital. Research papers do not favor managerial ownership due to a conflict of interest between the owner and the manager. Blanchard and Aghion (1995) assumed that the value of the company is not the same for the managers and external investors. They showed that managerial ownership could result in a sub-optimal level of restructuring and delay the process of selling the company to another investor. A high rate of unemployment increases the probability of such action because managers value their current positions. The

Transition Report 1995 documented that companies privatized by managers achieved worse results than companies privatized by external investors. This is explained by the managers' motivation to resist changes where there is no market for managers and the budgetary restrictions are rather soft. McMillan (1995) based his analysis on the model of a moral hazard, where the private cost of a manager to create company profit  $p$  are  $C(p,t)$ , where  $t$  stands for skills or type of manager. The owner can motivate the manager by offering a share in the created profit. McMillan also documented, with empirical studies from Russia and Poland, that motivation and skills are complementary. As a result, replacing managers hired on skills instead of political criteria is an important condition of restructuring. Carlin et al. (1994) analyzed Czechoslovak, Hungarian, Polish and Russian companies. Several obstacles to restructuring were found:

1. Opposition of employees, depending on their formal power and rate of unemployment in the country.
2. Lack of funds for investment.
3. High uncertainty of future revenues from restructuring given by the overall reform (e.g., the change in relative prices) and insufficient credibility of the government program.
4. Absence of competition policy and maintenance of monopoly power, which leads to artificially high prices and low production
5. Establishment of holding structures protecting the power of old managers.
6. Lack of a market with qualified managers and insufficient transferability of human capital, given by the informality of networks of company suppliers and customers and state institutions.

All the obstacles above were present in Slovakia. This study also points out that enhanced performance of large monopolies is partially caused by the preservation of monopoly power and the dismissal of redundant labor. Roland (1996) divided managers into several categories, to simplify the whole matter we use only two broad categories - bad and good managers. Bad managers will not support restructuring, since they would be its first victims. They will mobilize the employees to oppose restructuring. If the company is a monopoly, they will invest a large amount of profits into developing empires. Good managers are those who expect profits from profound restructuring. Roland pointed out that one of the goals of restructuring is the replacement of bad managers.

Privatization and the pressure for restructuring are both political goals. Privatization presents politicians a unique opportunity to acquire property and power. According to Canning and Hare (1996): *„...[privatization] is about the longer-term distribution of economic and political power. [...] Policy misjudgments or mismanagement could have grave consequences for social cohesion, threaten the consensus for reform as a whole and seriously undermine*

*the country's political stability. Privatization thus brings a myriad of interest groups to the fore and into confrontation with each other. [...] The state itself must be regarded as a conglomeration of different interest groups, comprising the political forces in power.*"<sup>233</sup> In our view, this applies not only to privatization but also to restructuring. Restructuring problems can be overcome by applying the policy of *divide et impera*' (Dewatripont and Roland, 1992). Restructuring is inconceivable without the credibility of important reforms, because "*...Lack of credibility could be serious enough to force even the best-intentioned government to abort the reform process, therefore validating the suspicions of the private sector.*" (Rodrik, 1989, p.756) The credibility of a reform is proportionate to its magnitude and pace. When analyzing corruption, privatization, and the commercialization of relationships between politicians and companies, Shleifer and Vishny (1994) proceeded from the assumptions that politicians require managers to employ excessive labor, thus ensuring them political advantages. As a result, compliant managers then obtain various privileges from the state. Grossman and Helpman (1996) predicted faster growth in sectors that are more resistant to the pressure of interest groups and pointed out the critical importance of political institutions in relation to economic growth.

Roland (1996) also perceived de-monopolization as a political problem. Restructuring is related to competition of product, labor and capital markets. If competition of product markets is missing, the de-monopolization of companies is necessary to achieve efficiency. In order for the companies to gain access to external funding, it is necessary to overcome the reluctance of managers towards external controls and developing their empires.

Privatization is a political tool. If governments concede too much to interest groups, they will not obtain the support of these groups in enforcing strict market rules, a precondition of restructuring. On the contrary, they lose credibility of their reform program. Old managers that gain a new role of owners then hamper the restructuring of companies and the adoption of the entire restructuring framework.

### **12.2.2 Corporate Governance<sup>234</sup>**

The need to concentrate large volumes of capital was the consequence of economic and technological development as well as of the market globalization. This led to the establishment of joint stock companies and other companies that obtain capital through loans and offering stakes in their equity to outsiders. This is

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<sup>233</sup> Cf. Boycko et al. (1995), who warned against the reform being perceived as a unit with one interest. On the contrary, a reform government is a temporary coalition of players with differing interests and methods.

<sup>234</sup> The paper by Shleifer and Vishny (1997) contains an excellent overview of the issue and relevant studies.

how companies separate ownership from control (management). Equity owners are not remunerated with stable payments, such as interests in case of debt, but they have legally guaranteed controlling rights over assets. They expect to receive a part of the distributed profits (dividends) and the residual value in case of company liquidation.

Owners (shareholders, investors) rely on the system of corporate governance to ensure return on investment. By Shleifer and Vishny's (1997, p.737) definition, "*corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.*" The OECD (1999a) defines corporate governance more broadly as "*a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.*" According to Zingales (1997), the system of corporate governance "[it is] *the complex set of constraints that shape ex-post bargaining over the quasi-rents generated in the course of a relationship.*"

The legal protection of investors determines the type of ownership and the access to funding by companies and countries. Since legal protection in continental Europe and Japan is weak, corporate governance depends more on large investors (sometimes families) and banks with longer-term relations with companies. This system is sometimes referred to as the *insider system*. On the other hand, the *outsider system* is typical for the United States and the United Kingdom. It is characterized by diffused ownership of equity, large institutional investors, recognition of the superiority of shareholders' interests in company laws, protection of minority investors by securities laws, and strict requirements for publishing information (Nestor and Thompson, 1999). In general, the efficiency of corporate governance depends on the transparency in publishing and using information, the protection of legal and contractual rights, and the responsibility of management.

The insider and outsider systems of management converge for several reasons:

1. International diversification of a portfolio brings higher revenues with smaller risk than a purely domestic portfolio.
2. Companies that issue shares on foreign capital markets can reduce their cost of capital.
3. Institutional investors (pension funds, life insurance companies and mutual funds) require international standards of management.

4. Globalization of product markets increases competition and thus forces companies to apply efficient management (Nestor and Thompson, 1999). Since globalization intensifies competition for obtaining resources, nationally produced savings are no longer monopolized by national companies.

Many transition economies failed in their efforts to enhance the performance of state-owned enterprises through privatization schemes. This stimulated new owners to maximize property in the short run at the cost of other stakeholders. In our view, we can differentiate between several types of bad privatization:

1. One form is the legal change of a state-owned company into a joint stock company owned by the state without pursuing fast privatization. The control remained in the hands of politicians and managers. In comparison with the previous "balanced" political regime, both sides here obtained incentives for a fast maximization of wealth as a result of the expected short-term position. The new legal form restricted the rights of government and offered more freedoms to old managers without increasing the responsibility of managers.
2. Another example is the privatization of assets by large shareholders without the protection of minority shareholders. This resulted in an expropriation of profits and assets. Majority shareholders used the legal environment to get rid of minority owners.<sup>235</sup>
3. A third type is the privatization of mutual funds associated with banks. Banks in general could have represented the interests of a large investor by concentrating on monitoring and good management techniques. In reality, they remained under political control because they lacked the experience in commercial banking and restructuring. As a result, a large part of their loans were bad loans. Moreover, the applicable legislation on bankruptcies, taxes, economic policy, and the delayed restructuring forced the banks to impose higher interest rates and to continue in bad projects.
4. Privatization by diffused shareholders, without the possibility to exercise the right of control or sale of shares, left the old managers without supervision and motivated them to transfer assets to other companies. The goal of mass privatization schemes was to achieve fair treatment of all citizens and protection against property being sold to foreign investors at low prices. However, these plans did not contain any provisions for protecting shareholders' rights. Only a small number of people benefited from this privatization, and the majority of the population remained frustrated with the worthless shares.

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<sup>235</sup> We do not claim, that privatization by large shareholders is bad in itself. This type of privatization was basically recommended at the beginning of the reform, e.g., also by Blanchard et al. (1991) to ensure the efficiency of the program. However the government should have protected minority shareholders at the same time.

5. Privatization favored old managers. When managers became sole owners, they usually lacked the capital and the willingness to share control with external investors. Very often the managers would rather reduce production output and bribe bank and government officials in order to obtain new funds or receive protection of their monopoly position.<sup>236</sup> Managers, as owners, resisted the adoption of rules and the establishment of institutions that are necessary for corporate governance. Even though their resistance to transparent management could not be sustainable in the long run, it caused serious economic and social problems to these economies. The resistance reduced the volume of investment and deteriorated the efficiency of business decisions.

Why would a manager - owner prefer private benefits from control (management) in preference to developing his reputation, which would give him access to funding in future? The direct explanation is that managers have monopoly information on the managed companies, which offers them an immediate opportunity to use that information for financial profit. The development of reputation can be too costly in terms of lost opportunity. The entire economic environment was too uncertain.<sup>237</sup>

Transfer pricing and sale of assets are two ways a manager - owner would exchange private information for profit. Prior to the privatization, managers of state owned companies had clear incentives for the transfer of profits or assets to another company they owned. Usually a state owned loss-making company was left with a high volume of unsettled bank debt and debt to input suppliers. Its products were then sold below market price through highly profitable trading companies. These products were sold to the original customers of the state owned company. These incentives also prevailed in the post-privatization period because the owners were too diffused to exercise their owners' rights. In some instances, new owners basically competed with the managers in looting the companies

The ownership of companies and the individual sales to owners were both problematic. This applies also to the privatization of small entities in the small-

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<sup>236</sup> Many studies implicitly assume that during a transformation of the economies managers have only economic tools at their disposal (restructuring, adaptation to consumer preferences and competition) and ignore political tools (rent seeking). Therefore it is not true, that they decide between restructuring and bankruptcy (Mochrie et al., 1998); their decision is only a combination of several tools: restructuring, expropriation, receiving support for sponsoring political parties and corruption of the bankers and state officials (customs duties, taxes, licenses); bankruptcy is only the last resort.

<sup>237</sup> Moreover: „If markets do not function well, allowing firms to prosper on basis of price distortions, monopoly power and connections or administrative and bueraucratic favours, then enterprise performance is unlikely to yield much information about managerial capabilities in a market environment.“ (Brada, 1996, p.13).

scale privatization, restitutions, and sale of large companies to external investors that were usually foreign. We do not take into account the sales to insiders (original management, employees, trade unions and town governments). These sales usually did not have sufficient funds to operate the acquired companies and the real privatization was only delayed.<sup>238</sup>

Many transition economies, in a politically motivated privatization, considered the creation of a framework for corporate governance only a secondary target. Such delay can be dangerous. Studies of economies in eastern Asia indicate that the weak management of companies is one of the main reasons for recent crises in that area (Nam et al., 1999, Jordan, 1999). The business environment there, similar to that in many transition economies, was based on relationships, such as ownership, family connections, linked political bargaining companies, banks, and government. The government implicitly guaranteed soft budgetary restrictions to companies, but did not allow for it in its budget). National conglomerates were thus protected from market competition and discipline. This situation is now temporarily balanced and all players must behave according to the rules and the behavior of other players. In order to bring about future change, the rules of the game would have to be changed and the initiator (leader) of the change identified. This initiator most likely would be the national government and change would occur with the help of international organizations and other governments. The studies came to the conclusion that reform in eastern Asia, mainly the structural reform, will require changes not only in the ownership, but also in the mobilization of financial resources that are monopolized by dominant business families. Transition economies, such as Slovakia, have found themselves in a similar trap. A trap where ownership once dominated by the state was replaced by ownership dominated by the "oligarchy." This new oligarchy will oppose structural reforms due to the fact that the success of future reforms significantly depends on how the government will treat the oligarchy.

### **12.3 Restructuring in Slovakia**

In the early 1990s, the restructuring of Slovakian companies was influenced mainly by the overall macroeconomic reform. Later influences were legislative reforms and the fact that institutions began to establish a market environment. The first liberalization of prices enabled companies to earn profits. This was possible

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<sup>238</sup> Aghion (1995) showed with a sample of data from Hungarian and Polish companies in the period of 1993/92, that a profound restructuring was carried out mainly in companies owned by foreign investors. On the other hand Earle and Estrin (1997) claimed that in Russia, managers had the best influence on restructuring, while market competition did not play any role. In our view their second argument actually confirms, that managers were more successful at rent seeking than foreigners.



due to the difference between the old cheap inputs and new more expensive output. The temporary growth of profits was also supported by a radical devaluation of the currency.

Liberalization of foreign trade constituted a compensation for the declined domestic demand. But, technical and commercial problems left Slovak companies unprepared to compete with foreign companies.<sup>239</sup>

The corporate governance system turned out to be a significant problem because it did not redress the mistakes of privatization. This could have been accomplished by changing the ownership of loss-making companies and making funding for their development accessible.

Restructuring of companies in Slovakia is the subject of few expert studies. A common feature of most papers is the poor quality of both the data and the specification of the models. Authors sometimes replace individual data with sectoral data. They then attempt to optically enhance the small number of observations by multiplying them over several time periods. Fidrmucová for example (1997) used 21 observations on the entire economy, including agriculture, industry, trade, construction, transport and tourism. He then multiplied that sum by four years, claiming that Slovak companies underwent a more consequential restructuring than Czech companies. Barbone et al. (1996) used 88 observations, i.e., a three-digit classification of sectors in the processing industry for eight quarters. By also using variables indicating the size of the companies, he reduced the number of observations in each regression. Poor specification of models is the result of the small number of observations or lack of knowledge about modern econometric techniques.

Three better-known and more expert papers on restructuring in Slovakia came to positive but incorrect conclusions regarding restructuring in Slovakia. Claessens et al. (1997) compared company data from Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia (883 companies in light industry with 579,000 employees, thus 93 %) and Slovenia in the period of 1992-95. He used labor productivity (value added per employee), operating profit, and overall productivity of the factors as indicators of restructuring. Labor productivity indicates the beginning of restructuring. The dismissal of excessive labor and the decline of real wages was easier and faster than the modernization of capital and the penetration of new markets. According to Aghion's classification, this is reactive restructuring. The operating profit reflects several changes, such as adapting the inputs to new relative prices and higher quality of output or higher revenues. Operating profit, unlike net profit, does not include the payments of interest, loans, and depreciation. These discrepancies could have been due to chance and the different rules that

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<sup>239</sup> Technical reasons are, e.g., outdated technologies, commercial ones, e.g., minimum experience with marketing.

apply in different countries. The overall productivity of factors is a complex computation that includes the efficiency of use of inputs (labor, material and capital). The authors replaced use of capital with electrical energy consumption. The study established the best values of labor productivity in the Czech Republic. The average growth in the monitored period amounted to 6.8 %, followed by Slovakia 5.1 % and Poland 4.7 %. The lowest growth was recorded in Bulgaria, -1.6 %, and Romania -1.2 %. The labor productivity growth in Slovakia was linked with the dismissals of labor, 8.2 % on average, 7.0 % in Poland, and 5.9 % in the Czech Republic. Operating profit was highest in Slovakia and followed by the Czech Republic. The overall productivity of factors was highest in the Czech Republic. Slovakia, Hungary and Poland recorded the lowest productivity based on mutually comparable overall factors. According to the study, companies in these four countries enhanced the use of production factors, unlike companies in Bulgaria or Romania. The most significant growth in overall productivity of factors in Slovakia was observed mainly with large companies in sectors of food processing, polygraphy, and chemical products. The lowest growth was recorded in the sectors of electrical equipment and the processing of building materials and glass.

According to Pohl et al. (1996) the most important restructuring of large companies was carried out in the Czech Republic, followed by Slovakia, Hungary and Poland. The size of the companies in their study is defined in relative terms. For example, in the case of Slovakia, they considered the 370 largest industrial companies that averaged 660 employees per company. According to the study, Slovak large companies achieved the highest return on capital, more than 30 %, while the second-ranked Czech large companies achieved "only" a 20 % return.

Djankov and Pohl (1996, p.1) claimed: "... majority of the Slovak large firms have successfully restructured in the absence of foreign investors and government-led restructuring programs... We find that privatization to insiders through management-employee buy-outs did not hamper firm restructuring as the new owners (old managers) invested heavily in new technology, laid off substantial part of their workforce, sought foreign partnerships, and were prepared to sell controlling stakes to outsiders in return for fresh financial resources." The authors documented their statements with 21 case studies.

In order to compare these results, we include a quotation of the IMF (1999, p.33-34): "... in Hungary and Poland ... Underpinning economic confidence are strong and well-regulated banking sectors, and the generally advanced state of corporate restructuring ... The slowdown in economic activity has been more severe in the Czech and Slovak Republics, ... The core of the difficulties, however, is the poor financial condition of much of these countries' banking sectors and the slow pace of restructuring in some large industrial enterprises."

