III. Rationalising public spending

This chapter first reviews the recent trends in public spending and the budget procedures which underpinned their unsustainable pattern. It then analyses the extensive set of reforms now being introduced and discusses requirements for improving their chances of success within a short time span as presently planned, in the light of other OECD countries' experiences. It finally reviews the challenges in moving forward with reform and provides a detailed set of recommendations for specific actions to improve both the framework of fiscal policy and the operation of the public sector (Box 10).

An unsustainable spending path in the post-transition decade

The spending growth was driven by social transfers and public employment

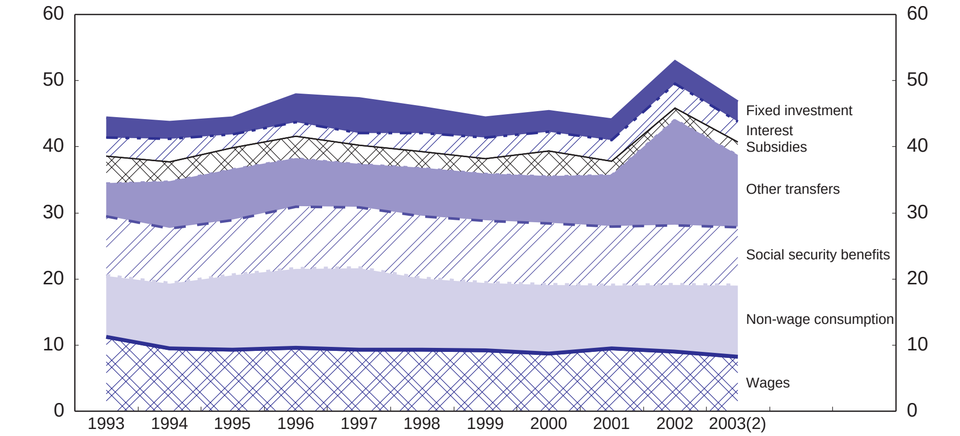
Public expenditure during the first decade of transition followed a pattern reminiscent of all OECD post-transition economies. It was characterised by the massive weight of social transfers and of the government wage bill. The public sector wage bill has remained significant in spite of subdued wages because of the very high level of government employment. Health care costs, recorded in the form of both social transfers and government wages, also remained large due to the generous terms of social insurance.[15] Sizeable subsidies were provided to enterprises to compensate for the losses arising from regulated prices that do not reflect costs (Figures 13 and 14). Total spending has attained a level well above the size of expenditure common in lower income OECD countries and this gap appears more pronounced because of the lower per capita income of Slovakia (Figure 15).

The composition of general government expenditure – including extra-budgetary funds which played an important role until 2001 and the rather less significant municipal spending – presents certain peculiarities when compared to other post-transition countries:

– The share of social transfers in GDP is slightly lower (13 per cent in 2001 against a Central and Eastern European Countries' average of more than 14 per cent[16]), though this is likely a temporary phenomenon due to favourable demographic factors which keep the pension claims relatively

Figure 13. Economic classification of public expenditure[1]

A. Slovakia



B. International comparison, 2002[3]

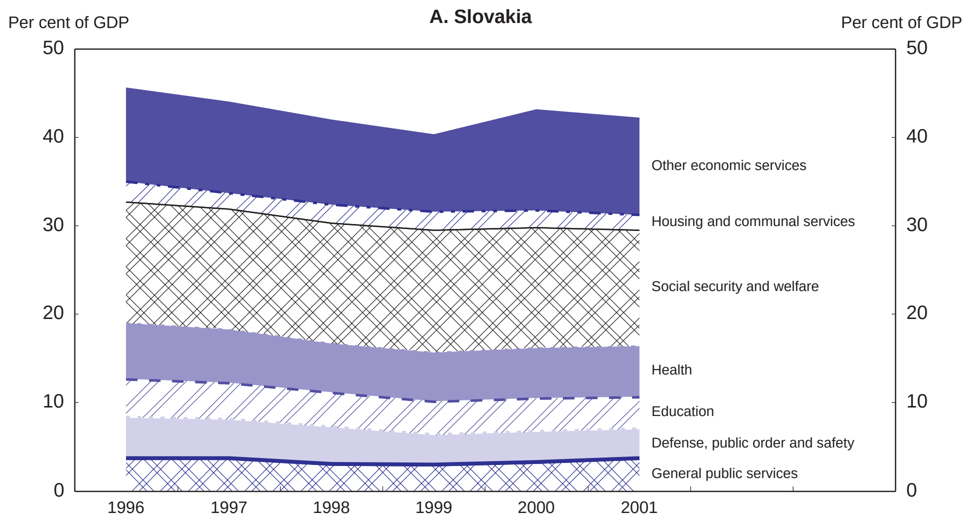
Per cent of GDP

	Income transfers	Subsidies	Interest payments	Government consumption: Total	Government consumption: Wages	Gross fixed investment	Other net transfers	Total outlays
Austria	18.8	2.8	3.6	19.0	9.8	1.3	6.5	51.9
Czech Republic	13.2	3.0	1.4	20.7	8.2	4.6	6.9	49.9
Denmark	17.5	2.2	3.7	26.3	17.6	1.8	4.2	55.5
France	18.1	1.3	3.1	23.8	13.7	3.0	4.1	53.4
Germany	19.4	1.5	3.1	19.2	7.9	1.6	3.8	48.5
Greece	16.4	0.2	5.5	15.5	12.1	3.8	4.9	46.3
Hungary	16.0	3.4	4.1	18.6	11.9	5.6	3.9	51.6
Ireland	8.3	0.8	1.4	15.1	8.3	4.4	3.5	33.5
Italy	17.1	1.0	5.8	18.8	10.7	1.8	3.1	47.7
Japan	10.6	0.7	3.2	17.9	6.9	4.7	1.4	38.7
Korea	4.2	0.4	0.6	10.4	7.6	6.0	3.9	26.0
Poland	17.6	0.9	4.2	14.9	10.7	3.3	0.6	41.6
Portugal	12.9	1.5	3.0	21.1	15.4	3.4	4.1	46.1
Spain	12.3	1.2	2.8	17.8	10.3	3.4	2.3	39.7
Slovakia[4]	**8.9**	**1.9**	**3.1**	**19.0**	**8.3**	**3.2**	**10.9**	**46.9**
Sweden	17.9	1.6	3.2	28.0	16.3	3.2	4.4	58.4
United Kingdom	13.6	0.4	2.0	20.0	7.4	1.3	3.5	40.8
United States	12.1	0.3	3.0	15.5	9.6	3.4	1.2	35.5
Euro area[5]	16.7	1.3	3.7	20.2	10.7	2.4	3.9	47.9
OECD[5]	12.5	0.8	3.0	17.3	9.3	3.2	3.1	39.0

1. Data is based on Government Financial Statistics (GFS) but it is not fully consolidated, possibly creating a particularly large distortion in 2002.
2. Estimate by the Ministry of Finance.
3. National accounts based except for Slovakia.
4. GFS-based 2003 estimates by the Ministry of Finance have been used for international comparisons, to diminish the impact of the distortion in data for 2002.
5. Weighted average.

Source: Ministry of Finance, OECD, IMF and World Bank.

Figure 14. **Functional classification of public expenditure**

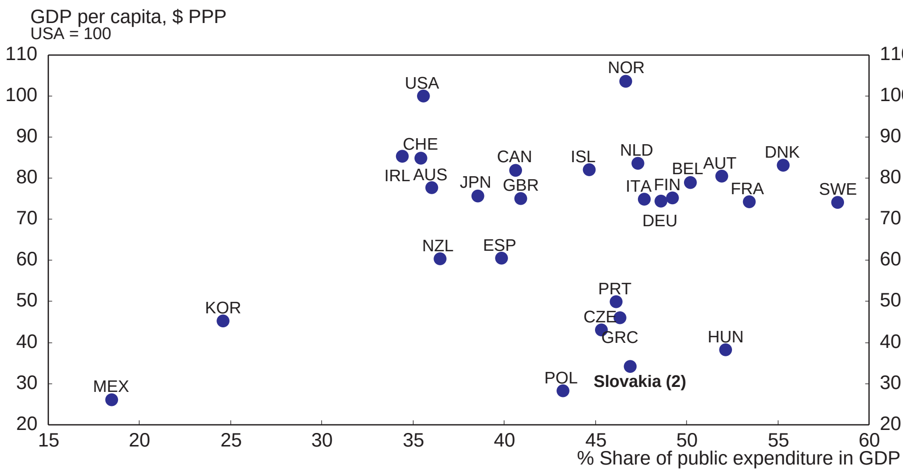


B. International comparison, 2001[1]
As per cent of GDP

	General public services	Education	Housing and community amenity	Health	Pensions and welfare	Economic services and subsidies	Defense, public order and safety	Total
Slovakia[2]	3.7	3.7	1.7	5.7	13.1	10.9	3.3	42.1
France	6.5	6.0	1.0	7.9	20.4	7.3	3.4	52.6
Germany	6.3	4.2	1.1	6.3	21.8	5.7	2.8	48.2
Austria	8.6	5.8	1.0	5.8	21.9	6.9	2.3	52.3
Denmark	4.5	8.3	0.9	5.4	24.2	5.3	2.6	51.3
Italy	9.5	5.1	0.9	6.3	17.7	5.8	3.1	48.3
Japan	2.3	4.3	0.8	6.5	11.2	6.5	2.4	34.0
Portugal	6.6	6.9	0.9	6.8	13.4	7.9	3.7	46.2
Spain[1]	5.6	4.4	1.0	5.6	13.5	6.9	3.3	40.2
Sweden	8.5	7.7	1.0	6.6	23.9	5.9	3.6	57.2
Belgium	9.9	6.2	0.4	6.6	17.4	6.1	2.9	49.4
Finland[1]	6.2	6.4	0.8	5.8	20.6	6.3	2.9	49.0
Greece[1]	10.0	4.2	0.2	3.9	19.6	1.1	4.4	43.3
Ireland	3.5	4.3	2.3	6.3	7.2	7.8	2.3	33.6
Netherlands	8.1	4.8	1.5	4.1	17.3	7.5	3.1	46.4

1. National accounts based except for Slovakia.
2. Latest data for Slovakia, based on Government Financial Statistics, available for 2001.
Source: Ministry of Finance, OECD, IMF and World Bank.