It is obvious that the studies results could have been correct. However, their explanations are problematic. As we will show in the next sections of this chapter, the good results of large Slovak companies reflected more of their successes in rent seeking activities, their monopoly position in the domestic market, and the ability to get rid of excessive labor without a profound restructuring.

## **12.4 Restructuring Policies of the Slovak Governments**

The government's role is to ensure hard budgetary restrictions for companies, to provide a functional law on bankruptcies and management in state-owned companies, to clarify the relation of state and private companies, and to develop a system of corporate governance. The states rely more and more on politically independent institutions to monitor the regularity of competition.

Very often, only direct state aid (subsidies, favorable public contracts, guarantees on loans) is considered a soft budgetary restriction even though the concept is much broader. Soft budgets are also a consequence of the behavior of the financial sector. Loss-making loans are implicitly guaranteed by the government. Various state funds collect dues and distribute them on the basis of opaque rules, a benevolent collection of taxes, and various mandatory payments. The contracts lose their seriousness without bankruptcies. If concerns regarding bankruptcies are socially motivated, then one has to be aware of the negative social impact the surviving companies have on the overall business culture, the perception of payment, the contracting discipline, and the small supplier inputs. Another consideration is what threat the delay of bankruptcies represents, i.e., one-time dismissal of labor. There are many companies in Slovakia protected against bankruptcy by law. This constitutes moral risk. Large state-owned companies are monopolies that enjoy privileges beyond those of private companies. They enjoy various legal concessions that are important to suppliers of inputs and thereby significantly influence the behavior of all players on the market. Poor management in these companies correlates with a poor restructuring of the economy.

Bankruptcy is a decentralized procedure based on market mechanisms and incentives. Bankruptcy is a simple mechanism that enables the creditors of companies to enforce their accounts receivable - by taking over the assets of the company, be it a sale as a whole functioning company, or a sale of individual assets. Bankruptcies are rarely used in transition economies, according to Mochrie et al. (1998). This is due to the creditors weak motivation to institute bankruptcy proceedings on the debtors.

They offer five reasons for this weak motivation. The reasons are:

1. Weak legal system, lack of trained lawyers and judges, corruption and non-existence of the institute of precedent. All of these conditions slow down the

litigation and reduce the predictability of outcomes. Long bankruptcy proceedings motivate the managers to transfers of assets.

2. Liquidation value of the company can be too low, because there are many financially distressed companies and only a small market with the necessary assets.
3. If the bank institutes bankruptcy proceedings on a company, it reflects a bad loan in its portfolio. The more companies, the more the bank spreads this negative information about itself, which it would rather keep secret.
4. Expecting a government buyout of the accounts receivable.
5. Small debt versus high costs of the bankruptcy proceedings. It is usually easier to agree on the payment of debt informally, out of court.

If the state forgives companies outstanding taxes or dues to various funds, e.g., for political reasons (revenues from the liquidation of often loss-making companies are low and political costs of enforcing them high), it then creates soft budgetary restrictions for the companies. At the same time, the state is the first creditor to be paid in a successful bankruptcy proceeding. It is not necessarily worth the trouble for the suppliers and banks to bear the costs of their debtors bankruptcy proceedings because the revenues will probably be low. Thus, debtors can survive on the market.

The restructuring policies of the governments in the past ten years can be chronologically summarized as follows:

1990. Companies influenced by macroeconomic reforms, collapse of COMECON, liberalization of foreign trade and the possibility of direct access to foreign markets favored by the devaluation of the currency, the general lack of experience of the managers to sell their products, liberalization of prices and the effort to solve company problems at its costs.

1991. Beginning dismissals of excessive labor. Preparation for the privatization by the forced development of privatization projects. Foreign investors interested in buying a company negotiate with the management and government. Spontaneous privatization, many organizational changes. Bankruptcy and Composition Act (No.328/1991) entered into force in October, but the date of effect of the act was delayed several times and the contents of it changed, thus the act basically has remained non-functional to date. Ovecková (1996, p.16) evaluated the act as follows: „[The act] *does not respect the interest of creditors nor the interest of the debtor, not even the interest of society to conduct bankruptcies as a tool for the revitalization of the economy.*“

1992. Voucher privatization and continuing „pre-privatization agony.“ Settlement of ownership issues. Managers could have tried to keep control in the original company using diffused ownership and by agreement with foreign investor (temporary weakening of company performance to achieve low purchase price).

More sensible from the point of view of security however was the fast transfer of profits and assets to a new company owned by the managers.

1993. Arrival of new owners and general unwillingness of the managers to subordinate to new control. Emergence of new political-economic coalitions. Resistance of old managers to the then applicable approach of reform and the beginning of the search for a new approach. The establishment of a new state created also new lobbying opportunities for the old managers.

1994. Change in the privatization strategy, beginning of the re-privatization of the stakes held by investment funds, demonstration of power of politicians encouraging the managers to rent seeking. The already initiated second phase of voucher privatization was canceled to the benefit of company managers.

1995. Significant re-privatization of stakes held by investment funds, Act on Prices and Act on Strategic Companies. The Act on Prices strengthened the possibilities of the government to control prices. It contains terms such as "appropriate prices", "economically justifiable costs" and "appropriate profit". The law left the actual definition of these terms to the Ministry of Finance. The companies are obliged to present on control by the Ministry their price and cost calculations, which normally are confidential documents. Paragraph 12 of the Act stipulates that the seller and the buyer must not agree on an inappropriate price if (i) there is a temporary imbalance on the relevant market, (ii) if the imports during the period of market imbalance have increased, and (iii) if the critical goods are traded through several mediators. The Act on Strategic Companies delayed the privatization and provided various advantages to a selected group of companies.

1996. The Foreign Trade Support Fund was established. The resources of the Fund came from mandatory dues of domestic importers and exporters, amounting to 0.1 % of the value of exported goods or goods released into circulation on the domestic market. Funds were used for the promotion of selected companies abroad etc., though this use was not transparent. The OECD (1996) noted the importance of company restructuring due to a high concentration of economic activities in large and partially state-owned companies. *„It cannot be expected that the current competitive advantages of some export articles will continue for ever.“* Moreover, *„concentrated ownership resulting from [managerial] privatization does not guarantee better trade performance... Unsuccessful companies have to be closed down... [The privatization program discourages foreign investors.] That can be costly in terms of backgrounds for company restructuring.* The OECD also noted the change in the economic policy in Slovakia and emphasizes: *„Business decisions of government officials can hardly be an efficient replacement of decisions made by individual owners, who also assume the corresponding risks... Legislation was not always consistent with the goal to create clear rules of the game for the market.“* The warnings of the OECD remained unheard.

1997. First formal attempts at state restructuring of companies and measures to restrict imports. The Act on Revitalization allowed selected companies a delay in their payments of taxes and contributions to funds, as well as penalties and fees, forgave insurance payments, penalty interests or interests on outstanding taxes and provided protection against bankruptcy. The criteria of selecting companies for restructuring were vaguely defined as maintaining or increasing employment and reviving production. The revitalization commission began its activity in August and by September it had registered 1,200 company applications, out of which 16 were approved, but never implemented. The act, with its consequences, encouraged companies to seek rent. The Act on the Export-import Bank of Slovakia, the loan activities of which (providing export medium-term and long-term loans) were exempted from the bank supervision. A set of measures to reduce trade deficit (May 1997), adopted by the government focused on the promotion of Slovak products on foreign markets, instead of restructuring issues. The goal of the measures hence was the development of a denser network of trade representation offices and mixed chambers of commerce, more frequent participation in exhibitions and lobbying. In May 1997, the draft law of the government designed to restrict imports was not submitted to Parliament. The act would have allowed the protection of the domestic market against imports, which *"causes harm or threatens production, sales conditions, position on the market or otherwise deteriorates the critical economic indicators of the domestic production branch."* In July, the government introduced a 7 % import surcharge, which was assumed to concern as much as 80 % of Slovak imports, including the necessary technologies. The Ministry of Finance, therefore, started to consider individual applications of companies to be exempted from the import surcharge. In September a new certification obligation entered into force. This concerned apparently 50 - 70 % of Slovak imports. Formal protection of ownership rights also became problematic.<sup>240</sup>

1998. Permanent marking time and the incapability of the government to admit the need to restructure. The year of parliamentary elections. Unpredictability of government policy was reflected in the statements, which in reality did not mean the beginning of a specific strategy but only expressed the wishes of government members. Prime Minister Vladimír Mečiar said in relation to the financing of the highway construction: *"...we have decided to issue government bonds for Slovak citizens and foreign nationals. Anybody can buy these government bonds even those who have money from illegal sources and do not know how to pay taxes on it. Now we give them a chance."*<sup>241</sup> The new government saw the economic situation in a more sober way. The new Minister of Economy Ludovít Černák said:

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<sup>240</sup> *Business Central Europe* (Madness, September 1997, p.58) describes how the controlling stake was "literally stolen" from the foreign company Inekon by the National Property Fund.

<sup>241</sup> *Trend* May 5, 1998, p.12B.

„Unfortunately I have only to say that those who do honest business are in a really tough position. The unfair forms of business are well known to everybody.“<sup>242</sup> The new government declared a new economic policy. This policy had three goals: prevent the collapse of some sectors, stabilize macroeconomy and create conditions for the restructuring and modernization of the economy.<sup>243</sup> The IMF mission (1998) noted the importance of developing the government program's credibility: „... if the market begins to notice that political programs are not in line with the need ... to deal with the weaknesses of the banking and corporate sectors. The government therefore has to send unequivocal signals of its determination to deal with these critical issues soon.“

1999. The government abolished the Act on Strategic Companies and the Revitalization Act and began to prepare some legislative and institutional changes. Several ministers were suspected of corruption and cronyism, which had a significant impact on the overall credibility of the government. It was criticized for not progressing from words to deeds.

IMF (1999) further urged the Slovak government to take the necessary steps: *”For the revitalization of the banking and corporate sectors it is most important to accelerate their restructuring and privatization. Delayed addressing of these serious economic issues would undoubtedly threaten the economic stability of Slovakia and reduce its chances for an early integration into Western Europe.“*

OECD (1999a) noted that a large number of companies underwent a first phase of restructuring, i.e., a reduction of labor and adapting the productivity of products and markets, but only few companies underwent profound restructuring. Many large companies ensure regional employment and therefore their restructuring will be challenging in regard to the maintenance of social peace. There is an immense imbalance between the export openness of the economy and the foreign investors' stakes in domestic companies. *„We have to hope that the current effort to enhance the external image of Slovakia will bring about good results in the form of funds for company restructuring.“* Moreover serious obstacles to the application of the Bankruptcy Act prevailed. This was due to its wording and the overload in the courts.

The government stated that for the first half of its period its priority in office will be *„...the abolishment of causes of the delays in restructuring and the slowing down in the growth of competitiveness of the Slovak economy, mainly the industry [and the establishment of a cross-sectoral group] with the participation of domestic and foreign experts to quickly develop a complex program to enhance efficiency and flexibility of the courts, mainly the commercial ones.“*<sup>244</sup> The rationale behind

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<sup>242</sup> Cernák (1998).

<sup>243</sup> Policy statement of the government - economic policy, November 1999.

<sup>244</sup> Office of the Government (1999a).

these steps is also important. The government argues, that it is aware of the real problems of the Slovak economy: *„Insufficient enforcement of contracts, regulations, decrees and acts and the influencability of courts are obviously among the main reasons for such phenomena, as the expansion of corruption, insolvency, decline of payment discipline, asset stripping, cronyism etc. All in all this prompts managers and owners in state-owned as well as private companies to seek short-term rent by harming and raiding the managed (but also the owned) companies, instead of attempting at a long-term turnaround and restructuring of these companies. It is one of the key issues, without the settlement of which all other measures and projects (mainly amendments to laws and new laws) will be perfectly inefficient, regardless of how well prepared they may be.“*

The measures of the government package are correct, however, if the government is not able to implement them, their credibility becomes questionable. Being more specific and having a smaller number of tasks, at least for the given two-year period would have alleviated this. The measures include: *„ ...a set of measures to reduce the risk of corruption and cronyism, including the proclamation of the Program of fight against corruption (in cooperation with the World Bank); b. principal measures to reduce costs in the so-called strategic companies, minimizing the risk of corruption and opaqueness (by hiring renowned managers to manage these companies, with a clear definition of remuneration from the achieved reductions, privatization of minority shares with the right to manage the company, sale of majority stakes); c. creation of a regulatory framework for natural monopolies; d. immediate initiation of restructuring and privatization of VÚB (General Credit Bank), SLSP (Slovak Savings Bank), IRB (Investment and Development Bank) and Banka Slovakia; e. conclusion of the process of reviewing privatization decisions and a clear declaration, which companies will be concerned by the effort to review the purchase contracts; f. priority development of a set of legislative and institutional changes in the legal framework for the bankruptcy system, collateral rights and bank acts.“*

## **12.5 Development in Industry**

There are two ways of assessing the restructuring in Slovak companies. According to economic literature, we can expect a slow and insufficient restructuring due to the ownership structure. This problem was created in the privatization, and by the links between managers and politicians. In addition, the creation of such a broad framework of corporate governance discouraged foreign investors and caused an insufficient inflow of necessary funds. The best methodology would be to use regression analysis of individual company data. Since we do not have access to individual data, we have to rely on sector data and on the data of the largest companies. These larger companies significantly



influence all other companies, directly or indirectly, and are good examples of the restructuring process to date. It is also possible that completely new companies could emerge; companies that have not been perceived at sector level. Due to their innovation efforts, these companies would soon be significant in the Slovak economy and in relation to imports. At the same time we will show the development of one of the "flagships" of the Slovak economy. "Flagships" is a term that journalists and politicians coined to call Východoslovenské Železiarne (VSŽ - Eastern Slovak Steel Mill). This mill serves as an example of an unsuccessful and dangerous attempt at privatization and restructuring.

### 12.5.1 Sector Data

Data on the development of labor, profits, sales and exports in the sectors of the Slovak industry will help demonstrate whether or not the delays in the creation of an efficient framework for corporate governance and the delays in the implementation was the cause of the companies' poor performance. In regard to the employment issue, it appears that the sectors were able to rid themselves of excessive labor by shifting the labor force from the light to the heavy industry. Companies that were restructured in the past six years should be moderately profitable. The initial passive resistance to restructuring became apparent in reduced sales. The following profound restructuring was expected to restore sales to the original level. Exports are influenced by many factors, such as devaluation or the overall development of demand on the global market. Exports can be viewed as an indicator of the companies capability to face stiff competition. We assume that good export performance reflects a successful company restructuring.

Table 1 clearly indicates a modest decline (6 %) of the total labor employed in industry during the period of 1993 to 1997. A clear reduction was noted in the processing of coke and refined oil products, 27 %, in the processing of non-classified products, 19 % and leather processing, 16 %. Only four sectors increased the number of employees. The most significant of these was in metal production (dominated by the VSŽ plant - the main employer in the period of 1993 to 1997), 10 %, and the manufacturing of rubber products, 8 %. The sector production and distribution of electricity, gas and water, where state monopolies play the main role, increased the number of employees by 3 % and food production by 1 %. We can conclude that the total reduction of labor in the four-year period was moderate mainly due to the expansion of the sectors controlled by the state or by monopolies, such as VSŽ.

In table 2, we provide data on the gross profit in current prices. It is alarming that the total profit of the industry has declined substantially. In 1998 it achieved only 17 % of the profit level achieved in 1993. However, the state-dominated sector, production and distribution of electricity, gas and water, achieved yearly

levels of profit approximately cumulatively equal to the entire industry. Exceptions are for the years 1995 and 1998, when this sector achieved 65 % and 278 % respectively of the total industry profit. Only six sectors reported positive profits during the entire period. These were mining, food production, coke, refined oil products, chemical products, rubber, plastics, and the production and distribution of electricity, gas and water. Only one of them, the food-producing sector, increased its profits during the period of 1993 to 1998. Two sectors reported loss in only one year. Those sectors were the non-metallic minerals and the manufacturing of products not classified elsewhere. Two sectors were able to achieve profits in 1998 - pulp and paper, almost twelve-fold growth and manufacturing of means of transport, mainly thank to Volkswagen with a 60 % profit.

The second group of companies is composed of six sectors. These sectors showed a loss almost permanently. Textiles and clothing recorded moderate profits in 1995 and since then they have showed a loss. Leather products, wooden products, and machine and tool production did not report any profit during the entire period. The latter sector, machine and tools, can be considered to be in a very bad situation due to a 1998 loss amounting to SKK 10 billion. This loss was two times higher than the entire industry profits. The sector of metal production reported significant profits in 1995; however, this cannot balance the losses in the remaining years. The electrical and optical equipment sector production was profitable only in 1997.