Figure 15. **Income per capita and public expenditure in OECD countries**[1]
2002



1. National accounts based except for Slovakia.
2. GFS-based 2003 estimates by the Ministry of Finance have been used for international comparisons, to diminish the impact of the distortion in data for 2002.

Source: OECD.

modest.[17] More structurally, the lower level of average benefits reflects the lower level of average wages (Table 10). As the share of labour income in GDP will increase with the catching up process the share of social transfers is bound to increase absent structural reforms. This pressure is particularly serious in pensions which represent the largest component of social transfers. Generous social assistance will also cost more in the future if the benefit parameters are not modified as presently

Table 10. **Wage/pension ratios**

	1995	1996	1997	1998	1999	2000	2001	2002
Minimum wage	2 450	2 700	2 700	3 000	3 600	4 000	4 400	4 920
Average monthly wage	7 195	8 154	9 226	10 003	10 728	11 430	12 365	13 511
Average old-age pension	3 320	3 727	4 124	4 490	4 878	5 382	5 782	6 104
Ratio average pension to average wage	46.1	45.7	44.7	44.9	45.5	47.1	46.8	45.2
Ratio average pension to minimum wage	135.5	138.0	152.7	149.7	135.5	134.6	131.4	124.1

Source: Social Insurance Agency.

planned by the government (For a detailed discussion of pension and welfare reforms see Chapter IV).

– Public consumption, at 19 per cent of GDP, is among the highest in the OECD area. The government wage bill at close to 9 per cent of GDP remains moderate in spite of prolific public employment because of low public wages. Should public wages for highly skilled employees converge more quickly to private wages, the government wage bill would grow even faster – unless the planned cuts in public employment are fully implemented. Excess employment and wage pressures are particularly serious problems in the education and health sectors (see Figure 16).

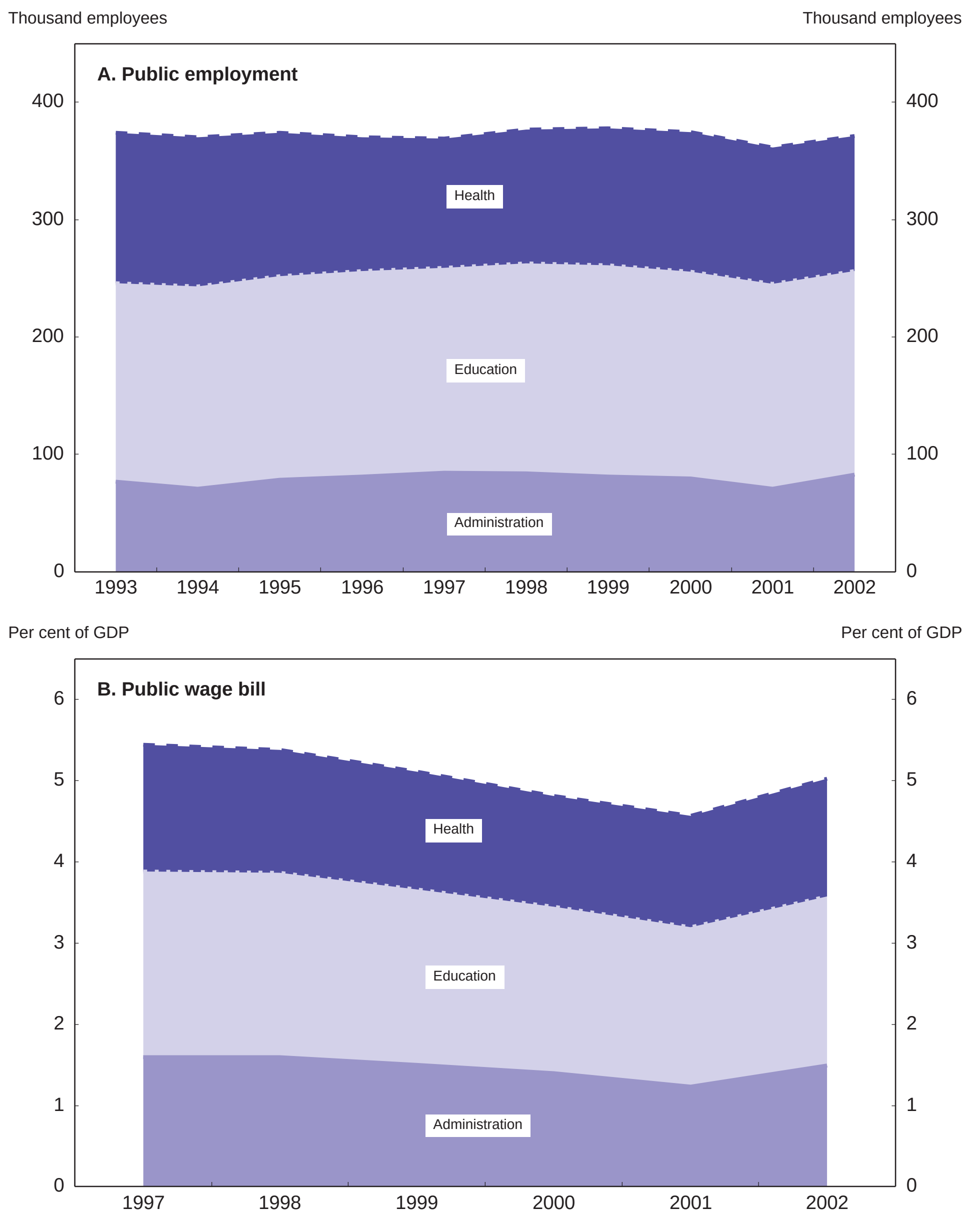
– Industrial subsidies have been higher than in other countries, reflecting large losses by the railways and regulated utilities, such as power generation and until recently gas distribution. Electricity, water, gas and fuel prices had been kept at particularly low levels through transition, and for a longer period than in the other post-transition economies, but recent adjustments permitted to reduce the associated losses and subsidies (Tables 11 and 12).

Costly public services

The low productivity of public services inflates fiscal spending. Until recently, the organisation of the supply of these services, both in state administration and in large-size collective services such as education, health care and rail transportation, had evolved little. Supply capacity and employment had remained largely static in these areas since the creation of the Republic in 1993. This is in contrast with profound changes in the society's needs and in the underlying technologies. As a consequence, large gaps have arisen between the *actual* and *potential* value for money in publicly provided services and have been filled by services produced by the private sector. Current trends in transportation and education offer telling illustrations.

Public transportation employs close to 100 000 workers (5 per cent of total employment) and is based on a dense railway network for interurban transportation, and on subsidised bus and tram services for urban transportation. While available capacity and employment have changed little in the last 10 years, service demand shifted rapidly to privately-supplied modes, notably road freight trucking and car passenger transportation (Table 13). Substitution is clearly taking place between railway and road-based transportation but pressures remain for duplicative investment in their respective infrastructures. Faced with growing fiscal constraints, the state was not able to cater to the large maintenance and development needs of both networks. Investments for both railways and roads had to be decreased, total public investment for infrastructures falling from 5.2 per cent

Figure 16. **Public employment and wages**



Source: Statistical Office of the Slovak Republic.

Table 11. **Energy prices**
2003, third quarter

	Electricity (US cent/kWh end-user price)	Natural gas (US$/$10^7$ Kcal end-user price)
Industry		
Slovak Republic	7.0	218.50
Czech Republic	5.3	206.80
Hungary	7.7	237.40
Poland	5.3	164.30
Households		
Slovak Republic	10.8	226.70
Czech Republic	8.3	325.60
Hungary	10.1	269.10
Poland	9.2	392.60

Source: International Energy Agency.

Table 12. **Price level of household utilities**
Ratio of household to industrial end-user prices

	1993	2000	2001	2002	2003 (Q3)
Electricity					
Slovak Republic	0.60	1.19	1.46	1.43	1.54
Czech Republic	0.56	1.27	1.40	1.55	1.57
Hungary	0.81	1.33	1.34	1.34	1.31
Poland	1.40	1.76	1.76	1.71	1.74
OECD Europe	1.80	2.06	1.95	–	–
Natural Gas					
Slovak Republic	0.62	1.07	1.08	0.95	1.04
Czech Republic	0.73	1.45	1.49	1.58	1.57
Hungary	0.91	1.33	1.16	1.14	1.13
Poland	1.33	1.86	1.75	1.95	2.39
OECD Europe	2.67	2.08	–	–	–

Source: International Energy Agency.

of GDP in 1997 to an expected 3.2 per cent in 2002. In terms of resource allocation in the transportation system, over-employment in railways in a sense crowds-out the development of the road infrastructure. The resulting poor quality and reliability of the transportation services, both for passengers and freight, are recognised today as a major hindrance to business investment, notably in the eastern regions where employment is lower.[18]

Serious problems of demand-supply mismatch also exist in education. Public education is a very large employer, its 173 000 workers representing 40 per cent of total general government employment and making up, in certain regions,

Table 13. **Shifts in transportation demand**
Transportation effected

	1993	2000	Percantage change
Goods transport (*billions of ton-km*)			
Rail	14.17	11.23	–26
Road	16.80	28.58	+70
Inland water	1.60	1.38	–15
Passenger transport (*billions of passenger-km*)			
Rail	4.57	2.87	–59
Automobile	14.36	24.41	+69
Bus	12.34	8.68	–42
Inland water	0.006	0.004	–50
Urban public transport (*thousand passengers/year*)	649	405	–60

Source: *Statistical Yearbooks of the Slovak Republic*, World Bank.

up to 15 per cent of the local employment. There is massive evidence of oversupply and qualitative shortcomings in these services. The most obvious are found in secondary education. Vocational education, which is a traditional area of strength in Slovakia, continues to absorb large and growing fiscal resources, while students increasingly seek general secondary education the supply of which is still limited (Table 14). As a result, there is growing demand for private and church schools which are more adapted to demand and also appear more cost-efficient than public institutions (Table 15). There are similar imbalances in university education, where available capacity in the most demanded disciplines falls short of demand, while established branches and chairs continue to be funded on a historical basis. There are also signs of crowding out of fiscal resources dedicated to tertiary

Table 14. **Shifts in primary and secondary education demand**
Number of students enrolled

	1990	1995	2000	Percentage change 1990-2000
Primary: total	721 687	661 082	650 966	–10
State	720 920	635 135	625 265	–13
Private	767	25 947	25 701	+3 250
Secondary general: total	55 644	76 380	80 615	+45
State	55 482	67 648	67 487	+22
Private	162	8 732	13 128	+800
Secondary vocational: total	224 584	248 892	195 016	–13
State	224 584	242 581	188 590	–16
Private	n.a	6 311	6 426	+735
Secondary: total	280 228	325 272	275 631	–1.6

Source: Institute of Information and Prognoses for Education, World Bank.

Table 15. **Costs of education institutions**

	1995	1996	1997	1998	1999
Expenditure per student in constant 1992 korunas (unit costs)					
Level of education					
Kindergartens	10 667	11 300	11 736	12 043	12 726
Primary schools	8 930	9 526	9 915	9 797	9 581
Secondary schools	9 793	11 045	12 927	12 792	12 536
Secondary vocational schools (MoE)	15 959	6 820	19 559	22 494	21 739
Church-affiliated schools	9 644	8 276	10 773	10 556	9 234
Private schools	5 264	3 569	4 305	6 156	5 150
Expenditure per student in percentage of unit costs in primary schools					
Level of education					
Kindergartens	119	119	118	123	133
Elementary schools	100	100	100	100	100
Secondary general schools	110	116	130	131	131
Secondary vocational schools	179	72	197	230	227
Special schools	212	238	258	258	248
Church schools	108	87	109	108	96

Source: Institute of Information and Prognoses in Education, World Bank.

education by primary and secondary tiers: teacher/student ratios soar beyond OECD averages in the latter while the share of GDP dedicated to tertiary education remains one of the lowest in the OECD. Demand is developing rapidly for private tertiary education, in spite of the high fees charged and the sometimes uncertain quality. It may be argued that since tertiary education returns are largely private, this area deserves more commercial provision and private funding of services. In all instances, present outcomes reveal serious value for money problems in publicly funded education.

Efficiency problems are also found in health services and the court system. A generous benefit package triggered exponential demand for health services. Payroll taxes for health remain the highest in the region at 14 per cent. Hospital admission rates rose by 18 per cent in the past decade, per capita outpatient visits by 20 per cent, and pharmaceutical consumption per capita grew at the highest pace in the OECD, even though the health status of the population did not improve commensurately.[19] Life expectancy remains low by the region's standards, and child and maternal mortality and morbidity rates from the main diseases remain comparatively high. Health expenditures have been contained at 5 per cent of GDP on a cash basis, but payment arrears have built up at more than 1 per cent of GDP per year and there are sizeable under-the-table payments for access to the most demanded services. Total health costs are likely to increase further as wages and prices in the health sector converge with average wages and prices in the economy (Table 16) and the population begins to age, even if the publicly funded proportion of spending might decline following reforms (see

Table 16. **Remaining price equilibration potential in the health sector**
Comparative price levels at current exchange rates, 1999, OECD = 100

	EU – 15	Hungary	Czech Republic	Slovakia
GDP Prices	99	42	39	33
Consumption goods prices	98	38	36	29
Investment goods prices	104	66	60	59
Health service prices	**84**	**19**	**19**	**13**

Source: OECD, *Purchasing Power Parities and Real Expenditures*, 2002.

below). The judiciary system, which consumes 0.2 per cent of GDP annually also presents major structural anomalies and comes only second to health services in terms of perceived corruption. A hypertrophied higher court system employs 90 Supreme Court judges and lacks specialised commercial courts. While most economic laws were successfully modernised (*i.e.* approximated to the *acquis communautaire*) they cannot be fully enforced, and certain segments of the population have no access to the court system at affordable cost[20] (Table 17).

Table 17. **Internationally comparative performance in the judicial system**
Perceived quality of public institutions[1]

	Rule of law		Control of corruption	
	1997/98	2000/01	1997/98	2000/01
Slovenia	0.83	0.89	1.02	1.09
Hungary	0.71	0.76	0.61	0.65
Estonia	0.61	0.78	0.59	0.73
Poland	0.54	0.55	0.49	0.43
Czech Republic	0.54	0.64	0.38	0.31
Lithuania	0.18	0.29	0.03	0.20
Slovak Republic	**0.13**	**0.36**	**0.03**	**0.23**
Latvia	0.15	0.36	–0.26	–0.03
Bulgaria	–0.15	0.01	–0.56	–0.16
Romania	–0.09	–0.02	–0.46	–0.51

1. The range is between –1.5 (worst) to +1.5 (best).
Source: William Davidson Institute, World Bank.

Recent efforts to reduce spending without structural reform

Past governments until the 2002 elections periodically reiterated their intention to restore fiscal sustainability, as regularly expressed in budgets at the beginning of fiscal exercises and in the medium-term pre-accession economic programs (PEPs) submitted to the EU. However, no fundamental reform in underlying spending areas was initiated. For instance, the ambitious 2001 PEP aimed to reduce the general government deficit from 3.3 per cent of GDP in 2000 to 2.7 per cent in 2004,[21] while also cutting tax revenues (Table 18). However, these intentions were overtaken by events and no savings were achieved in any of the key spending areas. A bold attempt to reduce welfare transfers to able-bodied beneficiaries – by halving them after two years of unemployment – did not really lead to savings as special public work jobs were ultimately offered to those most likely to lose from this measure. In the area of transport subsidies, an ambitious programme was introduced in 2000 to increase fares to cost-recovery levels but was subsequently watered down. Industrial subsidies did diminish in 2002 (current transfers were reduced from SKK 20 billion in 2001 to SKK 17 billion and capital transfers from SKK 23 to 8 billion, a saving amounting to 1.8 per cent of GDP in total) but there are concerns that transfers may have been actually shifted to other channels such as regional bodies subsidising their local utilities or consumers. Indeed during the same period subsidies to non-profit organisations and households increased by SKK 41 billion, more than 4 per cent of GDP.

These recent and unsuccessful consolidation efforts started always with attempts to implement across-the-board cuts in the main expenditure categories. Resources budgeted for social transfers, pensions, health and public employment were frequently nominally cut or increased less than nominal GDP, but these objectives were not backed by structural reforms in the respective areas. As equally observed in other OECD countries, such cuts proved short-lived. They gave rise to political pressures in the course of the budget exercises, or in the subsequent years, and intended cuts were typically offset or even reversed. Expenditures in the recent period 2000-2002 following the cuts effected in 1998-1999 confirm this inertia (Figure 17).

By contrast, infrastructure investment in transportation, utilities, buildings, schools and hospitals looked more flexible downward. Such expenditure turned residual when fiscal pressures became intense. In 2000 and 2001 government infrastructure investment, at 3 per cent of GDP reached one of the lowest levels among OECD countries. There is certainly room for refocusing and saving on

Table 18. **Expenditure projections and outcomes**

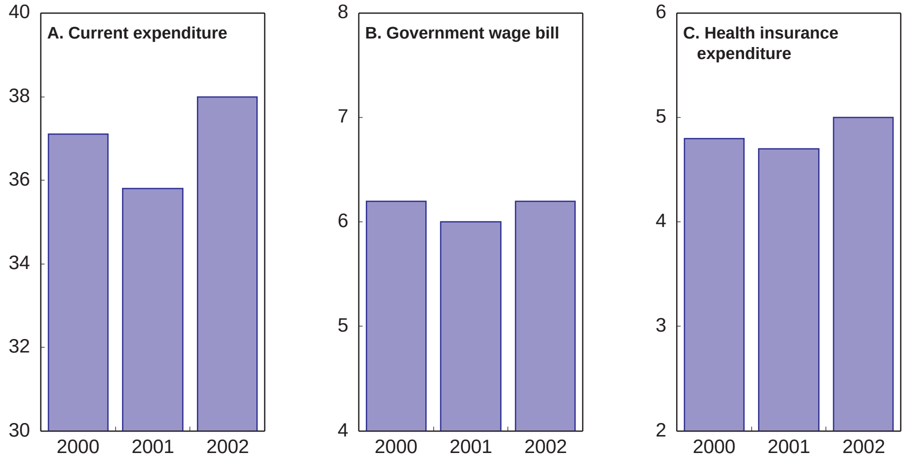
Consolidated general government expenditures as a percentage of GDP

	2000	2001	2002
As approved by the Parliament[1] (GFS)	37.5	39.1	38.6
Actual expenditures (GFS)	42.8	41.3	[52.9][2]
As projected in 2001 PEP (ESA-95)	–	46.6	47.0
Actual expenditures (ESA-95)	–	–	49.0

1. Estimation. No consolidated general government budget is voted by the Parliament. The voted state budget, including transfers to social security funds and local governments, provides the basis for the estimation of total expenditures.
2. Non-consolidated data.