According to the reported volumes of profits, most of the sectors show poor performance. The situation is serious. The entire profit in the industry declined to 17 % of the profit level of 1993, at current prices. The industry reports positive profits only due to the state-controlled sector - production and distribution of electricity, gas and water. This sector first ensures revenues for the state budget and only then addresses quality and the range of commercial services. This may be the reason for the Slovak government's apprehension about restructuring this sector. Delaying restructuring is not a solution.

Only four sectors did not increase their sales in the period of 1993-98 (in fixed prices, cf. Table 3). The sales of the sectors for textiles clothing, and leather goods recorded the sharpest decline, by 25 %. On the contrary, a steep increase of sales was recorded in the sectors: manufacturing of means of transport, by 342 %, manufacturing of electrical and optical equipment, +117 %, pulp and paper, +51 % and production and distribution of electricity, gas and water, +49 %.

Sales from exports have not grown in the period of 1993-97 in six sectors (cf. Table 4). The most significant decline in exports were recorded in metal production, by 48 %, and manufacturing of non-metallic minerals, by 32 %. On the other hand, the strongest growth was reported for production and distribution of electricity, gas and water (due to a low level in 1993), manufacturing of means of

transport, by 147 %, and manufacturing of electrical and optical equipment, +90 %. The industry sales originating in exports have grown by 22 % in fixed prices over the monitored period.

In order to measure the dependence between the development of individual indexes, we calculated correlation indexes for them. The highest correlation was reported between the development of sales and exports, 0.60. This indicates that sales on the domestic market were almost as important for sales growth as the exports. The correlation between the development of the number of employees and profits was negative as expected, -0.45. Other correlations did not exceed the value 0.20.

Apart from the development of four variables, (number of employees, profit, sales and exports), it is also interesting to monitor the development of the market prices. Some sectors were able to optically enhance their performance due to a faster growth of prices when compared with other sectors (cf. Table 5). We assume that the growth or decline of prices in these sectors depended on the adaptation of relative prices, competition between domestic and imported products and state regulation of markets. The most substantial growth of prices occurred in the food industry, textiles and clothing and non-metallic minerals. The lowest was recorded in the sectors leather goods, production and distribution of electricity, gas and water and manufacturing of coke and refined oil products.

In order to study the dependence between the development of the four variables and the price environment, we first divided the sectors into four groups according to the profit index. Table 6 lists the sectors with the strongest growth of profit, marked with „++“, then those with lower profit growth, „+“, still lower growth, „-“ and lowest growth, „--“. The groups for other variables are similarly marked. If there was a weak dependency between variables, we could expect a frequent occurrence of "plusses" for the sales and exports and "minuses" for labor in the upper part of the table and vice versa. It is difficult to predict the dependence on prices, even though we would like to link the restructured companies with the "minuses" for prices.

It can be noted that "pluses" for sales, exports and labor in table 6 are located in the center around the medium values of profit growth. Significant reduction of labor concerned the critical sectors with lowest growth of profits, sales and earnings. Sectors with the highest profit growth are linked with a decline of sales and often with a decline of exports, which is a surprising result. The price changes are scattered arbitrarily in the table.

### **12.5.2 The Largest 15 Companies**

In tables 7, 8, 9 and 10 we list the sales, pre-tax profits, and number of employees according to the sales of the fifteen largest Slovak companies. This

information is regularly published by the *Trend* weekly. We want to show that the few largest companies share in the overall industrial sales, profits, and excessive employment. This represents a danger to the Slovak Republic and also indicates insufficient structural changes. Concurrently, we want to take a look at the ownership structure and market position of the largest companies in order to show whether or not they represent the new private sector, foreign investment or state monopolies.

By comparing the data in the four tables, we will establish that the concentration of industrial sales in the fifteen largest companies is significant. Their share was approximately one half: 43 % in 1995, 52 % in 1996, 54 % in 1997 and 46 % in 1998. Moreover, this share did not show a clearly declining tendency as might have been expected due to the restructuring of industrial companies. Because of their immense sales, these few companies are able to directly influence the majority of Slovak companies and their employees.

The situation is even worse in regard to the development of profits. The largest companies produced 88 % of the total industry profits in 1995, but in the following year, their share exceeded 100 %. In 1996, they produced 153 % of the profits. In 1997, profits were almost unchanged showing 142 % of the profits; and in 1998, an incredible 317 % of total industry profits was shown. In 1998, selected largest companies produced not only the entire profits recorded in the industry, but also produced twice as much to balance off the losses of other companies. That of course not only has an impact on the state budget revenues, but also strengthens the position of the company managers in relation to government negotiations..

In regard to employment, the fifteen largest companies employed approximately 15 % of labor in industry, even though indirectly this number was much higher. In comparison with the share in sales (48 %) and profits (175 %)<sup>245</sup> these companies might appear to be incredibly efficient unless this efficiency is not determined by their ownership structure or market position. The latter is linked with successful rent seeking. In 1995, five out of fifteen selected companies were "state companies" in their legal form, and another three were state companies that were being prepared for privatization. Nine of the fifteen largest companies were controlled by the state. Two out of the remaining six were held by foreign investors. The two largest, VSŽ and Slovnaft, were privatized expressly for political purposes. Privatization of the remaining companies was opaque.

However, the privatization of companies does not mean that the state gave up substantial stakes. The state remained involved through the NPF, a 35 % stake in Všeobecná úverová banka (VÚB), 91 % in Slovenská sporiteľna and 51 % stake in Slovenská poisťovňa.<sup>246</sup>

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<sup>245</sup> Average values for the entire period

In regard to the domestic market, VSŽ owned 108 companies in various sectors in 1998 and can be considered both a monopoly and an empire.<sup>247</sup> Their activities brought the company a permanent threat of cross default in 1998. SPP is a monopoly that imports and distributes gas. In 1998, this company produced 60 % of the profit for the fifteen largest companies. Slovnaft, an oil refinery, usually linked with gasoline, also enjoys a monopoly position on the domestic market. This position became stronger after it created an alliance with another large company - Benzina, an owner of a chain of gas stations. Power plants, as well as all regional distributing energy works and Slovenské telekomunikácie (Slovak telecom) have a monopoly position by law. In 1998, they produced 23 % of the profits for the fifteen companies.

We can guess that approximately half of the fifteen largest companies were under state control or have a monopoly position. Six state monopolies produced as much as 83 % of the profits of the big fifteen in 1998. Their high productivity was therefore the result of their favorable position in the market rather than the result of restructuring.

### 12.5.3 The VSŽ Case

The VSŽ, eastern Slovak steel mill used to produce 9 % of the Slovak GDP and 12 % of exports.<sup>248</sup> This mill can serve as an example of opaque privatization, slow restructuring, and the building a managerial empire. During the period between 1994 –1997, the company recorded annual profits of about SKK 4 bn.<sup>249</sup> In 1998, profits were only SKK 21million (cf. Table 11) and the net profit was a negative SKK 7.2bn. VSŽ's creditors declared cross default. Since this company employs approximately 25,000 employees, the government initiated negotiations with the creditors in an effort to prevent mass redundancies. The behavior of VSŽ owners (cf. Table 12) was similar to blackmailing the government. The owners refused to agree with company restructuring if it limited their influence. According to Mathernová (1999), it was not possible for the creditors to apply the Slovak Bankruptcy and Composition Act for the restructuring of VSŽ. If the creditors applied the act (sold the company), they would achieve only a portion of their accounts receivable. This became a stalemate because, even though the government wanted to insure employment and the creditors want to restructure the company with a new management, an agreement with the owners could not be reached. The development of the crisis in VSŽ is an example of the difficulties in Slovak privatization and in the operation of domestic market monopolies.

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<sup>247</sup> Annual report VSŽ 1998.

<sup>248</sup> Data for 1996. P67value, 22.9.1997, „VSŽ“.

<sup>249</sup> Average calculated from the data in the table 11.

In the voucher privatization during the period of 1992-93, 65 % of the company shares were privatized. The VSŽ managers founded the company, Manager, on March 11, 1994. On the same day, the parliament voted no confidence to the government. However, three days later, the government adopted the sale of 10 % of VSŽ's shares to Manager at a price of SKK 200 per share. That price was three times lower than the market price. The link between the government and VSŽ was then constituted by the Minister of Finance and a former manager of VSŽ, Július Toth. In 1995, Hutník, a company founded by the VSŽ trade unions, privatized further 10 % of the VSŽ shares at the same price SKK 200 per share, even though the market price at that time was twice as high. The NPF sold the remaining 15 % of VSŽ shares to Ferrimex, s.r.o in July 1995, at SKK 200 per share. Ferrimex was owned by Hutník (25 %) and another company, ARDS (75 %), was controlled by some of VSŽ's managers. At that time, Alexander Rezeš, the most important VSŽ owner and Minister of Transport, Posts and Telecommunications, was the link with the government. Rezeš obtained favorable transport prices for VSŽ at the cost of the state owned railway company. Prior to the parliamentary elections in 1998, he worked as the leader of the election team of the then ruling HZDS.

With the arrival of new owners in VSŽ, the company progressively expanded its empire and the number of subsidiaries kept growing. In 1996, the company was the majority stakeholder in 86 companies and the minority stakeholder (20 - 50 %) in another 35 companies. The group included the Czech soccer club AC Sparta Praha, 91 % share of VSŽ, daily newspapers Národná obroda, 86 %, and Lúč, 77 %, and some investment companies and Slovenská poisťovňa, 20 %. The VSŽ owners also held stakes through third parties. Stakes in IRB, which was at that time the third largest bank in Slovakia, were held by VSŽ held 15 %, and stakes in through other co-owned companies were at least 40 %.<sup>250</sup> In 1997, the company admitted to holding majority stakes in 68 companies and holding minority stakes in 31 companies. In 1998, VSŽ held stakes in 102 companies in Slovakia and 16 in foreign companies.<sup>251</sup>

In 1997, the company was still considered healthy. (January 30) ING Barings recommended foreign investors buy VSŽ bonds because the company was highly profitable and it had excellent preconditions established for meeting its obligations. (February 1) Companies held by VSŽ reported investment in modern technologies amounting to SKK 3.5bn for 1996. (March 27) The Antimonopoly Office became suspicious and began to investigate VSŽ and ARDS. It was suspected that they had acted in harmony as IRB shareholders without declaring a concentration of shares. (April 9) Ludovít Cernák, opposition member of parliament (National Council)

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<sup>250</sup> P67value, 8.3.1998, „IRB“.

<sup>251</sup> Annual report VSŽ 1996, 1997 and 1998.

criticized the VSŽ for low investment into modernization of manufacturing and minimal enhancement of competitiveness. He predicted financial problems for the company and also stated that those found responsible would blackmail the state to "take care".

(April 15) Minister of Transport, Posts and Telecommunications and co-owner of VSŽ, Alexander Rezeš, resigned from his office. He began to focus more on company management, a task that had a negative impact on its performance. (May 7) The VSŽ began a campaign to develop a new plant in eastern Slovakia that would be designed for manufacturing cars. The new plant was supposed to buy a part of VSŽ output. VSŽ informed Toyota about these negotiations, but Toyota did not express great interest. (September 22) The company reported that it produced 9 % of Slovak GDP and at the same time it announced the need for government aid to assist in its revitalization. (December 18) VSŽ sold its 20 % share in the Czech company, Trinecké železárny. These shares had been purchased only a year earlier. In 1996, Trinecké železárny showed a loss of SKK 0.8bn and the revenues declined by SKK 1.2bn (5 %), which helped the company to compensate for the loss made in 1994 and 1995.

In 1998, VSŽ made a new investment. (January 9) VSŽ bought 68 % of shares in the loss-making Hungarian metallurgical company, DAM Diósgyőr, whose debt amounted to SKK 1.4bn. The purchase price was a symbolic \$1. The Hungarian government had previously spent SKK 5bn. for the revitalization of DAM. VSŽ now promised to increase DAM equity by SKK 0.7bn (March 2). Alexander Rezeš and Ján Smerek became members of the supervisory board of VSŽ and Július Rezeš (at the age of twenty) joined the Board of Directors. (March 9) VSŽ planned to invest SKK 5.9bn into modern technologies. (March 19) Reports emerged that the profit of the company for 1997 totaled SKK 0.6bn instead of the projected SKK 1.4bn. The *Trend* weekly noticed that VSŽ had concentrated the import of substantial raw materials in the Trans Trade Import AG Vaduz. This company was established in Liechtenstein and had no formal links with VSŽ. Projections of profit reduction and changes in the Supervisory Board and Board of Directors caused a 38 % decline in the price of VSŽ shares from SKK 660. *Trend* then published an anonymous report stating that the situation in the company was completely opaque since no one could determine which property belonged to the company and which belonged to the members of the Supervisory Board. A price intervention of the VSŽ was then expected. Company shares were registered by banks as collateral for loans and VSŽ could have been asked to make up for the emerged difference in value. State owned banks failed to undertake any such action.

(March 30) VSŽ signed the issue of \$200 Eurobonds. (May 12) Consolidated net profit for 1997 totaled SKK 0.3mld. while, in 1996, the profit was 1 billion

higher. The profit per share in 1997 was only SKK 16, while, in 1996, it was as much as SKK 77. The company registered SKK 15.2bn worth of accounts receivable after maturity (SKK +1.9bn. compared with 1996), SKK 8.9bn of long-term liabilities (SKK +0.9 bn) and SKK 19.2bn in short-term liabilities (SKK +0.7 bn). Bank loans totaled SKK 4.3bn (SKK -1.2 bn). The company's basic equity totaled SKK 16.4bn and shareholders' equity SKK 26.8bn. (May 22) The general assembly of the company voted for an increase of dividends, which also exceeded consolidated net profit by 15 %. (July 30) The issue of Eurobonds was delayed.

(October 26) The powers of both the Supervisory Board (SB) and the domestic shareholders were extended. As of that date the general assembly was entitled to elect and recall members of the SB with a two-third majority. Another SB was entitled to elect or recall the members of the Board of Directors. Some important decisions required the presence of 55 % of shareholders at the general assembly, but for other decisions only 30 % constituted a quorum. Jaroslav Gruber, the Vice President of the SB and the head of the trade unions in VSŽ, had 10 % of Hutník's voting rights. This was justified by claiming that there was a threat to VSŽ because 25 % of its shares were owned by foreign investors. The foreign investors were alleged to be uninterested in the company's development and more interested in its decline or liquidation.

(November 5) The company reduced its stake in Slovenská poisťovňa from 20 % to 13 % by selling the difference to Poštová banka. The shares were sold in two packages at SKK 1,910 and SKK 2,310 per share, even though the stock exchange offered only SKK 800 per share. This can be explained by noting that VSŽ had a stake in the partially state-owned Poštová banka. On the very day VSŽ announced negative profit for 1998. (November 9) VSŽ declared the intention to make 2000 employees redundant in 1999 and to restructure the portfolio of its 137 subsidiaries, including the Prague soccer club AC Sparta. (November 9). The company was unable to repay the \$35 million syndicated loan.

(November 10) The government continued its negotiations with VSŽ creditors. The members of the Board of Directors and the Supervisory Board refused the suggestion that they resign. The government considered the company a strategic one due to its size and influence on the Slovak economy. (November 20) VSŽ stated that the banks could announce cross default. „It is a decision to be taken by the banks,“ said the Vice President of the company. (November 26) The government tried to increase its influence on the company through state-owned banks. Slovenská sporiteľňa was designated to acquire 30 % of VSŽ shares. These shares were to be used as collateral on a loan. As a result of this action, the majority owners of VSŽ would lose their positions. This was basically nationalization used as a condition to ensure repeated privatization of the company. (December 7) Price Waterhouse Coopers prepared an in-depth audit as a basis for



the negotiations with the creditors and also as an assessment of the company's restructuring potential. (December 11) At an extraordinary general assembly, Mr. Gabriel Eichler, a foreign manager, was elected to the Board of Directors for a six month period. Alexander Rezeš and Jaroslav Gruber remained in the Supervisory Board, but Július Rezeš left. The Board of Directors gained greater independence from the Supervisory Board. The goal was to restructure the total debt of the company –(SKK 13 billion) and to find a strategic investor.

In 1999 (January 14) Slovenská sporiteľna became the owner of 13 % of VSŽ shares. The government controlled another 3 % through the Restitution fund and 10 % through Priemyselná banka. The owners to that date therefore lost their majority in VSŽ. (February 19) Alexander Rezeš resigned after the general assembly. (March 2) The new management planned to complete the restructuring process by June 1999.