Source: Slovak authorities.

Figure 17. **The inertia of the main expenditure categories**
Percentage of GDP



Source: OECD.

infrastructure investment but these cuts may have gone too far – without discriminating between infrastructure categories. There are signs of maintenance failures in important infrastructures.[22]

Budget procedures have been modernized but shortcomings remain…

Budget procedures have improved significantly since 1998. Before that Slovakia had no consolidated state budget and no central treasury and did not produce consolidated general government accounts. Large loopholes remained in the spending process via extra-budgetary funds and the reckless use of public guarantees.[23] In the past four years major breakthroughs were achieved in standard fiscal controls. Extra-budgetary funds have been integrated in the state budget, caps were put on public guarantees and granted guarantees were made transparent. A central treasury account was created. The state budget now consists of 49 chapters, each one specifying *total expenditures*, *current expenditures* (including *salaries and wages*) and *capital expenditures*. Appropriations for a chapter cannot be exceeded but each spending agency can make internal transfers within a chapter.[24] Budget preparation follows a fairly standard sequence, even if the social security and regional and local government budgets are not prepared fully in tandem with the state budget and there are shortcomings in the compilation of the consolidated general government accounts which become more serious with

Box 5. Preparation schedule of the 2004 Budget

January-April 2003	Ministry of Finance prepares the starting allocations and chapter limits for the 2004 state budget.
May 2003	Starting allocations, and chapter limits are approved by the government.
June 2003	Chapter administrators submit draft budgets to the Ministry of Finance in accordance with the approved limits. They formulate their proposals in economic categories (current expenditures, salaries, capital expenditures).
July 2003	Ministry of Finance consults with social security and health funds (via Ministry of Health in the latter case) and fixes deficit limits.
July 2003	Ministry of Finance briefs the Parliament about state budget preparation.
August 2003	Draft budget is submitted to economic ministers and to the government for discussion.
September 2003	The government approves the definitive draft of the state budget.
October 2003	The draft state budget, together with a general government deficit target, is submitted to the Parliament. Members of Parliament can suggest amendments – after consulting with the Ministry of Finance and approval by the "Committee for Finances, Currency and Budget". If amendments imply increases in expenditures, authors must specify financing sources by proposing cuts in other expenditures.
January 2004	Regions and municipalities inform the Ministry of Finance and the Parliament about their budgets.

decentralization (Box 5). Notwithstanding the important problem of consolidation, a full set of public accounts are made public with regular periodicity, according to international standards (Table 19).

The budget management process is broadly in line with average OECD practices but existing procedures are not strong enough to cope with the unusual pressures that the country faces. Strengthening budget procedures according to the best possible planning and control techniques available is necessary to meet the fiscal challenge. Three main shortcomings call for fundamental improvements in spending management:

– Established public expenditures are difficult to change and new initiatives tend to put upward pressures on aggregate spending. "Incrementalism"

Table 19. **Regular fiscal reporting**

Description	Frequency	Prepared by	Features
1. Financial position of state accounts	Daily	NBS	Provides summary data on overall fiscal position. Gives cumulative data on: – total revenues; – total expenditures; – loan operations; – listings of K1 (payments due in next few days) and K2 (payments on the waiting list); – major taxes (VAT, excise, and income tax); and – state funds
2. Report of balances on accounts of budgetary and subsidized organizations and subsidies to business entities from the state budget	Monthly	NBS	Provides fiscal data under following categories: – budget revenues; – extra budgetary revenues; – current and capital expenditures of budgetary organizations; – current and capital transfer to business; and – capital transfers entities.
3. Budget execution reports from the line ministries and spending agencies	Quarterly	Line ministries/ spending agencies	Balance sheet and operating account. Revenue and expenditure report by major economic categories.
4. Budget execution report from the municipalities	Quarterly	Municipalities	Balance sheet and operating account. Revenue and expenditure report by major economic categories.
5. Consolidated budget report of the central government	Quarterly	MOF	Complied from the ministry reports (no.3). Contains balance sheet and revenue and expenditure accounts. Revenue and expenditure report by major economic categories.
6. Health insurance accounts	Monthly	Health Insurance agencies	Provides summary data on: – revenues; – expenditures; – liabilities; – claims.

Table 19. **Regular fiscal reporting** (*cont.*)

Description		Frequency	Prepared by	Features
7.	Social insurance accounts	Monthly	Social Insurance Agency	Provides summary data on: – revenues; – expenditures; – liabilities; – claims.
8.	Unemployment insurance accounts	Monthly	National Labour Office	Provides summary data on: – revenues; – expenditures; – liabilities; – claims.
9.	Summary report on budget execution	Monthly	MOF	Complied from the ministry reports (no.2). Contains balance sheet and actual revenues, expenditures, financing and deficit.
10.	Revenues of public finances	Quarterly	MOF	Covers the general government. Contains data on revenues, expenditures, and deficit of the central government, state funds, and the local governments supported by charts and graphs. Compares current year's data with the data for the corresponding period last year. Gives data on central government foreign/domestic debt.
11.	Final accounts of the Slovak Republic	Annually	MOF	Finalized and presented before the National Council within six months of the close of the financial year. Includes the following main statements: – report on the main features of accounts; – macroeconomic overview; – report on state funds; – consolidated statement of financial assets and liabilities; – brief report from the auditor general; – statement of total revenues and expenditures; – statement of revenues and expenditures of municipal bodies; and – consolidated local government budgets.

Source: Government of the Slovak Republic, IMF.

dominates the budget process. Spending ministries and agencies prepare their draft budgets year after year on the basis of previous appropriations and existing personnel and facilities. The Ministry of Finance, the government and Parliament have little leverage on these proposals and are not really equipped to assess the individual and comparative merits of the proposed programmes. In the preparation of the 2004 budget more substantive discussions than usual took place between the Ministry of Finance and line ministries, and some budget reallocations ensued, but this effort remained on a relatively thin informational ground. Both mandatory transfers and policy programmes appear fairly rigid and it is difficult to phase out the existing programmes and symmetrically introduce new initiatives. From the viewpoint of spending ministries, making proposals which imply resource shifts away from the status quo is risky because it can lead to the endorsement of saving proposals and the rejection of new spending ideas. As the respective merits of programmes are not documented and compared, policy changes are difficult to motivate. The audit system does not support budget flexibility either, as it lacks modern principles of functional auditing and self-auditing. Prevailing audits may be penalising innovative chapter managers: certain agencies were recently sanctioned for "using current funds for capital expenditure, or capital funds for wages" or for "not spending budgeted wage funds and keeping actual payrolls lower than budgeted".[25] There is a need to diffuse the "result-oriented" culture in all budgeting, financial control and audit functions of the general government on the basis of a full adaptation of the existing legal framework.

– Some spending loopholes remain and are conducive to drifts. The most obvious and costly fiscal loopholes were already eliminated, such as the reckless distribution of public guarantees, soft loans from government-controlled banks, and free-wheeling extra-budgetary funds. Other non-budgeted expenditure channels remain open, however, including sizeable payment arrears by public agencies,[26] wage and transfer increases granted during a budget year without voting new revenues,[27] the quasi-fiscal operational losses of the railways, and non-amortised physical depreciation in public infrastructures. Asset depletion escapes budget planning and control because spending is managed on a cash basis. Existing cash-based budgeting and monitoring should be complemented with accruals-based indicators, in line with international best practices.

– Implementation shortcomings amplify fiscal bills. There are inefficiencies and cost overruns in the procurement of goods and services which represent almost a quarter of total public spending. The Slovak Republic was the first post-transition country to adopt a Public Procurement Act in 1994 and adapted it to EU rules in 1999, but public procurement appears still vulnerable to corruption and abuse. Provisions concerning open tendering are rather satisfactory and permit competitive government purchases, but restricted tendering and negotiated tendering give excessive discretion to contracting authorities. On the other hand, the payment and settlement system is now being handed over by the Central Bank to the Treasury, raising certain concerns that the shift, besides the expected transition costs, may be facing design and human capital challenges which may weaken the integrity of budget execution. Territorial decentralisation compounds the challenges of preserving the integrity of the payment system (Box 6). No loopholes should

Box 6. The difficult emergence of a treasury system

Until 2002 the National Bank of Slovakia (NBS) served as the government's bank, ran the payment system and acted as agent for the management of government debt. A formal contract established the terms and fees for this service. But in practice it was provided free of charge, NBS finding that the service helped it in its conduct of monetary policy. Budgetary control was done through quarterly credit limits set for individual spending authorities by the Ministry of Finance (MOF). Separate accounts were kept for 6 000 subsidiary spending units, all integrated within a Treasury Single Account (TSA). NBS entered MOF limits for respective expenditure accounts in a computerised database and proceeded to payments according to spending authorities' instructions, after checking that cash balances are available in each account and instructions conform to rules. Periodical reports were sent to the Ministry of Finance on the situation of TSA.

MOF reportedly had three main difficulties with this arrangement: *i)* it found that budget execution information was late, incomplete and not sufficiently detailed for its purposes; *ii)* the spending commitments preceding payments could not be monitored, impeding cash management; and *iii)* cash balances were remunerated at NBS policy rates, below market rates.

The government adopted in July 2000 a "Strategy for Building a Treasury System" elaborated in co-operation with the EU. Specifications for a new hardware and software system was finalised at a total project cost of SKK 1 billion. About 15 000 revenue and expenditure sub-accounts were to be set up, and payments would be handled as before, within an integrated Treasury Single Account. However, limits for individual sub-accounts were not designed for direct entry in the computer system but were to be provided "manually" by the Budget section of MOF – a feature which was subsequently questioned. The purchase of this system became highly controversial, and the Public Procurement Office contested and cancelled the selection committee decision three times in a row. Completion of the project is expected in 2004.

be permitted to arise in the integrity of public payments and procurement as a result of decentralisation reforms. Procurement, financial control and audit capacities should be strengthened in all government layers.