(March 17) The NPF tried to acquire 10 % of VSŽ shares privatized by the company Manager (controlled by Alexander Rezeš), since the latter did not pay the installment of the agreed purchase price. However, in the meantime Manager sold 6 % of the shares to another company. Gabriel Eichler emphasized the need of a fast foreign investment, which would enhance the know-how and corporate culture, including the governance and marketing. (March 29) VSŽ signed a „stand still agreement“ to prevent the declaration of a cross default with all creditors, except one, thus the signed agreement was not valid. (April 4) Gabriel Eichler claimed that creditors would receive only 15-20 % of their outstanding accounts receivable if the company were put into bankruptcy. VSŽ still employed 25,000 people and significantly influenced another 100,000 jobs. (June 3) The Minister of Finance announced that the state was the largest creditor of VSŽ with accounts receivable in amount of SKK 5 billion for unpaid taxes and it owned 30 % of the VSŽ shares.

(July 29) VSŽ began to sell some subsidiaries, luxurious cars, and one jet aircraft. The aircraft itself was initially leased for \$10 million (September 16). After meeting Alexander Rezeš, the Slovak president said that everybody agreed that the company could be saved exclusively with domestic funds, with the help of loans, and without foreign capital investment. (September 20) Slovenská sporiteľna sold 10 % of VSŽ shares to the state NPF (September 24). The general assembly strengthened the position of the government and Jaroslav Gruber was recalled. (October 28) The Minister of Finance ordered to stop trading with 21 % of VSŽ shares, which was supposed to return majority in the company to the old owners. (November 11) VSŽ sold some subsidiaries, including the soccer club AC Sparta Praha, some luxurious cars, garages, apartments, aircraft and 100 pieces of art.

## 12.6 Foreign Direct Investment

Investment in any country depends on its potential return and the related risk. The higher the risk, the higher the required return. Risk is usually linked with political stability, or the outlook for an enhancement in the market environment, and access to good quality information (cf. e.g., Collin and Rodrik, 1991). Local prices of the production factors (including labor and tax reductions), infrastructure and distance from the markets all influence the return on investment differently, but for the very decision to place the investment they are rather of secondary importance. If the transition countries want to attract a large volume of foreign capital, they have to reduce the risk of investment, so that the investors may participate also in less profitable projects.

The main importance of the foreign direct investment is to obtain the capital required for restructuring the economy and the companies. This must be done without straining the companies with new loans and the economy with the possibility of a fast outflow that is typical with many portfolio investments. Investment brings modern technologies, know how, new forms of management, and new corporate culture. At the same time, it accelerates the country's access not only to global markets but also to international alliances, such as the European Union. It is of substantial political and social importance. Foreign direct investment, however, assumes that the transition economy will agree with the foreign investors who acquire control over relevant companies, i.e., that their ownership rights will be protected comparable to national owners by the law and the executive branch of power. Foreign direct investment for companies assumes hard budgetary restrictions, which force the current owners to search funds even at the cost of sharing or losing control.

Slovak Foreign Exchange Act<sup>252</sup> considers the following as foreign direct investment: *„...such use of monetary funds or other property values and ownership rights, measurable in money, the purpose of which is the establishment, acquisition or expansion of permanent economic relations of an investing foreign national in an enterprise in the Slovak Republic in one of these forms: 1. establishment or acquisition of exclusively a share in business, including its expansion; 2. participation in a newly established or existing business, if the investor owns or acquires at least 10 % stake in the basic equity of the company, or at least 10 % of the share in net equity, or 10 % of voting rights; 3. financial loan for five or more years, extended by the investor for business purposes, if the investor participates in this business as defined in item 1 or 2, or a loan related with an agreement on participation in the distribution of profit; 4. use of revenues from an existing direct investment into this investment .“*

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<sup>252</sup> Foreign Exchange Act of September 20, 1995, section 2 paragraph k).

In the case of Slovakia, it became quite obvious that the amount of foreign direct investment would be based upon the rate of success of the reforms in a transition economy. Even though Slovakia achieved excellent results in terms of GDP growth with low inflation, the foreign direct investment coming to Slovakia remained low. In comparison - in the period of 1990 - 1998 the Czech Republic attracted more than SKK 13 billion, while Slovakia only less than 2 billion. (cf. Table 13). In 1998 the foreign direct investment to Slovakia achieved its maximum (cf. table 14), SKK 16 billion. Even though there was a 6 billion increase in the first half of 1999, investors remained cautious of investment opportunity in Slovakia, as was expected. Not even tax reductions and breaks<sup>253</sup> could substantially change their behavior as long as they were not accompanied by changes in the overall market environment and a larger actual openness of the economy (infrastructure of border crossings, customs duties and certificates). According to the governmental package of economic measures of January 1999, the government is well aware of that: *„The basis for the support of foreign direct investment is the creation of a transparent and stable business environment with clear rules for all players in the competition.“* (item 47)

Slovakia urgently needs foreign direct investment, because it is a small, open, and poor economy. Privatization of state stakes in banks and large companies is an opportunity not only to raise funds for the state budget, but also is an opportunity to acquire support for the adoption of necessary reforms.

## 12.7 Conclusion

The Slovak economy was a puzzle for a long time. While it had successful growth, low inflation, and a stable exchange rate, a low interest of foreign investors and continuing high rate of unemployment prevailed. As it turned out later, Slovak growth was achieved at the cost of price liberalization and structural changes. To date, the country has not been able to sufficiently ensure the protection of private ownership, the exercise of ownership rights through corporate governance, and hard budgetary restrictions. Company restructuring has also slowed down. The new owners, in coalition with political parties, often robbed companies and searched for rents. Until 1999, Slovak governments did not have a clear idea of a program for company restructuring.

According to the report of the World Bank Mission (1999), the restructuring program has to contain four elements:

1. Restructuring and privatization of state-owned banks. Private banks will harden the budgetary restrictions for companies to such extent that we could expect many changes in company ownership.

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<sup>253</sup> In force as of July 1, 1998 According to the Act on Income Tax.

2. Restructuring of the banks' portfolios of non-performing loans. Here too, changes in company ownership have to be expected.
3. Enhancement of the legal framework (Act on Bankruptcy and Composition, Commercial Code, Civil Code, Act on Banks, tax legislation) and court infrastructure.
4. Regulation and privatization of publicly beneficial companies.

In many cases these are companies of the country's top fifteen.

It is probable that the Slovak government will decide on a decentralized approach to company restructuring. It will then enable the creditors, who are most interested in satisfying their accounts receivable, to decide whether the value of a bankrupt company is higher in case of restructuring or higher in liquidation. This requires a significant amendment to the Act on Bankruptcy and Composition as well as limitations on the use of the Act on Execution, which is efficient in enforcing the collateral, but leads to a liquidation of companies, where restructuring would be more favorable.

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## 12.9 Annex

TABLE 1. Development of Labor in Industry

	1993	1994	1995	1996	1997	197/93
Mining	24,267	21,291	21,198	21,119	21,345	0.88
Food Production	51,394	50,963	50,102	51,047	51,810	1.01
Textiles and Clothing	55,403	55,696	55,326	53,312	50,373	0.91
Leather Goods	22,965	20,488	22,185	21,700	19,380	0.84
Wood Products	14,522	14,891	15,007	14,740	14,222	0.98
Pulp and Paper	23,103	22,498	22,676	22,229	22,001	0.95
Coke, Refined Oil Products	7,543	6,526	6,113	5,792	5,499	0.73
Chemical Products	29,336	27,517	27,025	26,900	26,636	0.91
Rubber and Plastics	13,417	14,048	15,057	15,312	14,554	1.08
Non-metallic Minerals	29,154	27,151	26,071	25,243	24,683	0.85
Metals	54,250	54,332	56,989	58,932	59,554	1.10
Machinery and Tools	80,629	72,563	71,881	69,273	67,562	0.84
Electric. and Optical Equipment	40,187	35,596	37,496	37,272	38,203	0.95
Means of Transport	28,659	26,521	28,834	28,286	27,778	0.97
Production not Classified Elsewhere	21,012	18,685	17,329	17,040	17,027	0.81
Electricity, Gas and Water	43,870	44,730	43,650	44,182	45,134	1.03
<b>Industry Total</b>	<b>539,711</b>	<b>513,496</b>	<b>516,939</b>	<b>512,379</b>	<b>505,761</b>	<b>0.94</b>

Data 1993: Statistical yearbook (SY) 1996 p.339, 1994-96: SY 1997 p.359 and 1997: SY 1998 p.360. Index 197/93 = Value 1997 / Value 1993.

TABLE 2 Development of Profit and Loss in Industry, current prices, SKK million

	1993	1994	1995	1996	1997	1998	198/93
Mining	833	810	1,270	759	369	646	0.78
Food Production	869	1,514	2,342	2,092	2,088	2,062	2.37
Textiles and Clothing	174	224	75	-369	-541	-126	-1.72
Leather Goods	-142	-597	-601	-761	-1,105	-2,120	14.93
Wood Products	-456	-533	-402	-404	-1,093	-530	1.16
Pulp and Paper	-153	1,300	4,108	867	1,814	1,559	11.19
Coke, Refined Oil Products	1,449	3,525	3,730	2,255	3,908	1,020	0.70
Chemical Products	1,177	1,073	2,203	1,684	982	803	0.68
Rubber and Plastics	1,053	1,079	1,201	925	756	584	0.55
Non-metallic Minerals	714	397	700	-1,025	376	974	1.36
Metals	12	-380	2,318	338	-935	-2,713	-227.0
Machinery and Tools	-3,719	-5,445	-3,750	-5,327	-7,901	-10,321	2.78
El. & Optical Equipment	-953	-723	-953	-346	613	-210	0.22
Means of Transport	-726	77	1,105	-572	299	413	1.57
Production not Classified Elsewhere	55	-212	146	322	122	170	3.09
Electricity, Gas and Water	26,178	23,385	25,651	19,638	15,695	12,163	0.46
<b>Industry Total</b>	<b>26,365</b>	<b>25,494</b>	<b>39,143</b>	<b>20,076</b>	<b>15,572</b>	<b>4,374</b>	<b>0.17</b>

Data 1993: Statistical yearbook (SY) 1996 p.340, 1994-96: SY 1997 p.360, 1997: SY 1998 p.361 and 1998: Statistical report on basic development tendencies in the Slovak economy in 1998, table 15. Index 198/93 = Value 1998 / Value 1993.

TABLE 3 Development of Total Industry Sales, fixed prices Dec 1995, SKK mil.

	1993	1994	1995	1996	1997	1998	198/93
Mining	14,107	9,489	9,649	10,266	11,521	13,199	0.94
Food Production	74,877	68,841	66,038	68,713	69,294	66,897	0.89
Textiles and Clothing	18,403	18,753	16,460	16,146	14,289	13,805	0.75
Leather Goods	5,239	5,286	6,093	6,072	4,950	3,910	0.75
Wood Products	6,068	6,743	7,401	7,036	7,338	6,798	1.12
Pulp and Paper	22,934	26,419	27,917	29,950	34,693	34,696	1.51
Coke, Refined Oil Products	22,740	33,677	32,572	31,211	35,585	26,469	1.16
Chemical Products	30,494	34,208	36,562	36,721	37,536	36,410	1.19
Rubber and Plastics	13,283	15,644	17,384	17,711	18,625	16,595	1.25
Non-metallic Minerals	19,785	19,165	18,588	18,303	19,691	22,045	1.11
Metals	65,361	70,330	76,603	68,169	75,824	73,092	1.12
Machinery and Tools	29,831	28,048	31,240	33,345	33,281	36,973	1.24
Electrical and Optical Equipment	19,102	19,692	21,864	24,439	31,316	41,471	2.17
Means of Transport	15,671	15,990	26,867	31,804	37,099	69,326	4.42
Production not-Classified Elsewhere	9,846	9,249	9,497	10,426	10,122	10,370	1.05
Electricity, Gas and Water	61,098	91,236	89,007	100,808	101,187	91,044	1.49
<b>Industry Total</b>	<b>434,891</b>	<b>478,368</b>	<b>501,623</b>	<b>515,361</b>	<b>543,165</b>	<b>560,115</b>	<b>1.29</b>

Data 1993: Statistical yearbook (SY) 1996 p.340, 1994-96: SY 1997 p.361, 1997: SY 1998 p.362 and 1998: Statistical report on basic development tendencies in the Slovak economy in 1998, table 15. Index 198/93 = value 1998 / value 1993. SY lists data for the years 1993 and 1995 at prices of 1995, for the years 1994 and 1996 at prices of 1996, for 1997 at prices of December 1995 and for the year 1998 at current prices. The author used price indexes from table 5 to recalculate the data on a single basis December 1995.

TABLE 4 Development of Export Sales, fixed prices December 1995, SKK million

	1993	1994	1995	1996	1997	197/93
Mining	1,233	1,352	1,352	1,410	1,714	1.39
Food Production	7,141	5,973	6,301	5,575	5,132	0.72
Textiles and Clothing	10,065	10,191	9,330	9,038	7,977	0.79
Leather Goods	2,620	2,396	2,487	2,321	2,332	0.89
Wood Products	2,588	3,359	3,650	3,325	3,208	1.24
Pulp and Paper	9,761	12,737	14,361	15,228	17,715	1.81
Coke, Refined Oil Products	9,897	15,244	15,951	16,133	16,164	1.63
Chemical Products	18,282	21,618	23,746	23,862	24,001	1.31
Rubber and Plastics	8,359	9,161	10,638	10,451	11,962	1.43
Non-metallic Minerals	10,222	10,044	9,804	7,111	6,938	0.68
Metals	44,305	47,269	49,563	27,475	23,173	0.52
Machinery and Tools	14,735	12,275	13,425	13,819	14,456	0.98
Electrical and Optical Equipment	8,653	10,142	11,388	12,197	16,456	1.90
Means of Transport	11,846	11,875	20,614	22,764	29,206	2.47
Production not Classified Elsewhere	3,691	3,165	3,727	4,195	3,895	1.06
Electricity, Gas and Water	942	16,144	16,345	19,098	18,765	19.93
<b>Industry Total</b>	<b>166,754</b>	<b>195,772</b>	<b>216,663</b>	<b>197,322</b>	<b>203,094</b>	<b>1.22</b>

Data 1993: Statistical yearbook (SY) 1996 p.341, 1994-96: SY 1997 p.361 and 1997: SY 1998 p.361. Index 197/93 = Value 1997 / Value 1993. SY lists data for the years 1993 and 1995 at prices of 1995,



for the years 1994 and 1996 at prices of 1996 and for the year 1997 at prices of December 1995. The author used the price indexes from table 5 to recalculate the data on a single basis - December 1995.

TABLE 5. Development of Industry Prices, December 1995 = 100

	1993	1994	1995	1996	1997	1998
Mining	91.5	96.5	106.1	103.2	105.7	106.2
Food Production	76.4	90.6	100.0	104.5	110.9	117.4
Textiles and Clothing	77.8	87.0	98.8	101.1	108.0	113.8
Leather Goods	104.0	106.3	107.5	108.2	105.4	111.4
Wood Products	80.9	85.9	94.2	98.4	105.8	112.5
Pulp and Paper	69.0	75.5	94.5	92.5	87.7	91.2
Coke, Refined Oil Products	104.2	114.4	100.0	111.6	116.9	117.4
Chemical Products	81.4	88.7	102.7	105.2	107.0	107.0
Rubber and Plastics	81.0	84.5	96.4	103.5	105.9	107.8
Non-metallic Minerals	72.1	79.4	93.3	99.6	103.9	107.1
Metals	79.5	86.8	99.2	103.8	107.0	111.0
Machinery and Tools	82.3	92.2	98.5	104.9	110.6	112.3
Electrical and Optical Equipment	83.3	87.2	95.8	98.7	103.3	103.2
Means of Transport	87.4	104.5	111.8	115.6	111.5	114.8
Production not Classified Elsewhere	83.8	90.8	95.1	96.2	103.4	108.5
Electricity, Gas and Water	102.3	95.8	99.6	99.3	106.9	111.8
Industry Total	81.9	90.0	98.1	102.2	106.8	110.3

Data 1993-97: Statistical yearbook 1998 p.128 and 1998: Statistical report on basic development tendencies in the Slovak economy in 1998, table 8.

TABLE 6. Comparison of Indexes

	Profit	Labor	Sales	Exports	Prices
Pulp and Paper	++	+	++	++	+
Food Production	++	++	--	--	++
Mining	++	-	--	+	--
Non-metallic Minerals	++	-	-	--	++
Production not Classified Elsewhere	++	--	-	-	-
Means of Transport	+	+	++	++	-
Rubber and Plastics	+	++	+	+	+
Chemical Products	+	-	+	+	-
Coke, Refined Oil Products	+	--	+	++	--
Electricity, Gas and Water	-	++	++	++	--
Wood Products	-	++	-	+	++
Electrical and Optical Equipment	-	+	++	++	-
Metals	--	++	-	--	++
Textiles and Clothing	--	-	--	--	++
Machinery and Tools	--	--	+	-	+
Leather Goods	--	--	--	-	--

Calculations with the indexes of labor and exports 197/93 and indexes of profit, revenues and prices 198/93. -- denotes  $x < 1.Q$ , -  $1.Q < x < 2.Q$ , +  $2.Q < x < 3.Q$  a ++  $3.Q < x$ , where Q = quartile.

TABLE 7. Company Data for 1995 According to *Trend Top 1996*

Rank	Name of company	Sector	Pf	Sales	Profit	Labor
1	VSŽ Ocel	Metallurgy	a.s.	38,950	1,733	10,123
2	SPP	Gas	š.p.	36,788	13,322	5,586
3	Slovnaft	Oil	a.s.	31,917	3,274	5,276
4	Slovenské elektrárne	Energy	a.s.	26,176	7,487	10,382
5	Volkswagen	Automobiles	s.r.o	13,689	397	1,421
6	Západoslovenské energet. závody	Energy	š.p.	11,301	335	3,771
7	Stredoslovenské energet. závody	Energy	š.p.	10,750	232	3,700
8	Slovenské telekomunikácie	Telecom	š.p.	9,883	2,802	15,306
9	Matador	Tires	a.s.	7,835	1,195	4,445
10	Východoslov. energetické závody	Energy	š.p.	6,787	169	2,084
11	Severoslov. celulóžky a papierne	Pulp	a.s.	6,710	2,222	3,678
12	Duslo	Chemicals	a.s.	6,357	274	3,408
13	Chemlon	Artificial fibers	a.s.	4,534	29	2,967
14	Slovakofarma	Pharmaceuticals	a.s.	4,039	929	2,147
15	Chemko	Chemicals	a.s.	3,872	65	2,744
Top 15 Total				219,588	34,465	77,038
Share of Top 15 in Industry in %				43	88	15

Sales = net revenues in SKK million, Profit = pre-tax profit in SKK million, Labor = number of employees.

TABLE 8. Company Data for 1996 According to *Trend Top 1997*

Rank	Name of Company	Sector		Sales	Profit	Labor
1	VSŽ	Metallurgy	a.s.	48,828	2,221	39
2	SPP	Gas	š.p.	39,439	13,792	5,941
3	Slovnaft	Oil	a.s.	35,889	2,307	4,984
4	VSŽ Ocel	Metallurgy	s.r.o	29,882	214	11,630
5	Slovenské elektrárne	Energy	a.s.	29,088	4,936	10,748
6	Volkswagen	Automobiles	s.r.o	18,187	501	1,955
7	Slovenské telekomunikácie	Telecom	š.p.	12,864	4,199	15,374
8	Západoslovenské energet. závody	Energy	š.p.	11,950	251	3,732
9	Stredoslovenské energet. závody	Energy	š.p.	10,804	4	3,615
10	Matador	Tires	a.s.	7,966	404	4,604
11	Duslo	Chemicals	a.s.	7,189	535	3,418
12	Východoslov. energetické závody	Energy	š.p.	7,153	122	2,056
13	Slovalco	Aluminium	a.s.	6,504	37	745
14	Severoslov. celulóžky a papierne	Pulp, paper	a.s.	6,086	309	4,309
15	Slovakofarma	Pharmaceuticals	a.s.	4,413	912	2,168
Top 15 Total				276,242	30,744	75,318
Share of Top 15 in the Industry in %				52	153	15

TABLE 9. Company Data for 1997 According to *Trend Top 1998*

Rank	Name of Company	Sector	Pf	Sales	Profit	Labor
1	VSŽ Holding	Metallurgy	a.s.	62,069	1,071	44
2	SPP	Gas	š.p.	41,548	9,645	6,265
3	Slovnaft	Oil	a.s.	40,173	3,113	4,704
4	VSŽ Ocel	Metallurgy	s.r.o	35,557	201	11,666
5	Slovenské elektrárne	Energy	a.s.	28,983	2,435	11,282
6	Volkswagen	Automobiles	s.r.o	21,721	343	2,745
7	Slovenské telekomunikácie	Telecom	š.p.	15,236	4,310	15,278
8	Západoslovenské energet. závody	Energy	š.p.	12,642	215	3,728
9	Stredoslovenské energet. závody	Energy	š.p.	11,333	68	3,648
10	Slovalco	Aluminium	a.s.	8,078	16	746
11	Matador	Tires	a.s.	7,824	185	4,375
12	Východoslov. energetické závody	Energy	š.p.	7,663	128	2,067
13	Duslo	Chemicals	a.s.	6,752	243	3,690
14	Severoslov. celulóžky a papierne	Paper, pulp	a.s.	6,660	323	4,370
15	Chemlon	Artificial fiber	a.s.	4,643	-184	2,568
Top 15 Total				310,882	22,112	77,176
Share of Top 15 in Industry in %				54	142	15

TABLE 10. Company Data for 1998 According to *Trend Top 1999*

Rank	Name of Company	Sector	Pf	Sales	Profit	Labor
1	Volkswagen	Automobiles	s.r.o	56,713	608	4,704
2	SPP	Gas	š.p.	43,514	8,574	6,440
3	VSŽ Ocel	Metallurgy	s.r.o	33,223	-716	
4	Slovnaft	Oil	a.s.	31,509	910	4,341
5	Slovenské elektrárne	Energy	a.s.	29,592	1,535	11,313
6	Slovenské telekomunikácie	Telecom	š.p.	16,974	1,751	14,848
7	Západoslovenské energet. závody	Energy	š.p.	13,062	147	3,762
8	Stredoslovenské energet. závody	Energy	š.p.	11,629	-237	3,700
9	Slovalco	Aluminium	a.s.	8,116	56	
10	Východoslov. energetické závody	Energy	š.p.	7,975	51	2,087
11	Severoslov. celulóžky a papierne	Pulp, paper	a.s.	7,577	402	
12	Matador	Tires	a.s.	7,171	215	3,878
13	Duslo	Chemicals	a.s.	6,350	132	3,236
14	Slovenské energetické strojárne	Machinery	a.s.	6,180	72	631
15	Slovakofarma	Pharmaceuticals	a.s.	4,600	372	2,010
Top 15 Total				284,185	13,872	60,950
Share of Top 15 in Industry in %				46	317	13

TABLE 11. Selected Consolidated Financial Data on VSŽ

<i>Operating Data</i>		1998	1997	1996	1995	1994
Operating Revenues	SKKmn	45,597	50,625	51,415	53,668	42,968
Operating Profit	SKKmn	21	2,886	4,118	7,073	3,262
Income Tax	SKKmn	-176	585	1,161	3,285	1,396
- percent of profit	(%)	x	67	61	62	77
Net Profit	SKKmn	-7,231	285	756	1,973	426
Rate of Operating Profit	(%)	x	5.70	8.01	13.18	7.61
Rate of Net Profit	(%)	x	0.56	1.47	3.68	0.99
<i>Rate of Return on Basic Equity</i>						
- on gross profit	(%)	x	2.69	5.76	14.68	5.31
- on net profit	(%)	x	0.88	2.27	5.51	1.24
<i>Data Per Share</i>						
Number of Shares	000pc	16,448	16,449	16,448	16,448	16,448
Net profit Per Share	(SKK)	-440	15.93	76.51	154.96	85
Dividend Per Share *	(SKK)	x	20.00	40.00	30.00	20.00
Price of Share as of December 31 at the BCPB	(SKK)	180.00	685.00	560.00	432.00	400.00
<i>Financial Data</i>						
Working Capital	SKKmn.	1,225	3,896	2,685	4,778	720
Current Liquidity			1:1.20	1:1.15	1:1.27	1:1.04
Tangible Assets– ZC	SKKmn	32,563	32,833	31,821	29,325	28,225
Shareholder's Equity	SKKmn	19,272	26,809	27,411	26,427	24,539
Bank Loans and Aids	SKKmn	15,816	14,879	14,990	11,316	8,024
- long-term loans	SKKmn	** 514	8,533	7,371	4,783	1,264
<i>Other Data</i>						
Depreciation	SKKmn	3,737	3,658	3,374	2,816	2,536
Wages and Other Personnel Costs	SKKmn	8,110	6,842	6,320	5,366	4,055
Average Number of Employees ***		32,412	25,706	25,981	25,283	25,242

\* Dividend per share is based on non-consolidated profit of VSŽ a.s. \*\* +8357 long-term debt in default.

\*\*\* Number of employees in 1999 in companies, where VSŽ owns a stake higher than 50 %. Source: Annual report VSŽ 1996, 1997 a 1998

TABLE 12. Development of Ownership Structure in VSŽ

	2.1999	1.1998	5.1997	1.1996
<i>Slovak Legal Persons</i>	59 .23	55 .98	60 .61	
Slovenská sporiteľna	13 .43			
Harvard Capital & Consulting Slovakia, a.s.				12 .16
Všeobecná a.s.	10 .75	10 .79		
Hutník, a.s.	10 .22	9 .99		10 .00
Eurotrade a.s.		9 .91		10 .01
Priemyselná banka	9 .27			
Ferrimex, s.r.o.	3 .84	9 .65		15 .27
Manager, s.r.o.	3 .79			6 .23
Reštitučný investičný fond	2 .94			
Poštová banka	1 .46			
ARDS o.c.p., a.s.	1 .17			
<i>Foreign Legal Persons</i>	24 .34	27 .21	20 .34	
Chase Nominees Limited, London	14 .23	11 .21		
The Central European Growth Fund plc., London	3 .40			
State Street Bank and Trust Company, Boston	1 .49			
Royal Trust Corporation, London	1 .14			
Creditanstalt Bankverein				6 .06
<i>Natural Persons</i>	16 .43	16 .81	19 .05	

Slovak legal persons with more than 5 % shares, except for 1999, where with more than 1 %. Source: Annual report VSŽ 1996, 1997 a 1998

TABLE 13. Comparison of Foreign Direct Investment

	1990	1991	1992	1993	1994	1995	1996	1997	1998
CR	72	595	2,889	3,423	4,547	7,350	8,572	9,234	13,457
Hungary	569	2,107	3,435	5,585	7,095	11,026	14,668	15,882	18,255
Poland	2	115	1,520	3,825	6,242	11,033	18,299	26,284	38,413
Slovakia	-	-	-	453	762	1,066	1,361	1,558	1,888

Cumulative data according to the balance of payments in USD million. Source: Hunya and Stankowsky, WIIW-WIFO Database, 1999, as quoted in Hošková (1999)

TABLE 14. Foreign Direct Investment to Slovakia

	Volume (SKK million)	Increase (SKK million)	Increase (%)
1993	15,179	-	-
1994	24,005	8,826	58
1995	31,797	7,792	32
1996	43,863	12,066	38
1997	54,812	10,949	25
1998	70,988	16,176	30
1999	76,914	5,926	8

Data as of December 31, except for 1999, as at June 30 Source: NBS and calculations of the author

## **13 Banking Sector in the Slovak Republic**

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This chapter analyzes the development and the position of the banking sector in the Slovak Republic since 1993. It characterizes the banking sector of the Slovak Republic using four groups of banks into which the sector can now be distinguished. Reasons are identified for such excessive differentiation of banks, whereby increased attention is paid to banks controlled by the state. The case of the IRB serves as an illustration of the state's policy when acting as an owner of a bank. The situation in the banking sector of the Slovak Republic is compared with the situation in other Visegrad Group countries; based on this comparison, the causes of this specific development in Slovakia are pointed out.

## 13.1 Introduction

It is generally recognized that countries or regions with a functional, open and large banking sector achieve faster economic growth than those where the banking sector is not developed enough, where it is closed or inefficient. Another imperative for fast and healthy economic growth is competition inside and outside the banking sector - the existence of a healthy and strong capital market, other financial non-banking institutions (pension funds, mutual funds, etc.), or even non-financial institutions providing quasi-banking services (e. g., sales for installment payments). These conclusions are backed by recent studies by Beck et al (1999) and Demirgüç-Kunt and Maksimovic (1998) that analyzed the position of the banking sector and the legal situation, including the position of the capital market in a large number of countries. A recent empirical study by La Porta et al (1999) examined the ownership relationship in the banking sector, whereby it used as its basis an older work by Gerschenkron (1962), which defends public ownership of banking institutions. However, the authors came to the opposite conclusion when they showed that public ownership of banks prevails in countries with a lower per capita income, less developed financial systems, a less effective government, government interventions into the economy and insufficient protection of ownership rights. They also found that state ownership of banks rather slows down than accelerates the development of the financial sector; furthermore, this is associated with a slower growth of income, primarily due to lower growth of productivity.

This chapter analyzes the development and position of the banking sector in Slovakia. The first part describes the history of banking in Slovakia and introduces the most important factors that have had an impact on its development since 1993. The second part includes an overview of important parameters of the sector as well as its development since 1993. The third part analyzes the four groups of banks into which we believe the banking sector in Slovakia evolved. In part four we compare the Slovak banking sector with banking sectors in the Czech Republic, Hungary, and Poland. In part five we attempt to find the causes for specific development in Slovakia.

## 13.2 Overview of the Development of the Banking Sector in Slovakia

The history of banking in Slovakia dates back to early 19th century when various savings associations, financial institutions, and credit cooperatives (often self-supporting) sprang up on this territory. After the collapse of the empire in 1918, a rapid development of this sector followed, but its structure remained rather scattered. From 1953 onward, a network of state-owned savings banks was founded, and its role

was to manage the savings of the population and to provide loans to citizens. After 1968, Slovenská štátna sporiteľna was established from the network of state-owned savings banks in Slovakia, which continued accumulating the savings of the population. Until 1990, the needs of the business sector were served by the State Bank of Czechoslovakia (SBCS), which was founded in 1950. However, political changes after 1989, and the transition from a command economy to a market economy, and later the dissolution of Czechoslovakia brought immense changes to banking in Slovakia.

In 1990, Všeobecná úverová banka (General Credit Bank -- VÚB) and Investičná a rozvojová banka (Investment and Development Bank -- IRB, which operated in both republics of the federation) were separated from SBCS in Slovakia to provide banking services to business clientele. SBCS then performed the duties as the central bank. In the same year, Tatra banka renewed its operations. In a very short time, VÚB, IRB, and Tatra banka also became important players also in the area of primary deposits of the population, and thus upset the established monopoly of Slovenská štátna sporiteľna. Between 1991 and 1993, over ten new banks were established, some of which with foreign capital. In addition, two housing construction savings banks and Konsolidáčnà banka (Consolidation Bank) were also established, which had the task of managing loans granted before 1989 for constant inventory roll-over. In 1992, state-owned banks received a capital injection, but with regard to their total assets it was insufficient.

The necessity to establish a central bank of the new state emerged with the establishment of the Slovak Republic on January 1, 1993, and as well as its currency separation on February 8, 1993. Based on the National Council of the Slovak Republic Act on the National Bank of Slovakia (which determines the National Bank of Slovakia's position, functions, and tasks), the National Bank of Slovakia (NBS) was established on January 1, 1993. The NBS is an independent institution whose main task is to safeguard the stability of Slovak currency. The National Bank of Slovakia performs above all the following activities:

- defines monetary policy and instruments for its implementation;
- issues bank notes and coins;
- directs the circulation of money;
- coordinates payments and settlement between banks;
- supervises the performance of banking activities;
- oversees prudential functioning and efficient development of the banking system;
- represents Slovakia in international financial institutions.

The Slovak Republic had taken over the Bank Act that was approved by the Federal Parliament of CSFR in 1992. This Act reflected the level of knowledge of that time as well as legislation valid in the European Union. Repeatedly, the National



Council of the Slovak Republic amended the Act on Banks; the amendments of 1994, 1998, and 1999 were especially important.

Articles that enabled banks to provide mortgage loans were added into the Act on Banks in 1994. The slow development of mortgage banking after this amendment was rather the consequence of the government's unclear housing policy, a non-existent housing market, and excessive legal protection of tenants. The amendment of 1998 reacted to demands of the OECD; it simplified the procedures for granting a banking license, and it also established equal terms for domestic and foreign investors. The relatively extensive amendment of 1999 strengthened the position of banking supervision for the NBS; the amendment also introduced stricter requirements on bank owners (i.e., holding bankers accountable for their action). Changes were also made to provisions associated with forced administration and mortgage banking; furthermore, banks were given the opportunity to exchange information regarding classified loans, which in the past was prevented by the institute of bank secret. We expect that the Act on Banks will be amended even further so that it will be in full accordance with Basle's twenty-five criteria for prudential banking, especially in those areas pertaining to the position of banking supervision, consolidated risk management, and transborder cooperation of banks.