Public debt has grown at a worrying pace

The recent growth of public debt has been phenomenal not least because of the large bank restructuring costs, with interest payments increasing by more than 1 per cent of GDP in the last six years (Table 20). Yet the level of official debt remains below European averages – and below the Maastricht benchmark. In addition, the magnitude of privatization revenues in 2002 helped reduce the public debt stock by SKK 59 billion (6 per cent of GDP) and another SKK 61 billion were dedicated to the reduction of hidden liabilities in public guarantees (Box 7). Significant non-tax revenue sources are expected to be exhausted however (after the full privatisation of the gas company SPP), and not more than 2 per cent of GDP is expected from privatization proceeds in 2003.[28] If the 2002 level of the deficit is not sustainably reduced, and the privatisation receipts are not systematically used to reduce public debt, Slovakia could hit the EMU ceiling on debt (60 per cent of GDP) before 2010. If a wider definition of public liabilities was used, including the hidden cost of environmental commitments,[29] the debt stock would presently attain 45 per cent of GDP on an ESA-95 basis. The proportion

Table 20. **Official debt and total public liabilities**

	1995	1997	1999	2000	2001	2002
In SKK million						
Consolidation Bank	–	–	99 625	140 516	32 345	30 179
State risk-adjusted guarantees	–	34 138	52 254	63 572	70 302	57 344
Guarantees and off-budget liabilities	–	34 138	151 879	204 088	102 647	87 523
Reported gross government debt	121 842	200 449	344 854	410 120	431 771	410 117
Total gross government liabilities[1]	121 842	234 587	496 733	614 208	534 418	497 640
In per cent of GDP						
Consolidation Bank	–	–	11.9	15.5	3.3	2.8
State risk-adjusted guarantees	–	4.8	6.3	7.0	7.1	5.3
Guarantees and off-budget liabilities	–	4.8	18.2	22.5	10.4	8.2
Reported gross government debt	21.4	28.3	41.3	45.1	43.6	38.2
Total gross government liabilities[1]	21.4	33.1	59.4	67.6	54.0	46.4
Memorandum item:						
Interest paid on public debt						
In SKK million	11 956	13 698	26 421	26 121	31 627	39 257
In per cent of GDP	2.1	1.9	3.2	2.9	3.2	3.7

1. Excluding the implicit pension debt.
Source: Ministry of Finance.

Box 7. How are privatisation revenues used?

Privatisation revenues jumped from SKK 2.3 billion in 1999 to SKK 40 billion in 2000, SKK 36 billion in 2001 and SKK 161 billion in 2002, attaining 16 per cent of GDP in this last year and 25 per cent cumulatively by the year end. The government reported that more than one third of the proceeds were used to reduce state debt, more than another third were blocked in a reserve fund for the second pillar of the planned pension reform, and the rest for reducing off-budget liabilities in the railways, health and education systems.

The government announced that it expects to realise SKK 18 billion in privatisation revenues in 2003 and a further SKK 16 billion in 2004. About 70 per cent of the 2003 revenues will be used to finance called guarantees inherited from the past.[1] The small amount of remaining revenues will be used to repay principal on state debt.

The largest asset which remains in state hands is the 51 per cent government share in the gas monopoly SPP. This company transports 70 per cent of the Russian natural gas heading to Western Europe and associated transit fees contribute a large entry to the Slovak balance of payments. A conglomerate consisting of Ruhrgas of Germany, Gaz de France and Gazprom of Russia, acquired a minority share with management rights in 2002. The government has not decided about selling its remaining stake because it expects growing future dividends. The electricity generator SE is also fully state owned and may have a large market value when divested from its liabilities; however, the government would have to clean SE's balance sheet and decommission its old nuclear plant first.

1. These are cash expenditures according to GFS standards but, in principle, should be allocated to the years of granting of guarantees in the accruals based ESA-95 standards. However, in the present application of ESA, the cash cost of past guarantees are booked in the year of disbursement.

would in fact be higher if the implicit pension debt – representing the discounted value of future PAYG deficits – was explicitly recognised, but no calculation of this liability is available.[30] These pressures underline the need for the authorities to pursue the comprehensive reform of public finances and deal with the underlying debt burden.

The new fiscal management system

Policymakers have long realised that prevailing budget procedures do not facilitate spending reforms. Not even the best budget procedures can substitute for political willpower in necessary reforms, but budget institutions may help or hinder such efforts by making the costs and benefits of spending programs more or less transparent, informing policymakers and the public about alternative options, and providing a more or less binding framework for the implementation of decisions.

Important initiatives were taken to modernise the fiscal system. These efforts have been intensified since the election of a new government in 2002. They cover a wide spectrum of fiscal management and contain many elements. Capacity-building for implementation appears, at times, to fall behind. Reforms could be too straining for available political and administrative resources. In spite of these shortcomings, the Slovak fiscal modernisation effort is one of the most far-reaching institutional transformation programmes launched in OECD countries in recent years.

A *medium-term fiscal framework*

A first step was made toward creating a medium-term budget framework in 2000, when the Financial Policy Institute (FPI) of the Ministry of Finance published three year projections of total budget revenues, expenditures and gross public debt. These projections were based on FPI's own macroeconomic forecasts. Even if spending projections were not negotiated with the Budget Section of the Ministry and later became controversial, the exercise was an important innovation and provided the background for the 2001 pre-accession economic programme (PEP) submitted to the EC. It, however, had no role in domestic policy making. Communicating with the EC remained the core motivation for the preparation of multi-year projections in both 2001 and 2002. These were equally non-binding and very optimistic in their revenue and spending forecasts (Table 18). They have nevertheless introduced ESA-95 based general government projections in Slovakia. In the following year, the 2002 PEP projections were produced for the entire general government sector, both on the GFS-cash and ESA 95-accruals bases.

The government then announced a major initiative in 2003, promising to submit a three-year budget framework to Parliament together with the 2005 budget act. The FPI was given the responsibility for projecting government revenues during the first three-year period, and its staff was strengthened accordingly.

The medium-term framework for 2005 will include the following elements: *i*) a baseline macroeconomic projection; *ii*) a revenue projection path on the basis of the tax package applicable from 2004; and *iii*) projections of *mandatory* spending which cannot be modified by policy decisions at the executive level but through a demanding parliamentarian process. On that basis, and taking into account the Maastricht objective for 2006, the room available for non-mandatory, discretionary spending will be calculated for the projection period. The medium-term framework is planned as an indicative document at this stage, and not as a binding budget voted by the Parliament.

This plan is an important step forward but suffers from certain weaknesses. First, general elections will be held in 2006 and the announcement of a medium-term fiscal framework is more credible when made effective at the beginning of a new legislature (it is nevertheless an achievement to introduce it, even in the course of the legislature). Second, revenue projections will be fragile as 2004 will be the first year of application of the new tax system and additional cuts in social-security taxes are difficult to plan in these circumstances. Third, ongoing territorial decentralisation makes spending projections difficult. Finally, the medium-term budgeting exercise has been designed principally in macroeconomic terms, and even if the government plans to provide functional spending projections for the main budget chapters, these may not be consistent with aggregate projections. A credible medium-term framework will need to be directly grounded in spending priorities (Box 8).

Functional budgeting

The Slovak Republic needs to reduce spending while reallocating resources from lower to higher priority uses. To make fiscal consolidation compatible with the necessary strengthening of public services and infrastructure, a results-oriented approach to budget making is necessary – even if this type of budgeting represents an experimental avenue even in the most advanced OECD countries. The authorities have taken important initiatives in this area in the past two years.

The government adopted in November 2001 a "Resolution on Programme Budgeting" and "Methodological Instructions of the Ministry of Finance for the Implementation of Programme Budgeting".[31] Four areas were selected for pilot applications of functional programmes in the 2002 budget.[32] Such chapters spelling out functional objectives were to be presented only *pro forma*, however, in parallel to the standard economic budgets which would be voted by the Parliament and remain binding. This feature made the experiment merely academic, because functional budgets require that programmes are given performance objectives and managers discretionary power in resource utilisation. Traditional economic budgets do not offer this freedom. Following the pilot projects launched in 2002, actual experiments will indeed begin in 2004 when the Parliament will vote and appropriate functional spending lines.

Early experience with pilot projects reveal communication problems between the Ministry of Finance as the main proponent of the methodology, and spending ministries. Further familiarisation and training is necessary in line agencies. International experience shows that functional budgeting succeeds when line agencies understand and support it fully, and do not see it as a burden and an additional reporting obligation. In each ministry an influential sponsor is required. The government recently created a working group including high-level line-ministry officials to analyse, assess and update functional budgeting.

It is useful to concentrate the pilot projects in spending areas where mismatches between costs and benefits are most blatant. Public transportation; primary, secondary and university education; health services; and the entire court system appear as natural candidates. The ongoing devolution of spending

Box 8. Medium-term planning of road investment

The planning of the road construction and its funding raise complex fiscal management challenges. Firstly, investment needs are particularly large, notably on a gross basis (including maintenance spending) while budget resources available are limited and proved unstable in the past. Second, lack of multi-year investment budgets make medium-term allocations and procurement vulnerable to policy changes. Third, road development come under a cascade of international and local planning layers that make consolidated planning difficult. Finally, if new room is opened for commercial motorways, then the respective contributions of public and private funding may be altered.

The present quality of the road network varies according to regions and types of roads. Western districts, including the Bratislava agglomeration, are relatively well connected to the European motorway network and FDI investors highly value this infrastructure. In contrast, eastern regions are poorly equipped with motorways and expressways, and this is a recognised hindrance to domestic and international investment. Maintenance backlogs have accumulated, notably in the so-called secondary (Class II) and smaller roads which are under territorial and municipal government responsibility and which represent 75 per cent of the road network. The World Bank estimated in 2002 that a pragmatic road maintenance and development schedule would call for annual investments of approximately \$500 million.[1] Against this benchmark, the actual yearly investment of \$215 million falls short by approximately 1 per cent of GDP. As more than 80 per cent of total road spending goes to new motorway construction, the gap is most serious for maintenance.

A National Road Fund created in 1990 to provide stable funding outside budget constraints faced chronic endowment and spending control problems and was dissolved in 2001.[2] No alternative financing scheme replaced it and the road budgets for 2002 and 2003 were cut to an unexpected degree. In the course of the latest budget exercise, in June 2003, the government nevertheless decided to allocate a further EUR 600 million (3 per cent of GDP) for highway projects in the next three years.[3] This funding programme will be backed by the EU and associated funds.[4]

Planning interdependencies between complementary roads is challenging. It is now becoming more complex under territorial decentralisation. Co-ordination between the Slovak national network and road networks in neighbouring countries (in the Czech Republic, Hungary and Poland) and at the trans-european level is facilitated by the role taken by the European institutions involved in co-financing. In contrast, subsidiarity under the national level creates co-ordination difficulties. Motorways and Class I roads will continue to be planned by the central government and operated on its behalf by the Slovak Road Authority (SRA),[5] and the layers below by regional governments. There is no clear scheme yet concerning the transfer of financing resources and technical expertise to regions and municipalities, including for the management of the highly important national road maintenance data base on pavements and bridges.

Box 8. Medium-term planning of road investment (*cont.*)

In these circumstances, proposals for some re-centralisation of road planning, financing and management have become more prominent. The World Bank launched the idea of a "reformulated" National Road Fund as a co-ordination mechanism. This Fund could finance the SRA and the regional road agencies and municipalities in accordance with "five-year road development plans". Yearly disbursements would be conditional upon the fulfillment of performance yardsticks in the plans.

The Slovak authorities seek to increase the role of commercial and private investment in road development but also consider that public-private partnerships are not yet fully effective in this area – in the light of the disappointing experiences in the Czech Republic and Hungary.[6] They state an intention to invite private investors to the launching of the D1highway project between Bratislava and Kosice in 2006. Cost-effective tolling on the basis of electronic vehicle identification and new metering technologies is expected to facilitate the commercial exploitation of roads.[7] However, the definition of the projects to be submitted to private bids remains controversial and highly dependent on the outcome of political negotiations.[8]

1. This estimate include $90 million for making up the maintenance backlog, $100 million for routine maintenance, $100 million for upgrading the network to EU axle weight standards (a five year investment programme) and $200 million for the minimal yearly development of the motorway network. A more extensive version of the motorway development programme would require $340 million per year.
2. The Road Fund suffered serious problems in practice: Firstly, multi-year investment planning proved impossible because of political interference. Secondly, resources could not be stabilised. The Fund was supposed to obtain 40 per cent of hydrocarbon tax revenues and 70 per cent of vehicle licenses fees but in practice in certain years it received not more than 6 per cent of anticipated receipts. Thirdly, borrowing went out of control, at rates much higher than interest on public debt. Total Fund liabilities had already reached 4 per cent of GDP in 2000. Finally, a technocratic and apolitical management could not be established and suspicions of illicit transactions proliferated in road construction contracts.
3. Including the D1 motorway connecting Bratislava and Kosice in the east, another dual carriageway connecting Bratislava and Kosice, and the East Slovakia highway in the north of the country.
4. A € 350 million loan (more than 1 per cent of GDP) from the European Investment Bank (EIB) was approved by the cabinet at the same time as the new highway projects. Additional road financing is expected from 2004, of an amount of SKK 5-6 billion (0.5 per cent of GDP) from the EU Cohesion Fund and of SKK 3 billion (0.3 per cent of GDP) from the EU Structural Fund. Slovakia also plans to apply for funding from the European Union's ISPA program to get additional € 160 mn (0.4 per cent of GDP).
5. In 2002, SRA signed an innovative road administration contract with the Ministry of Transportation, as a quasi-commerical entity, under an arms' length relationship.
6. See OECD *Economic Survey of Hungary*, June 2002 and OECD *Economic Survey of the Czech Republic*, April 2003.

Box 8. **Medium-term planning of road investment** (*cont.*)

7. Slovakia participates in major regional and European projects for electronic tolling, notably to a project for electronic vehicle screening among Czech Republic, Hungary and Slovakia, and to a plan to introduce electronic tolling for freight vehicles by 2007 which is endorsed by the European Union. A study identified a potential to generate yearly $23 million in the Slovak road market by 2005, assuming tolls amounting to 4 US cents per car km, in line with international standards.
8. A disagreement emerged recently within the government coalition concerning the precise trajectory of the principal motorway of the country between Bratislava and Kosice (project D1). The government delayed its final decision on this project after the ethnic Hungarian Coalition Party (SMK), which represents the Hungarian population concentrated in southern districts and is a junior coalition partner, requested priority implementation of the southern link. The pro-business coalition member ANO then proposed to build that corridor on a commercial basis, financed by private investors. According to ANO's officials, the southern route – running from Bratislava through Nitra (this section of the motorway is already completed) and Zvolen to Kosice – could be built in five years for SKK 50-55 billion (5 per cent of GDP) and would permit investors to recoup the investment through tolls. Meanwhile, the construction of the Bratislava-Kosice motorway proceeds on a more northern route, passing through Trencin and Banska Bystrica. A related issue is whether it would not be more efficient to build a motorway link from Kosice to the Hungarian border that could make the Budapest-Vienna motorway accessible to a larger part of Slovak population. Obviously, the fragmentation of small size central European countries and strong ethnical orientations make the rational planning of the road infrastructure more politically difficult.

authority to sub-central governments in education, health, transportation and welfare subsidies further compounds the task.

On the other hand, administrative decentralisation provides a natural experiment for functional budgeting. Sub-central governments will spontaneously explore alternative modes and organisations for the provision of similar services and social benefits. In principle they should discover freely, by taking different options, the costs and benefits of alternative avenues such as service delivery by public agencies, public-private partnerships, not-for-profit activities, commercial concessions and plainly competitive commercial providers. It must be stressed nevertheless that the proper implementation of functional budgeting at sub-central levels calls for clear performance targets and additional administrative and governance capacity, that may be in short supply, and which should be further developed. Central government should define national service objectives precisely and monitor their achievement, without drifting toward micromanagement.

Comprehensive budgets for accurate expenditure accounting

In January 2002, all extra-budgetary funds (XBFs), except the Agricultural Market Regulation Fund (transformed into an Agency), the Nuclear Fund (which accumulates revenues for the decommissioning of nuclear power plants), and the Housing Development Fund (which was to be liquidated in January 2003 but ran out of funds for mortgages and stopped accepting new applications) were abolished and their finances integrated in the budget. Earlier, the experience with the Road Fund was disastrous from a fiscal management viewpoint, as this Fund, because of the pressing road-building needs and a hectic decision-making setting (see above Box 8), had overrun its planed expenditures by a wide margin via direct borrowing.

After the integration of the XBFs in the budget, the key shortcoming in the integrity of budget accounts concerns the deficits of quasi-fiscal bodies which build up arrears and borrow under explicit and implicit government guarantees. Railways, the state-owned power generator, hospitals and health insurance funds, and, in the future, regional governments and municipalities – in spite of formal rules which limit their borrowing – are likely to remain risk areas.

Until last year, public utilities' losses have been justified by distributional objectives, in favour of low-income users and public-service obligations (PSOs). In practice, these losses were also due to massive excess employment and unprofitable investments. This financial burden was rarely fiscalised and took grey forms such as cross-subsidies within these large-size utilities, direct borrowing from financial markets, and payment arrears to suppliers.

The government is now determined to make these fiscal costs explicit and to show them in the budget, even if this comes at a cost. It launched a price-adjustment scheme in 2001 to bring the distorted energy tariffs to more neutral levels, in line with EU directives.[33] The implementation was delayed until 2003, after the election year.

Railways generate massive expenditures and deficits. The monopoly ZSR (divided into a service and a track entity in 2002) is formally in the corporate sector and its operations are fiscalised only occasionally by the take-over of its debts by the government. Unlike in the energy sector, fiscal regularisation cannot be effected by raising railway tariffs to cost-recovery levels, because of massive inefficiencies which would penalise the users. The government therefore decided to directly subsidise the enterprise from the state budget. For the first time in 2003 direct subsidies were provided to fully cover the PSO costs of the enterprise.[34]

Major progress has been made in improving the transparency of state guarantees, a big fiscal loophole until the late 1990s. The 2002 state budget set limits on new guarantees. All new guarantees to private financial and non-financial parties were to be monitored and recorded, and the expected schedule of future payments for existing loan guarantees were to be disclosed in the budget. The government decided not to grant any new guarantees except for rolling-over the guaranteed debts and securing finance for EU co-funded projects. However, large guarantees likely to be called had to be granted to railways and other government borrowers in 2002. New ESA-95 based government accounts and projections will include this information on a risk-adjusted basis.[35] More generally, complementing cash-based budgeting with accruals-based monitoring is being put into place, but only at a slow pace because of technical difficulties common in many OECD countries.[36] These difficulties are compounded due to the challenges created by the decentralisation reform for the accurate consolidation of intergovernmental transfers. These are large enough to create distortions even in the production of cash-based general government accounts (see Table 9 and Figure 13 above).