The NBS became the regulator of the banking sector in Slovakia. At the beginning of 1994, it issued a series of measures No. 2-5/94 that govern capital adequacy, loan engagement, liquidity rules, and regulation of the foreign exchange positions of banks. In 1995, the NBS issued a measure on the classification of the loan portfolio. These measures became the basis for the NBS's role as a banking supervisor. In 1996, the NBS issued a measure on keeping a register of loans and guarantees exceeding 3 million SKK. Most of the measures were gradually amended to better correspond to the needs of banking supervision. Furthermore, the original measure on capital adequacy also contained a timetable for banks to gradually achieve the required capital adequacy of 8 percent by the end of 1996 (i.e., for banks that were below this limit at that time). It was later modified in 1995, giving banks undergoing restructuring an exemption from the duty to comply with this measure for a period of three years. For these banks the method of calculation of the required resources to cover loans has also been modified. In this way the NBS made capital adequacy criteria softer for banks undergoing restructuring, which was also reflected in loan engagement level, liquidity, and foreign exchange position. This procedure did not motivate banks to operate in a prudential manner; on the contrary, it was one of the causes leading to the gradual deterioration of the situation in restructured banks.

In 1992, coupon privatization laid the foundations for the creation of a capital market in Slovakia. The capital market grew dynamically in 1994; the reason for growth was not the development of alternative forms of company financing procedures, but the struggle for decisive stakes in companies from the first wave of

coupon privatization. The stock market served only as an instrument for assuming control over companies. After property relations in companies were settled (i.e., every company was controlled by a majority owner), the stock market became superfluous. Not a single initial public offering was registered in Slovakia that would serve to finance a developmental project. The reasons include the following:

- incorrect concept of the presence of hundreds of companies on the stock market;
- weak protection of minority investors;
- generally weak enforcement of laws;
- inappropriate government interventions against investment funds that damaged their shareholders;
- missing interest of companies to get finances on the capital market (lacking corporate culture).

Other components of the capital market are oriented above all at trading in government securities; corporate bonds are traded to a substantially lesser extent. Market capitalization is about 7 percent of the GDP, whereby the stock market contributes to this number by about 53 percent. Therefore, the capital market does not constitute a counterbalance or competition to the banking sector, which brings Slovakia closer to the model typical for continental Europe (i.e., the dominance of the banking sector in the economy). This dominance is also emphasized by the present system of pension insurance and low popularity of collective investment.

### **13.3 Main Parameters of the Banking Sector**

The banking sector in Slovakia saw convincing development from 1993 to 1997.<sup>254</sup> Growth was posted in the number of banks, branch offices, and employees (see Charts 1 and 2). Total assets and capital of banks also grew rapidly (see Charts 3 and 4). The growth of total assets was also reflected in the growth of loans to clients, with loan expansion taking place in 1996. It was caused by two factors -- optimistic expectations after an almost 7 percent GDP growth in 1995 and massive privatization that created a higher need for external financing in the newly founded private companies. However, this loan expansion also brought about an increase in the volume of classified loans (Chart 5), which grew in the course of 1997-1998 by 31 billion SKK, and their share from the cumulative volume of loans increased from 29.6 to 35.6 percent. For this reason, the quality of assets gradually worsened and the share of interest bearing assets in the banking sector decreased. This development was accompanied by the growth of paid interest (Chart 6) resulting from the desperate effort of some banks to resolve their liquidity problems by attracting sufficient

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<sup>254</sup> Sources: Monetary review and annual reports of the NBS, Trend Top 1999 in the finance sector

primary deposits and lowering their dependence on the interbank market. In 1997 and 1998, the interbank market was characterized by the strong volatility of interest rates caused by the crises of emerging markets, attacks on the Slovak crown, and an expansive fiscal policy of the government. This unfavorable development led to great losses in some banks; on the other hand, some banks that were not burdened by bad loans and had enough primary resources reported extreme profits (ROE over 50 percent -- see Chart 7).

From 1993, Slovak banking underwent fundamental modernization. Banks were forced to invest in information technology as well as in technological equipment to prevent a complete loss of their position on the market, or to build a position in new areas. Banks invested about 75 billion SKK on aggregate during this period. Banks stood at the forefront of development of Slovakia's financial, foreign exchange, and capital markets. New products and new channels were developed, such as bank cards, automatic teller machines, POS terminals, and electronic banking. However, extensive investments were not always effective; for example, banks often bought real estate without properly assessing the necessity of such investment from a long-term outlook. Similarly, some investments in information technology have shown to be incorrectly selected. It is likely that investment activity in some banks was used as an instrument to finance political parties, but evidence for this is difficult to uncover in the circumstances of Slovakia's legislation.

CHART 1. Number of Commercial Banks and Branch Offices of Foreign Banks

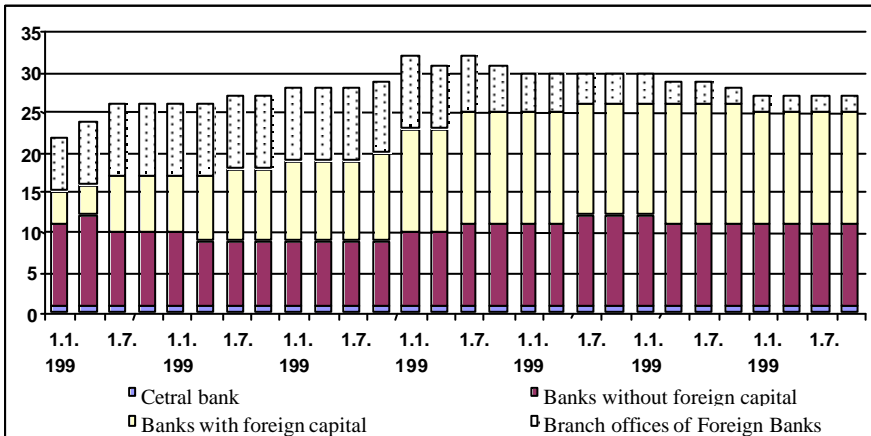


CHART 2. Registered Number of Employees in the Banking Sector of the Slovak Republic

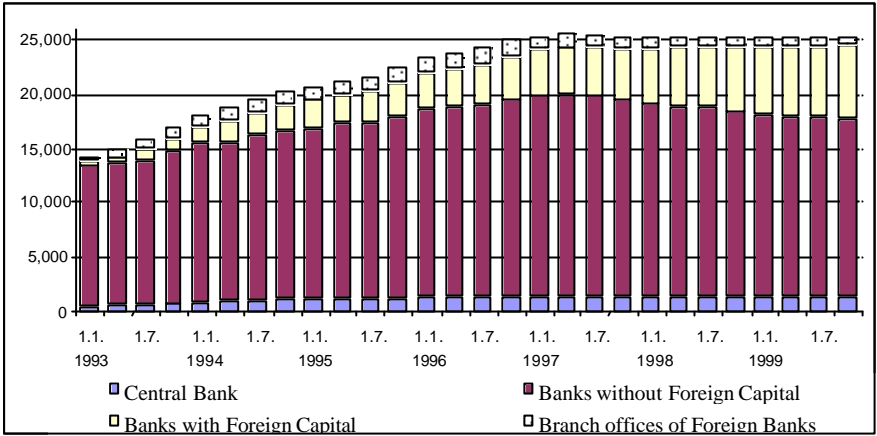


CHART 3. Total Assets of the Banking Sector of the Slovak Republic, billions of SKK

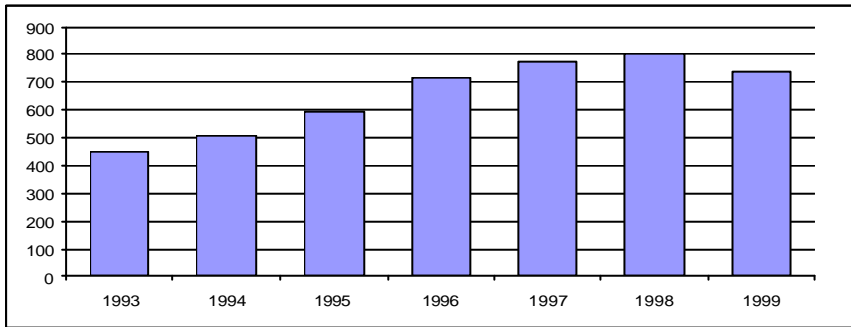


CHART 4. Own Capital of Banks, billions of SKK

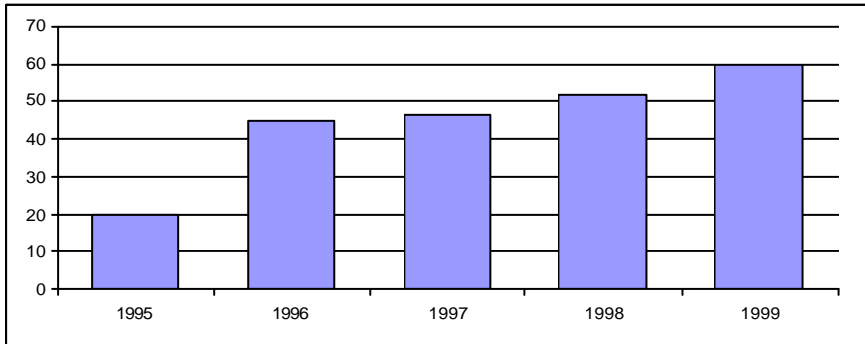


CHART 5. Classified Loans vs Cumulative Loans of the Banking Sector, billions of SKK and %

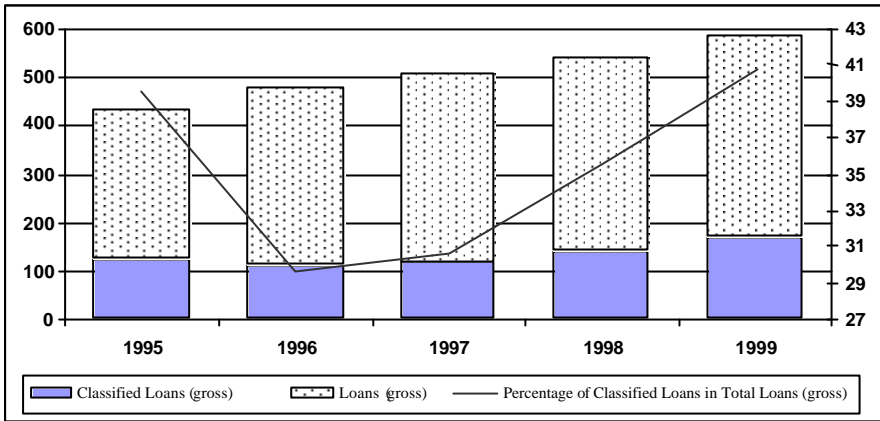


CHART 6. Average Interest Rates on Deposits and Loans, %

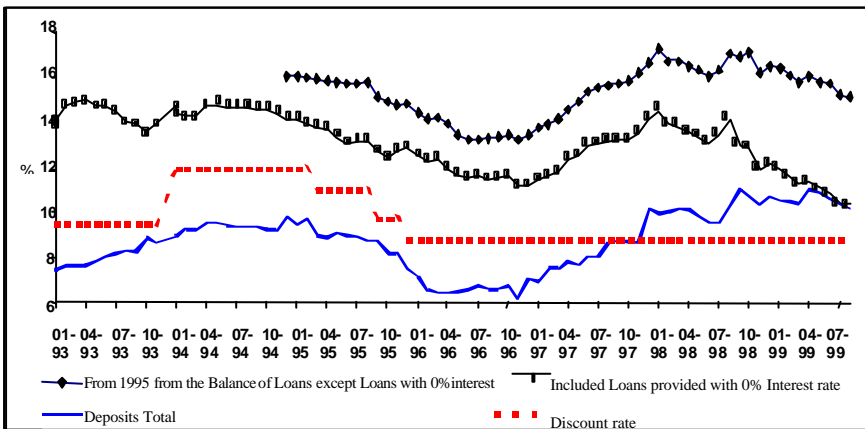
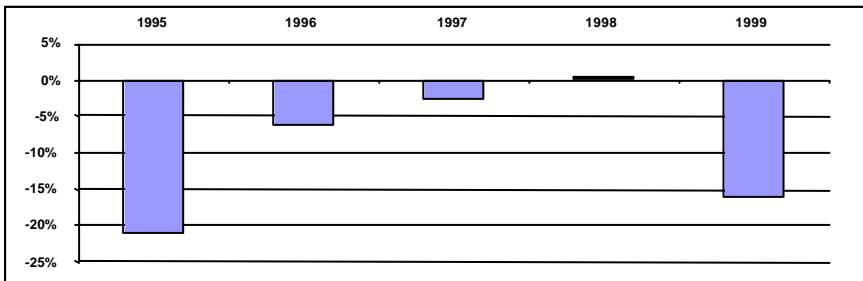


CHART 7. ROE



## 13.4 Characterization of the Situation in Banks

Heritage of the past and ownership relations in commercial banks gradually led to the formation of four groups of banks. The first comprises of large banks with a decisive influence of the state: Slovenská sporiteľna (SLSP), Všeobecná úverová banka (VÚB) and Investičná a rozvojová banka (IRB). The second group includes small and medium size banks in private hands, usually with prevailing foreign capital: Tatra banka, Ludová banka, ING Barings, Istrobanka, etc. The third group comprises of small and medium size banks with domestic capital; the fourth group includes two housing construction savings banks, which operate under modified business conditions. From 1993 to 1999, development in these individual groups significantly differed.

### 13.4.1 Large State Banks

In 1993, these banks controlled 88 percent of client deposits, and their total assets made up 66 percent of the total assets of the banking sector of Slovakia. However, at the end of 1999, only 52 percent of client deposits were in these banks, and their total assets were only 46 percent of aggregate total assets. These figures show that large state controlled banks were gradually losing their dominant position on the market. This development was natural to some extent, because up till 1990 deposits and loans were concentrated in two institutions. Nevertheless, large state banks could not benefit from this advantage, which had the potential to earn enormous profits due to their position, and these institutions got on a trajectory of steep reduction of their market share and profit.

This unfavorable development had several reasons. All three banks carried a burden of zero yield loans from the period before 1989; SLSP and IRB administered social loans and credits for cooperative housing construction; VÚB handled a certain portion of loans for the business sector. This heritage of the past in 1993 represented about 50 to 55 billion SKK in total (i.e., about a quarter of the whole loan portfolio). Apart from this burden of the past, at the beginning of their operations in 1991 and 1992 (the time of small-scale privatization), these banks did not have enough experience with lending in an environment of a transforming market and did not have methods in place to assess loan risks (the environment largely differed from the environment of developed economies and often new entities were involved without a history). Inherently, this was reflected in a massive increase of classified loans in the loan portfolio of these banks<sup>255</sup>. Legislation, above all the Bankruptcy and Settlement Act, however, did not give banks a chance to get rid of this burden quickly and effectively. Bankruptcy proceedings took far too long, and during this time owners

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<sup>255</sup> December 1995: 124 billion SKK and 75 percent share, December 1999: 169 billion SKK and 67 percent share.

had the possibility to plunder the property; the whole process in most instances ended with the liquidation of the company or declaring the debtor with no assets left. Creditors did not have a chance to quickly change the ownership situation in the indebted entities. Due to indecisive legislation that protected debtors, banks only collected fractions of the owed sums and all this at high cost. Banks were unable to get rid of these claims even in six or more years. Furthermore, this development contributed to a growth of interest rates.

The government was unable to secure the protection of the rights of creditors (for political reasons, because there have always been concerns and unwillingness to launch an effective process of bankruptcy and settlement); however, the state also failed from 1995 to 1998 as the owner of large banks and also as their regulator. Since 1994, it has been unable to guarantee that capital adequacy in the three banks, under its control, would achieve 8 percent although it had a declining tendency. This situation required capital strengthening of the banks in 1997, at the latest, when the consequences of the 1996 loan expansion fully surfaced (these three banks then provided loans of 30 billion SKK). Deterioration of the quality of assets also continued in 1998 and 1999. In 1998, the Ministry of Finance recognized that the operating profit of the banks was no longer sufficient to enable setting aside enough provisions. In the first half of 1999, all three banks already reported an operating loss, which meant that the volume of received interest and charges was no longer sufficient to pay for resources, services, and operations. At the same time, the quality of loan guarantees deteriorated, which led to a growth of uncovered losses and capital of the banks; therefore, they got into negative digits. The average weighted value of capital adequacy of these three banks at the end of 1999 was 6.6 percent. At the end of 1999, the government resolved to increase the capital in these banks and transferred a substantial portion of non-performing loans, which resulted in achieving the required capital adequacy of 8 percent in these banks at the end of 1999.

We believe that the banking supervision responsibilities of the NBS did not proceed actively enough in the case of these three state controlled banks and allowed the situation to deteriorate over a protracted period. In the case of IRB where a certain domestic interest group assumed control 1996 without prior approval of the NBS, the central bank only intervened when the situation in the bank significantly worsened, and the owners were unwilling to invest their own resources to increase the registered capital of the bank. IRB can serve as a condensed example of problems of a bank controlled by the state in Slovakia:

- the loan portfolio contained low yield assets dating from before 1989;
- the bank did not have enough primary resources and was therefore exposed to fluctuations on the financial market;
- the bank participated in the loan expansion in 1992 and 1996;
- the ownership structure became nontransparent;

- capital adequacy in 1996 was only 3.51 percent despite the implementation of the exemption of the NBS;
- the bank, since 1996, has been reporting a loss;
- banking supervision wanted to avoid implementing tougher measures against the shareholders of the bank.

### **13.4.2 Small and Medium-Size Banks with Foreign Ownership**

This segment began to develop in 1990 when Tatra banka renewed its operations. Other banks were founded from 1992 to 1994. Basically, all began doing their business "on a green meadow," which in this case meant also a certain advantage, because they did not have to carry a burden of the past. The lack of experience on the part of employees could be overcome relatively quickly thanks to provided foreign methodologies and technology. It can be stated that these banks had a prudential approach to all active transactions from the very beginning. Most of them became active on the primary deposits market. From 1996 to 1998, deposits in these banks doubled and now represent about 25 percent of all deposits. All banks regularly met the capital adequacy requirement; in the first half of 1999, the average weighted value of this indicator for this group of banks in the first half of 1999 was 15.6 percent. Similarly, these banks reported high profits; in 1998, they earned a profit after taxes of 3.5 billion SKK. Their return on assets was 1.6 percent, and the return on capital was 22 percent. It is clear that this enormous profit stemmed from deformation of the banking sector in Slovakia, when ailing state controlled banks prevailed on the market. The process of restructuring and privatization of state controlled banks will bring about a correction in the banking sector, and at the same time slimmer profit margins for the second group of banks. After privatization of large state controlled banks, this group will face growing competitive pressure from the privatized banks, which would further press down the profit margin.

### **13.4.3 Small and Medium Size Banks with Domestic Owners**

Private banks with domestic capital were established from 1991 to 1995, whereby the founders were industrial companies, banks, trade unions, as well as private persons. One method of their establishment was to take over the branch offices of Czech banks that lost their banking license. Although this group of six banks was not burdened by non-yielding assets from the past, their development, as in the case of large state controlled banks, was influenced by such unfavorable factors as:

- missing experience with lending for entrepreneurial activities under conditions of a market economy;
- a missing system of risk management;
- political pressure, including political motives for establishing a bank;
- legislation protecting debtors;



- banking supervision that is not effective enough.

In addition, these banks did not have wide client backing; their capital strength was rather insufficient, and they had to invest large sums of money into their infrastructure. The effectiveness of their investments was often highly questionable. The economic performance of individual banks differed (the group is quite heterogeneous), but on aggregate the group in 1998 reported a loss of at least 150 million SKK and in 1997 a symbolic profit of 30 million SKK. Two banks got into insurmountable problems at the end of 1999, which in one instance led to a withdrawal of the bank's license and in the other to a takeover of the bank by another bank. The development in these banks will lead to more frequent cessation of the independent existence of these banks, either by merging with another bank or by liquidation. The independent existence of some of these banks would be possible in case of specialization at a certain segment of the market. However, Slovakia's small market, high operating costs, and the need for extensive investments into technology will press towards the abolition of these institutions.

#### **13.4.4 Housing Construction Savings Banks**

Two housing construction savings banks were established in Slovakia in 1992 and 1993, founded jointly by German and Austrian housing construction savings banks with the largest Slovak banks SLSP and VÚB. These housing construction savings banks benefited from favorable conditions for doing their business:

- an annual state premium to interest of 6 000 SKK;
- required minimum reserves of 3 percent (8 percent for other banks);
- the institute of solidarity depositors (though abolished from 1997 to 1998);
- the only form of a housing construction loan under acceptable price terms;
- low interest paid on deposits and high interest yield from government bonds on the interbank market.

Due to these conditions, total assets of the housing construction savings banks more than tripled from 1996 to 1998; in 1998, these banks reported a profit after taxation of 783 million SKK. Return on assets was 1.8 percent and return on capital 12.9 percent. Operating profit was over 3.5 billion SKK. However, the housing construction savings banks had to put aside a substantial portion of this sum as a reserve because at the end of a six-year savings cycle it is necessary to repay the deposits of solidarity depositors and with the growth of provided loans the number of doubtful claims is also growing. From 1996 to 1999, the volume of loans provided by these two banks increased from 60 million SKK to about 20 billion SKK; in 1999, we estimate that standard loans with a reservation and classified loans constitute about 1.5 percent of total loans, although about 0.4 percent were classified loans. This figure will presumably grow, but it cannot be assumed that it would overstep the average share of classified loans to the population -- about 12 percent. We estimate the created

reserves at 7 to 8 billion SKK, which, together with guaranty in the form of real estate should fully cover presumed losses. However, it can be expected that the profits of the housing construction savings banks would gradually decrease similarly as their market share, where we expect the volume of mortgage financing of housing construction to grow swiftly thanks to the state compensation to changed interest and the possibility to get an immediate loan -- without the need for saving.

### 13.5 A Comparison with other Countries of the Visegrad Group

In 1989, the situation in the banking sector was similar in all V4 countries. Several state controlled institutions dominated the financial markets and benefited from their monopolistic positions. After the fall of the Iron Curtain, new players got on to the market and the banking sectors began to develop dynamically. Therefore, domestic banks suffered under these circumstances, primarily from the low quality of management and insufficient risk management (i.e., reflected in the growing volume of classified loans and the decreasing market share coupled with lower profitability). The complicated financial situation of the business sector and growing competition from foreign banks have weakened the position of domestic bank entities. Pressure developed for a more consequent banking supervision, and the process of restructuring and privatization of state controlled banks began. However, the pace of transformation differed. While Hungary and Poland had already initiated the process of restructuring at the beginning of the nineties, the Czech Republic and the Slovak Republic began with the privatization of state controlled financial institutions only recently, but the banking sectors of both countries were much more developed than in Poland and Hungary. A comparison of the banking sectors of the V4 countries is in Table 1 and in Charts 8-10.

TABLE 1 Comparison of the Banking Sectors of V4 countries, %

	Czech Republic	Hungary	Poland	Slovakia
Degree of Concentration of the Banking Sector	62	40	41	50
Share of Total Assets from GDP	137	77	56	112
Share of Classified Loans from Total Loans	29	4	10	33
Share of the State on Total Assets of the Banking sector	84	37	52	74

\*Concentration is calculated as the share of three largest banks on the total assets of the entire banking sector.

The Czech Republic<sup>256</sup> had five large banks as of January 1, 1990. However, small banks with domestic owners sprang up quickly, but they often had insufficient capital strength and they had liquidity problems. From 1989, the CNB issued 63 bank licenses. Licenses were withdrawn from fourteen banks because of their bad financial situation and failure to observe the rules of prudential banking. Licenses of three banks were terminated by a merger with parent companies abroad (HypoVereinsbank, Bank Austria and Creditanstalt). At the end of 1998, thirteen foreign banks operated on the Czech market and ten branch offices of foreign banks, and their share of activities of the entire banking sector was 16 percent. Their importance continues to grow constantly not only in view of their share of total assets (25 percent), but also in view of their influence on other banks, which are forced to improve the quality of their services to clients, improve their products, reduce costs, etc. In 1998, the number of banks dropped to forty-five, which along with the growing volume of total assets meant greater concentration in the banking sector. In 1994, an average bank had total assets of 27.7 billion CZK; by 1998, this figure almost doubled. The quartet of large banks -- CSOB, Česká spořitelna (CS), Komerční banka (KB), and IPB represents 75 percent of the cumulative total assets of the Czech market. In the period from 1990 to 1999, the volume of deposits more than doubled, which was linked to the development of wages, to proceeds from restitutions and coupon privatization, and to higher levels of inflation. The issuing of loans reached its peak in 1993. Stricter regulatory measures for loan guarantees by real estate, liquidity problems of the business sector, and growth of classified claims decelerated the pace of providing new loans. The process of privatization of state banks began only in 1999 with the sale of CSOB to Belgian KBC. The privatization of CS and KB is negotiation phase.

Poland<sup>257</sup> began its bank reform after adopting an amendment to the Bank Act and the National Bank of Poland (NBP) Act in 1989, which regulate the banking environment. The ambition of the Ministry of Finance and the NBP was to demonopolize the banking sector before the privatization of the largest state controlled banks. In 1988, six large banks operated in Poland, and in 1990 their number increased to 75. After recapitalization of a majority of commercial banks, the Ministry of Finance decided to launch a process of privatization of state controlled banks. According to the original plan, two banks were to be privatized every year, but this target could not always be met because of difficulties with finding a suitable investor and in part also due to political reasons. Nationally oriented parties had reservations towards a rapid sale of banks to foreign investors. As in other central European countries, the banking sector in Poland is characterized by its concentration. The ten largest banks have over 67 percent of net assets and generate 75 percent of gross profit. Classified loans represent roughly 10 percent of loans of the entire banking

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<sup>256</sup> Czesany (1999), Machala (1999), CNB (1999) and Chuchvalcová and Vinter (1999).

<sup>257</sup> National Bank of Poland (1999), Harper and Styczek (1998), and Wojtowicz (1998).

sector. Strong competition is originating because Poland began a reform of its pension insurance system in 1999; it introduced mandatory individual savings through commercial pension funds. The capital market in Poland is developing and market capitalization at the end of 1999 was about 17 percent of the GDP.

CHART 8. The Number of Foreign and Domestic Banks in V4 countries

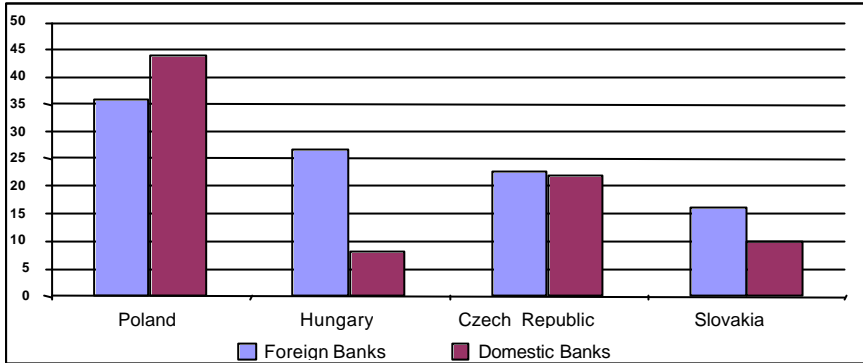


CHART 9. Share of Foreign Banks on Total Assets of the Banking Sector, %

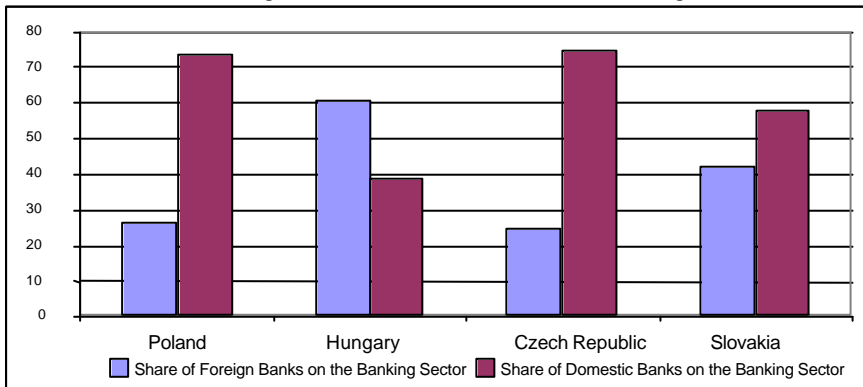
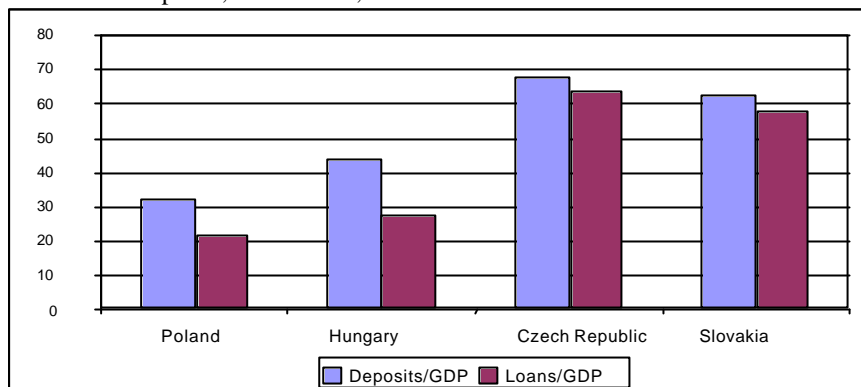


CHART 10. Deposits, Loans/GDP, %



The banking sector in Hungary<sup>258</sup> developed very dynamically, and from the beginning it oriented itself towards foreign investments. In several waves, from 1992 to 1994, the recapitalization of banks took place whereby the state injected over 360 billion HUF into the banking sector. Capital adequacy of large banks exceeded 14 percent, and it remains at this level up to now. The state radically lowered its share in the banking sector; in 1996, it dropped below 33 percent. The share of residents decreased at a similarly dramatic rate while the engagement of foreign entities moved in the opposite direction to their current control of over 50 percent. The volume of classified loans is in the range of 4 percent; from this perspective, the banking sector in Hungary is among the best of the V4 countries. Return on capital in the first half of 1999 dropped to 4.9 percent as a result of higher expenses associated with inflationary growth and investments into branch offices and information technologies. Return on assets dropped from 1 percent to 0.5 percent compared with the preceding year. Small banks have the greatest problems in Hungary. Competition in Hungary is tough; at the end of 1999, market capitalization was approximately 30 percent of the GDP.

### 13.6 Causes of the Specific Development in Slovakia and Lessons to the Drawn

Development of the banking sector in Slovakia, especially the years between 1995 and 1998, was strongly conditioned and is still conditioned by the overall situation in the economy. The following factors play a significant role in this situation:

- prevailing state ownership in the banking sector;
- lesser openness of the banking sector;
- high government consumption;

<sup>258</sup> Hungarian National Bank (1996, 1997, and 1999).

- the degree of redistribution;
- low quality of institutional operations;
- virtually nonfunctional capital market;
- rising corruption;
- weak level of protection of ownership and creditor rights;
- weak law enforcement;
- a relatively extensive state sector.

These factors are reflected in the unwillingness of the state, as the owner of several banks, to either address the problem of loss-making assets by restructuring the banks or from the legal perspective by improving the position of creditors. They are also reflected in the limited possibilities of the NBS's role in banking supervision to effectively and resolutely take action in instances when rules of prudential banking were violated or with regard to provisions of the Act on Banks or with NBS measures.

Unlike Poland and Hungary, where a rapid restructuring of the banking sector was undertaken and its gradual privatization, and where the capital market effectively functioned, in Slovakia the role of the financial sector has been underestimated. In addition, the state's role in the economy was understood incorrectly; instead of a regulatory and supervisory function, the state actively engaged in the economy whereby it misused its specific position. In this aspect the situation in Slovakia was similar to that in the Czech Republic, where in the first years of economic reform the regulatory and supervisory function of the state has been underestimated, which eventually led to the withdrawal of fourteen bank licenses because of their bad financial situation and violations of rules of prudential banking. Although the state took part in gradual increases of registered capital in Czech banks it controlled and non-performing assets were gradually transferred from these banks to Konsolidacná banka, the share of classified loans in Czech banks remains high. This demonstrates that if restructuring of a state controlled bank is not followed by a change of ownership, moral hazard is increasing as well as the probability of an irresponsible lending policy.

The development of the banking sector in Slovakia (but also in other countries of the V4) provides evidence of many disadvantages of state ownership. On the other hand, it shows the important role of the state in securing the effective work of regulatory institutions, clear and enforceable laws, as well as the protection of ownership rights for effective functioning of the banking sector.

An inevitable condition for the functioning of the banking sector is a healthy business sector. Banks have an irreplaceable role here in the imposition of tough budgetary limitations for businesses. These can only be implemented when legislation enables banks to effectively use their rights of creditor and a quick and inexpensive termination of undertaking for unsuccessful companies.

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## 14 Economic Policy Recommendations

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The chapters in this book have focused on a variety of topics such as the protection of economic competition and the situation in the labor market. In addition to analyzing developments in the given area, all the chapters attempt to review the key economic policy decisions that helped shape these developments. Economic policies in various areas have all shared certain characteristics and problems. These common features, spread throughout a decade of rapid change, often can serve as a useful lesson for the future. The upcoming decade can be expected to bring about further many changes in the economic arena. The final chapter provides a brief overview of the main features identified and the recommendations advocated.

1. *Significant preference for short-term goals over long-term goals.* Most economic policy decisions in the nineties shared an emphasis on short-term benefits and had minimal interest in areas that would bring short-term costs and long-term benefits. In Slovakia, this problem took on an even greater significance than in other comparable transition economies due to the frequent discontinuation of reforms designed to produce short-term costs.