Devolving of spending power to sub-central governments

Slovakia is making an exceptional leap forward in regionalisation. From being the least decentralised transition country it is becoming one of the most decentralised ones within a very short time span (Box 9). The decentralisation reform not only responds to the political objective of developing participatory democracy but is also meant to enhance the efficiency of government by making it directly accountable to regional constituencies. Under present plans the share of public spending devolved to regional and municipal governments will attain 20 per cent in 2005. Sub-central governments will be funded by central government grants,[37] which will first remain itemized and then become progressively fungible. Sub-central governments have their own "federalist" interpretation of this plan as they envision to be entirely funded by untied grants by 2005.

Several important questions concerning the fiscal implications of decentralisation remain open at this stage:

– Will it be possible to plan, budget and implement the general government finances on a consolidated basis after decentralisation, on a short (budget year) and medium-term (multi-year fiscal framework) basis? Sub-central budgets will not be voted by the national Parliament – even if there is a need for co-ordination in areas where there are national externalities of local revenue and expenditure decisions. The current balances of sub-central budgets can be preserved – in principle – if budget rules are properly enforced, but revenue and expenditure *levels* cannot be controlled as sub-central governments have their own revenue sources (these are mainly fee-earning revenues at this stage, rather than own taxing powers which will increase in the future). Capital expenditures will be even less controllable as long as VUCs and municipalities have not reached borrowing caps. In sum, the planning and implementation of general government finances will remain difficult even if safeguards are available against excessive overspending. It is highly important to rapidly achieve the full transparency of sub-central government accounts and rigorously enforce the newly-prescribed sub-central budget rules.

– How will functional budgeting be applied in programme areas devolved to sub-central governments? Are there risks of excessive cuts if a functional

Box 9. The decentralisation reform

The Parliament adopted in the autumn of 2001 a set of basic laws creating Higher Territorial Units (VUCs or regions), amending the Act on Municipalities, and transferring 4.5 per cent of GDP of further spending responsibilities to the sub-central layers. Municipalities, which were previously in charge of waste disposal, drinking water, public lighting, and maintenance of local roads (where they spent 2.9 per cent of GDP in 2000) get the responsibility for social assistance, some registration bureaus, some roads and communication systems, territorial planning and building permits, environmental protection, primary schools, sports and parts of health care. VUCs become responsible for regional development, territorial planning, secondary schools, social assistance, health care, cultural events and protection of monuments, maintenance of regional road networks, communications, civil protection, and some co-operation functions with EU institutions.* Total sub-central (municipal and regional) spending with old and new responsibilities is expected to represent 15 per cent of total general government spending in 2003 and 20 per cent in 2005. The government approved in May 2003 the "Project of Further Decentralisation of Public Government for the years 2003-2006" to confirm that decentralisation should be completed by 2004 and that an "Act on Budgetary Rules of Territorial Self-Governments" should detail applicable budgeting and auditing provisions by 2005.

Under decentralisation the VUCs' and municipalities' budgets will be prepared annually. The approval and management of these budgets will remain the *exclusive competenceof elected representation* of VUCs and municipalities. Municipalities will not submit their budget proposals to any state authority. VUCs will submit their draft budgets for the upcoming budget year to Parliament and to the Ministry of Finance (MOF) *for information*. Both VUCs and municipalities are obliged to submit their quarterly income statements to the MOF.

There will be detailed fiscal rules for sub-central governments. The current budget must be balanced and borrowing will be permitted only for capital spending. Loans above SKK 75 million (about € 1.8 million) will require the MOF approval. A*fter January* 2005 total debt cannot exceed 60 per cent of current revenues of the previous year, and debt service (repayment of interest and principal) cannot exceed 25 per cent of current revenues. Certain municipalities such as Kosice (second largest Slovak city) are over-indebted, but the total official debt of municipalities was only SKK 14.7 billion in 2003 out of a total gross general government debt of more than SKK 500 billion.

Independent auditors will review the final accounts as well as the compliance of sub-central governments with existing laws, budget rules and debt limits. They will be responsible for warning the MOF of any breaches. A procedure of receivership will be put in place for municipalities that are not current on their accounts payable within 60 days. One remaining problem is that some regional governments have not appointed independent auditors, taking advantage of a legislative loophole – the existing legal norms pertaining to VUCs fail to specify how to enforce compliance.

* VUCs can negotiate financing with EU and EIB funds.

area does not enjoy adequate priority at the regional and local level? What kind of minimum service standards should be set by the central government in critical areas such as education, healthcare and labour market policies while avoiding micromanagement? Functional budgets at sub-central level may in principle facilitate spending rationalisation but transfers from the central government are effected today according to economic categories. It is not clear if it is proper to make central government funds fully fungible across economic categories at the discretion of sub-central governments, within a programme area. This may lead, for instance, to improper maintenance of capital assets, if there is a political bias in favour of civil service employment and wages. On the other hand, regional governments are better positioned to identify the most efficient ways of attaining performance objectives in local circumstances. In the area of public transportation for instance, they can discover the most effective network mix if they are allowed to shift resources between rail and bus budgets. They would also be motivated to introduce competition and challenger companies in each mode if they are free from supplier interests. Full transparency of sub-central government performances in service delivery would facilitate the responsible application and diffusion of results-oriented budgeting. The central government should make a special effort to promote this comparative transparency.

– Will sub-central governments be the *purchasers* or the *suppliers* of public services? The present central government strategy is to transfer both funding and supply responsibilities in a bundled way. Sub-central governments therefore become concurrently service agencies, owners of companies and, by the same token, political hostage to supplier interests. This is a hindrance to spending rationalisation when public services represent up to 30 per cent of regional and local employment and votes.[38] The experience of Slovakia and of other OECD countries reveals serious risks of supplier entrenchment under spending devolution, which might be magnified by over-reliance on central government grants.[39] Off-budget deficits and payment arrears in supplier organisations may also be a problem to be feared.[40] To enforce the "money follows users" principle freely and rigorously, it is necessary to liberate sub-central governments from supplier interests.

– How can complementarity between European, national, regional and local service networks be optimised under devolution? How to enhance the planning and funding of infrastructures in transportation, education, health and other services when there are externalities? The problem is compounded when there are network interdependencies in infrastructures, and hence risks of redundancies and mismatches across fragmented investments. How to avoid free-riding downward and upward devolution cascades? This standard externality problem in public finance is faced in a particularly acute form in Slovakia because of the speed of decentralisation and the severity of the budget constraints. The authorities will need to devise co-operation and co-ordination channels in transportation, education and health areas. International co-operation is also necessary across the frontiers of this small economy.[41]

Reform of the public employment regime to facilitate adjustments

A new public employment regime is being put in place following two acts adopted in 2001. The new *State Service Act* concerns more than 36 000 employees in central government except those in the special functions of police, army, customs, fire brigades etc. It sets minimum qualifications for state service detailed in a "Catalogue of Activities in the Public Service". Employees not meeting these criteria were to be given the choice between quitting with a 5 month wage compensation, or accepting a precarious job contract. Those having the required qualifications were to be given the so-called "preparatory" status and would take examinations within 6-24 months to become "state servants". However, practically none of these provisions could be implemented by October 2003.

The *Civil Service Act* concerned more than 400 000 employees in regions, municipalities, budgetary and contributory organisations (schools, hospitals, regional and district state administrations, social insurance funds, theatres, etc.). There are qualification criteria also listed in a "Catalogue". Employees who fulfill the criteria and submit an application will become public employees. Those failing the criteria were to lose their positions starting from May 2002 with, in principle, a severance pay amounting to two months of wages. The layoffs planned for May 2002 concerned employees of regional and districts state administration centres (12 per cent of the former and 5 per cent of the latter, together 770 positions, were to be cut). The initial plan failed as a result of successful pressures from line ministries, but the quantitative targets were subsequently attained by cutting the unfilled job positions. Conflicts between the Ministry of the Interior that was to organise the layoffs and line ministries were supposed to be resolved by a new *Civil Service Office*, whichcould not fulfill this mission.[42] On the contrary, there seem to be new risks that decentralisation increases the number of employees in general government, as posts newly created at subnational level are not fully offset by layoffs in district administration centres.[43]

These two Acts nevertheless establish a formally flexible regime for public employment, which remains subject to collective negotiations with public sector unions. The wage-setting framework provided by the new regime is adaptable. National salary scales prescribed by the legislation are anchored to "average private and minimum wage developments" but "within the possibilities of the state budget". Together with performance-based remuneration options and the latitude offered by functional budgeting, an environment now emerges that is conducive to quantitative and qualitative changes in public employment.

Four problems nevertheless persist:

- The new Acts conserve too many seniority-based pay steps. This impedes the recruitment of qualified professionals by crowding-out the budget available for new hiring. Highest seniority-based pay positions represent 20 per cent of the Public Service and a higher proportion of the Civil Service. Only 200-300 "elite positions" are available for the entire government sector for higher level recruitment independent of seniority. The allocation of these positions to line ministries is not based on comparative assessment of needs but on political bargaining between Ministries. More transparent and better co-ordinated allocation of new job positions would be desirable.
- There are conflicting signals emanating from the government on the stability of the new employment regime. For instance, the above mentioned individual evaluations planned for 2003 were not realised. The applicability of the Civil Service Act to sub-central employees is not guaranteed either, even if most local authorities favour it as a framework facilitating employment and wage negotiations. Certain government ministers mentioned recently "confusions and illogical provisions" entailed by the Acts mentioned above. The new regime of public employment should be fully clarified and the provisions of the new State and Civil Service Laws should be fully enforced.
- Public sector employees express concern that "performance-based pay" may lead in practice to the collapse of wages to their flat, "pre-performance premium" levels. Health employees' and teachers' unions have been particularly adamant about this prospect.[44] Indeed, downward leveling-off of wages is a risk in the absence of adjustment in employment levels. The trade-off between quantity and quality is dreadfully illustrated by the excessively low ratio of teachers' salaries to average wages, where Slovakia lags the entire OECD area.[45] The government should give signals that the vicious cycle of low wages, low motivation and low performance in public services will be overcome by employment cuts and better remuneration for well-performing employees.
- No large scale campaign is on the cards for the re-training of public servants. Training as "investment" faces here the same budget constraint as the other public investments. The consequences of this shortcoming of the public employment reform may be serious in areas where professionals are difficult to find in the labour market, such as teachers trained in new pedagogical tools and social workers able to work in demanding

socio-cultural settings. The need for training is particularly acute in the implementation of new budgeting and financial control techniques.[46] Providing effective re-training for committed civil servants with insufficient skills should be a priority and be protected from budget cuts.