2. *Preference for short-term economic growth over solving institutional problems and restructuring.* Economic growth is a key economic policy goal. However, in Slovakia, short-term, unsustainable growth reached by fiscal and monetary stimulation is not sufficiently differentiated from long-term sustainable economic growth driven primarily by forces on the supply side. The solution of serious institutional problems (both in formal and informal institutions) and the problem of restructuring the economy, inherited from the socialist era, are and have been the prerequisites for long-term economic growth. The debate on economic policy and its implementation in Slovakia still contains an implicit notion that it is possible to "grow out" of problems. This notion gives preference to stimulating growth over resolving painful structural and institutional problems. Two possible motives may explain this attitude. The first is the above-mentioned preference for short-term goals and achievements that is driven mainly by political incentives. The second possible explanation is a faith that rapid growth will allow for less painful solutions to these problems. It is becoming clear that efforts to put emphasis on growth have failed. Despite rapid growth, institutional and structural problems have led, for example, to a crisis in the banking and enterprise sectors



(see chapter on bank and enterprise restructuring) and high unemployment (see chapter on the labor market).

3. *Insufficient institutional capacity of the state and the public sector.* The ability of the state to effectively resolve the society's problems is neither a given, nor unalterable ability. It depends on specific historical and economic circumstances, particularly on the power of the state, formal and informal institutions and the quality of the state administration. Every state has its evolving institutional capacity. If the capacity is low, it is appropriate to first focus on the basic functions of the state and gradually increase the scope of its interventions with growing institutional capacity (see World Bank, 1997, especially pp. 3 and 4).

Almost all post-communist states, including Slovakia, were (and to a degree still are) plagued by the following problems: (i) the presence and interference of the state in areas where it simply should not be present regardless of its institutional capacity (particularly the state as an entrepreneur); (ii) the presence and activity of the state in areas that may be subject to state intervention but can be effectively dealt with in a different way, or in areas where the absence of the state carries no significant negative consequences. Given the insufficient institutional capacity, the state should at least temporarily withdraw from these areas and focus on its key tasks; otherwise there is a threat of (and usually also the presence of) insufficient institutional capacity for the really key activities of the state. These activities include, for example, law enforcement, provision of a basic regulatory framework, good macroeconomic policy, provision of public goods or formation of a stable, good enterprise environment. The insufficient institutional capacity of the state is related to further issues.

4. *Insufficient ability of the executive to adjust to a rapidly changing environment.* Slovakia, like other transition economies, has undergone major changes in the nineties. It has become an independent country, decentralized to a degree. It has moved from a one-party dictatorship to a democracy based on the division of powers between various political and economic actors and has transitioned from a centralized economy to a market economy. The central state administration and political parties formulating economic policies have often failed to keep pace with these changes. They have proposed and promoted measures that did not conform with the new environment and therefore these measures either failed or were not implemented at all. The law on revitalization can serve as an example (see chapter on restructuring and corporate governance and chapter on industrial policy).

5. *Independence as a key to success of some institutions. Independence without a clearly defined status, tasks and responsibility as a problem for other institutions.* There exist certain formal institutions that demonstrate possible solutions for several of these problems. The National Bank of Slovakia, despite a

number of critical reservations, can be viewed as one of the best functioning public institutions in the country and monetary policy conduct can be evaluated favorably. In this case, the bank's independence is the key to its success. This independence means not only independence from political influences, but also assures personal stability and the opportunity to form a unified institutional culture (with independence in personnel policies including remuneration as one of its prerequisites; see chapter on monetary policy). The Slovak Anti-monopoly Office serves as a good counter-example. Despite its nominally independent status, it has failed to reach equally good results from its work, particularly due to its dependence on the government – from political interference in its activities and changes in top posts to restrictions in the personnel area (see chapter on economic competition). Independence certainly is no universal antidote and its use has to be tied to specific situations that make sense. Moreover, independence without a certain formal or informal "contract" – a clearly defined task, status and responsibility – may lead to inefficiency, corruption or irresponsibility. For instance, the implementation of active labor market policies by the National Labor Bureau was directed by the tripartite system (with representatives of the state, labor unions and employers represented in its leadership) and led to these phenomena (see chapter on the labor market).

6. *Preference for direct state control over a good regulatory framework.* Independence is related to preference for direct state control as a regulatory instrument. This approach is in a certain way logical in the short-term during the transition period – if the state has insufficient institutional capacity in the area of regulation and politicians are highly risk-averse against potential political consequences of poor regulation. But the term short-term is the key factor. Long-term costs of direct state control are very high, such as inefficiency and rent seeking, abuse of regulated prices in the political process, abuse of natural monopolies to finance political parties and corruption. It is no coincidence that despite declining labor productivity, wages in the industrial sector of water, electricity and gas distribution grew at a rapid pace (see chapters on fiscal policy, industrial policy, restructuring and corporate governance).

7. *High public expenditure and insufficient will to reduce it along with the destabilizing role of fiscal policy.* Slovakia, along with other transition countries, has a very high share of public expenditure on GDP (particularly given the degree of economic development). In other words, the level of redistribution and taxation is one of the highest in the world given per capita income (see IMF, 1998). After an initial decrease in the early nineties, the level of redistribution had a stagnating and at times even rising tendency. A high level of economic redistribution significantly impedes economic growth. This is a serious problem for the Slovak economy, which counts among economic with the so-called medium per capita

income and requires high economic growth to reach EU countries' levels. Furthermore, fiscal policy has often had a destabilizing effect mainly due to a high overall and structural deficit in the years 1996-1999. This directly contributed to a high foreign trade deficit and subsequent economic problems. Insufficient state control over a large part of the fiscal sector outside of the state budget is a related problem (see chapters on fiscal and monetary policy).

8. *Insufficient implementation of a hard budget constraint.* Since January 1, 1991, there have been efforts at instituting a hard budget constraint for enterprises (when a company has to rely on itself and in case of insolvency, instead of receiving further financing, it becomes subject to sanctions in the form of ownership change or bankruptcy). In spite of this, the budget constraint has in practice been softened significantly by two factors – insufficient enforcement of the bankruptcy law and provision of loans particularly by state-controlled banks regardless of the likelihood of repayment. Enterprises survive not only thanks to voluntary loans from bank, but also using involuntary "loans" from the state (not meeting required taxes and payments), suppliers and employees (not paying for supplies or wages). These groups often failed to get paid or received late payments that they were entitled to contractually or by law. This led to inter-company indebtedness, high claims of the state towards the corporate sectors and a high share of classified loans. The corporate sector did not undergo a cleansing process and enterprise exit for unsuccessful enterprises (see chapters on privatization, restructuring and corporate governance, banking and fiscal policy.)

9. *Privatization which did not lead to significant improvement in corporate governance.* Privatization in Slovakia suffered from two basic problems: (i) insufficient transparency and poor selection of owners and (ii) disregard for an institutional and regulatory framework that would motivate the new owners to seek more effective functioning of the enterprises instead of rent-seeking.

Until now, the attention has focused mainly on the problems in the course of the privatization itself. The voucher scheme did not lead to clear ownership and direct sales. These actions were characteristic of the 1995-98 period and were often carried out under questionable circumstances that favored intransparent and incapable new owners. The "post-privatization" economic policy should also be discussed, because it contributed to privatization failures, fraud and insufficient enterprise restructuring. It failed to secure a functional judiciary and commercial law and put insufficient emphasis on the capital markets' institutional framework (see chapter on privatization).

10. *Political control of banks and inadequate bank supervision.* The consequences of the aforementioned problem of preference for direct state control over a good regulatory framework may be illustrated using the example of banks. Due to the specific nature of banking (almost exclusive use of others' resources)

and insufficient experience with banking, the consequences of this approach were far worse and their elimination far more costly than in other sectors. The state provided credit for many industrial enterprises that would not have secured credit otherwise (and for good reasons) mainly through the three largest banks. The state thus slowed down restructuring and distorted resource allocation. The cost of restructuring these banks will exceed 100 billion Slovak crowns. At the same time, the building of institutional capacity for banking supervision was neglected and banking supervision intervened only *ex post*, when it was too late to prevent problems. Due to the development of a fairly sizable private sector, this meant that banking losses cumulated not only in state banks, but also in poorly regulated private banks (see chapter on banking).

*11. Preservation of the inherited industrial structure even with changing export markets.* Slovakia's inheritance from the socialist period was an industrial structure characterized by a high share of heavy and less sophisticated industry and heavy machinery production (with a high share of arms production). The industry was highly energy- and capital-intensive. Two significant changes took place during the nineties: (i) the industry was reoriented from the former Comecon export markets to European Union markets (while preserving the central European market) and (ii) the machinery industry segment was focused mainly on arms production. It failed to restructure and shift to non-arms production and gradually disappeared to a large degree.

But with these two exceptions, the inherited industrial structure was largely preserved despite the fact that its high energy- and capital-intensity contradicts Slovakia's comparative advantage and its low sophistication raises the cyclical sensitivity of the Slovak economy and limits the room for economic growth. Economic policy contributed to these developments by preserving the distortions from the socialist era (distorted input prices, state investment in the energy sector) and by the privatization mechanisms and by fiscal policy in the years 1996 – 1998. The overall political climate and manner of privatization also led to an absence of foreign investment, one of the key restructuring tools in the transition period (see chapters on industrial policy, privatization and foreign trade).

*12. Unemployment, which does not provide sufficient supply of workers or pressure for greater labor market flexibility.* At the onset of transition, unemployment in Slovakia evolved similarly to other central European countries (with the exception of the Czech Republic). Then, within a year, it jumped to over 10 % and remained at this level throughout the duration of the transitional recession (1991-93). Developments began to differ from 1994, when Slovakia recorded high economic growth. Poland, with a similar level of economic growth, significantly reduced unemployment and Hungary, even with much slower economic growth, successfully reduced unemployment into the single digits.

Slovak unemployment, aside from a minor decline in 1995 and 1996, stagnated and then began to rise in 1997. This development did not lead to a substantial revision in active and passive labor market policies or to a rise in flexibility and regional mobility in the labor market. Active employment policy focused on keeping afloat non-performing enterprises on the basis of highly intransparent criteria and with highly ineffective results (see chapter on labor market).

On the basis of this analysis, we provide recommendations for future economic policy implementation in Slovakia. The state should focus on building up its institutional capacity and restructuring its position within the society and the economy. We have mentioned several tasks that no other entity can manage and are key for economic success. The post-communist state should focus on having the ability to effectively intervene in these priority areas. This assumes the necessity of restructuring of formal institutions and instituting change informal institutions. Both can be achieved not only through personnel reform (entry of new people into state administration and education of current employees), and through an overall modernization of the state apparatus. The state should withdraw from activities that do not have high priority, since they demand scarce personnel and financial resources. Without the implementation of the fundamental priorities, the state will fail to achieve the same results as similar activities in stabilized and developed economies. The state should fully restructure its direct interventions in the economy from the position of an entrepreneur to a regulatory position (in the areas where this shift has not yet taken place). This fundamental shift involves recommendations in the following areas:

1. *Fiscal sector restructuring and stabilization.* This sector involves two aspects. The first is institutional capacity - at present, the finance ministry as the main "treasurer" of the state lacks direct influence and responsibility for the fiscal sector as a whole and there is no institutional capacity to forecast, implement and supervises overall fiscal policy. Along with building such a capacity, there has to be the political power to implement stricter supervision over the use of public funds and reforms. This would raise the efficiency of their use.

2. *Reform of the tax system and the system of mandatory insurance leading to fiscal stabilization and lower redistribution.* The preceding point is tied with a number of necessary tax reforms that should stabilize the fiscal sector. It should also shift the focus of taxation from direct to indirect taxes, and provide an overall modernization of the tax system. But reforms of the remainder of the fiscal sector, including particularly pension, health and disability insurance, as well as unemployment insurance, are even more key at this time. This sector shares two characteristics - a significant propensity to run deficits and (in most cases) insufficient efficiency. Although there are no painless solutions, reforms should be guided by two basic criteria: (i) shifting a greater share of responsibility and rights

to the individual, together with protection of the most vulnerable groups and (ii) by increasing public supervision and transparency of these systems.

3. *Restructuring of the status of several public institutions.* In particular, this should involve: (i) strengthening the independence of the Anti-monopoly Office and other existing regulators; (ii) creating of a new system of regulatory bodies and (iii) increasing supervision and responsibility of public institutions that manage large amounts of public funds (e.g., the Social Insurance Agency, General Health Insurance Agency and the national Labor Bureau).

4. *Completing the privatization in the banking sector and the consolidation of the private banking sector* (by instituting a "hard" budget constraint for banks – strict enforcement of capital adequacy and prudence rules) *and strengthening of banking supervision* (in accordance with the plans to separate it from the NBS).

5. *Preserving NBS independence and creating a medium-term monetary program and inflation targets.* Given the proven favorable results of central bank independence, attempts to reduce its independence must be opposed. It is also necessary to further strengthen the quality, openness and transparency of monetary policy. With regard to inflation targeting and the shift to qualitative monetary policy management, it can be recommended that the one-year inflation target be extended to the medium-term horizon. These targets should be set within an overall medium-term monetary scenario aimed at Slovakia's integration into the EU and the European Monetary Union.

6. *Focus on creating a suitable enterprise environment and conditions for good corporate governance. Completion of legislative environment changes towards better law enforcement and hard budget constraint functioning.* One of the tasks that the state should give up completely is the role of an entrepreneur. Instead, the state should focus its institutional, personnel and financial resources toward creating a suitable business environment (i.e., an environment where it pays to enterprise and not focus on rent-seeking). This business environment would also include prerequisites for good corporate governance as a condition for investment inflows.

7. *Privatization of the energy sector and of other state-owned enterprises providing public services which do not constitute natural monopolies.* High investment requirements are needed for the restructuring of these enterprises. If they are to be able to provide high-quality, cheap products and offer the high benefits of competition for the economy as a whole, their reasonable privatization is advisable.

8. *Introduction of competition into some currently monopolized sectors as fast as possible.* Many sectors that had long been considered natural monopolies are not natural monopolies – for instance, electricity generation or telecommunications services. The introduction of competition will have favorable

effects in terms of creating pressure to reduce costs of the existing monopoly producers, and will also provide significant positive externalities for the overall modernization of the Slovak economy.

9. *Completion of price regulation reform and creation of independent regulatory bodies for the areas where the existing providers have real monopoly status.* Benefits from competition and deregulation (where one player is in a dominant position) can only be realized in an environment with adequate market regulation. The belief that the introduction of a market economy and competition will suffice even without changes to the institutional and regulatory framework was one of the mistakes of the first stage of the transition period. Without adequate regulation, markets with insufficient competition offer monopolies a chance for significant rents from their position.

10. *Maintaining high openness of the Slovak economy allowing specialization.* The turnover of Slovakia's foreign trade consistently exceeds 120 % of GDP. This places the country among the most open economies in the world. This openness allows the Slovak economy to specialize in tradable goods, which leads to higher labor productivity and economic growth. Therefore, all protectionist pressures, with the exception of protection from unfair competition, must be resisted. But even in preventing unfair competition, one must carefully review whether it really involves unfair trading practices and whether these practices really threaten the development of the Slovak economy. A key task of economic policy is to work on opening up the neighboring markets further.

11. *Attracting foreign investment primarily by a high-quality economic environment, less so or not at all by discriminatory and intransparent conditions.* Foreign direct investment in a transition environment carries a number of positive externalities, particularly in the areas of know-how transfer and corporate governance. A possible multiplier effect for lagging regional economies also needs to be considered. Governments of several transition economies offer large foreign investors especially favorable conditions. The usefulness of this practice is questionable for three reasons. First, several surveys among investors have shown that special preferential treatment is merely one of the factors, and often not the key one, investment decisions. The quality of the economic environment (accessibility of export markets, tax system, quality and price of labor, quality of commercial law and state administration, etc.) is far more important. Second, beyond a certain level of incentives, it is questionable whether the costs outweigh the benefits of these programs, especially if the funds could be used for alternative programs. This is true mainly in conjunction with the third question – intransparent and individual benefits create room for corruption and inefficient decision-making.

12. *Labor market policy reform.* The Slovak labor market needs reform in three basic respects. First, active employment policy based on intransparent and

inefficient selective provision of benefits to some employers should be transformed into a system of clearly defined benefits. These benefits should provide automatic entitlement to those who employ the long-term unemployed or other particularly vulnerable groups. Besides, a passive employment and social system policy reform should be considered, as these often provide disincentives for job seekers who command only relatively low-wage employment in the labor market. Third, job seekers with little or no education and new graduates are the dominant group among the unemployed. These facts suggest not only a need for education as such, but a need for education that provides students with skills that will enable them to gain employment or start a business. The educational system and its reform thus constitute a key factor in resolving the problem of unemployment.

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