Reform of the social security system

As discussed in detail in Chapter IV, the pay-as-you-go (PAYG) pension system faces serious fiscal pressures. In May 2002 and September 2003 the government adopted a set of parametric changes which, backed by favourable demographic balances, should help enhance medium-term sustainability – even if longer term balances remain still unstable. The most important changes concerned the gradual lifting of the retirement age for women to 60 years as prescribed in May 2002, and the further increase of the retirement age for both sexes to 62 decided in September 2003. Benefits will be indexed to a mix of inflation and wage indicators. Authorities project that these changes will redress the PAYG balances, from a deficit of –4 per cent of GDP projected earlier for 2030.[47] There is further room for a gradual increase of the common retirement age to 65.

Foundation of a second privately funded pillar completing the PAYG system has been voted by the parliament and will be introduced in 2005. The present 28 per cent contribution rate would be partly (9 per cent) diverted to this second pillar. This would result in revenue shortfalls for the first pillar amounting to approximately 1 per cent of GDP per year, which will need to be funded from the budget.[48]

The health care system also faces mounting fiscal pressure, which shows up in arrears cumulating through funding layers. The current government has adopted measures to settle the debt as well as a new reform strategy that puts an emphasis on introducing accountability into the system. Thus, a set of three draft Acts sent to Parliament in 2003[49] allow both mandatory and voluntary cover, introduce a regulatory framework for health insurance, transform health insurance companies into joint-stock companies and define a basic benefit package covered by mandatory health insurance. Service providers are to sign a contract with insurance companies that are expected to compete for insurees, and competitive pressure is to ensure accountability of both service providers and insurers. As for patients, co-payments have been introduced to discourage frivolous visits to doctors. Private insurance could cover the services excluded from the basic package as well as extra services such as a faster access to elective surgery and better amenities in hospitalisation. The introduction of private insurance is in part to eliminate the long-standing practice of informal payments to doctors to gain a privileged access.

Assuming that the implementation of this reform will effectively cap mandatory health care expenditures by the revenues of health insurance companies, the latest pre-accession economic programme (PEP) projected balanced health accounts during the period 2004-2006. There are, however, several risks to this projection. First, experience in countries that have adopted a similar model of competitive social insurance shows that expenditure control is likely to be less effective than desired.[50] Second, this is particularly so in the absence of any adjustment in care facilities that are excessive, and it remains to be seen how much the devolution of hospital ownership responsibilities to regional and local governments will contribute to such adjustment. Third, a major source of spending pressure is the catching-up of health-sector wages and prices to average levels in the economy.[51]

Recommendations

The Slovak government has responded to the rapidly growing fiscal challenges by thoroughly transforming budget institutions. This provides an opportunity to upgrade Slovakia's fiscal management to above the average and closer to the best budget techniques available in OECD countries. This ambition raises two main issues:

– Does such a transformation make immediate fiscal consolidation easier or more difficult – in other words, is there a short-term fiscal price to pay?

– Is the devolution of spending power likely to go too far and too fast relative to the professional and technical skills available at the sub-central level, thereby threatening fiscal consolidation?

It must be recognised that a thorough transformation of budget institutions will come with short-term costs. These include both administrative and learning costs, and also the budget costs of previously hidden expenditures and liabilities. Such explicit expenditures are justifiable but must be well explained to domestic and international constituencies. Notably, the second pension pillar and the fiscalisation of duty losses by public utilities are likely to increase the budget burden.

More gradual phasing-in of decentralisation is favoured by several commentators. This would indeed be a more cautious strategy. However, in the context of the political dynamics already in motion in the regions and municipalities, it may be difficult to step back from the announced measures. Several territorial and local fiscal initiatives have already been launched. In these circumstances, safeguards minimising the additional fiscal risks of decentralisation must be rapidly put in place. Notably, reinforcing the fiscal procedures applicable in regional and municipal governments, and subjecting them from the outset to strong functional and procedural audits (for instance in transportation, education and other costly public services) is required.

The recommendations below focus on specific further actions aimed at helping Slovak policymakers face these immediate challenges (Box 10).

Box 10. Recommendations for public sector reform

1. Include a spending path, defined in real terms, in the medium-term fiscal framework to be annexed to the 2005 Budget Act. This spending path must be determined on the basis of a conservative estimate of the trend growth and tax revenues.
2. The spending path should be made as binding as possible and should be communicated as a core element in the medium-term economic projections submitted to the European Union.
3. Review *all* spending programmes, including so-called "mandatory" schemes based on legislation, without limiting cost-benefit assessments to "discretionary" spending. Parametric improvements in pension, social assistance and family benefit systems should remain on the agenda.
4. Important progress was achieved on pension reform and should help moderate the medium-term pressures on the system. Target to gradually increase the standard retirement age to 65.
5. The medium-term spending objective should be based on a strategic vision of functional expenditure priorities. A functional decomposition of the medium-term expenditure path should be elaborated.
6. Diffuse a "results-oriented" culture in all budgeting, financial control and audit functions of the general government. Fully adjust the legal framework to that effect.
7. Complete cash-based budgeting and monitoring with accruals-based indicators, in all government layers.
8. Plan for spending cuts in case of revenue shortfalls after the phasing-in of the 2004 tax reform, thereby avoiding a fiscal drift similar to that seen in 2002. Select lesser priority spending items for orderly cuts in the case of such an eventuality.
9. Dedicate privatisation revenues to debt reduction and to pension reform. Endow a reserve fund for pension reform (as a buffer for the PAYG 1st pillar and, if the 2nd pillar is implemented, to alleviate its cash cost for the budget).
10. Elaborate a long-term national infrastructure development plan. Spell out network development targets in rail, road, air and waterways transportation and communications. This plan should be integrated with European network development plans.
11. Develop co-operation and co-ordination between neighboring sub-central governments for the planning of transportation, education and health infrastructures of common interest. Improve co-operation with neighboring countries for the development of cross-border transportation networks.
12. Clarify the respective contributions of European, national, sub-central and private (including PPP) participants to the realization of the network plans.
13. Address inefficiencies in state-owned enterprises by exposing them fully to the disciplines of market competition and private ownership. Separately privatise the freight arm of the railways company to a qualified international operator and promote competition in rail passenger services.

Box 10. Recommendations for public sector reform (*cont.*)

14. Adjust capacities in public services (facilities and staff levels) proactively, according to service and infrastructure availability targets. Do not rely on *ex-post* adjustments from budget cuts (these lead to unintended infrastructure attrition and adverse selection in the quality of employees).
15. Use part of the budgetary scope created by government employment adjustments to raise wages and bonuses so as to be able to retain and recruit high-quality staff. Make the creation of new job positions more transparent and improve co-ordination between ministries.
16. Clarify the new public employment regime and fully enforce the provisions of the new State and Civil Service Laws. Make sure that the vicious cycle of low wages, low motivation and low performance in public services is overcome by cuts in excess employment and better remuneration.
17. Provide re-training to motivated civil servants with obsolete skills. This must be a priority in public sector reform and effective programmes should be protected from budget cuts.
18. In the areas where municipal fragmentation generates supply inefficiencies, provide incentives to consolidate services through amalgamation at inter-municipal or regional (VUC) level.
19. Introduce competition and apply the "money follows the user" principle in fiscally funded services. Allow for competition between national and regional agencies, not-for-profit institutions and commercial providers. Minimise distortions to competition arising from ownership differences.
20. Help equip sub-central governments with professional skills in medium-term budgeting, programme budgeting, accrual accounting, and results-oriented auditing and self-auditing.
21. Loopholes should not be permitted to arise in the integrity of the payment and procurement system as a result of decentralization reforms. Procurement, financial control and audit capacities should be strengthened in all sub-central governments.
22. Sub-central government accounts should be made fully transparent and newly-prescribed sub-central budget rules should be fully enforced.
23. Define minimum quality standards in constitutionally guaranteed services and monitor sub-central compliance while avoiding micromanagement. Make the disbursement of central government grants and possible shift to untied grants conditional upon successful compliance by sub-central governments with these standards.
24. Set up a legal framework conducive to functional, results-oriented auditing in all public spending areas, at central and sub-central levels. Fund academic, private and sub-central programme auditing institutions and projects. Make their findings widely available.

Notes

1. See Sabol and Hošková, 2003.
2. Around 5 per cent, up from 4 per cent a year ago. See monthly Dun & Bradstreet reports on the creditworthiness of 5 000 Czech and 1 000 Slovak firms About three quarters of endangered firms (category IV) are likely to go bankrupt within a year. Their likelihood of bankruptcy is 150-times higher than among the firms with best payments discipline (category I) (*www.dbis.cz/speng/press/press_release_0603.htm*).
3. Under the assumption that one quarter of employment in loss-making enterprises might disappear, which would imply a loss of about 7 per cent of total employment, and that rationalisation in the public sector would reduce the share of general government employment in total employment to the OECD average, which would mean a loss of about 3 per cent of total employment, the total number of vulnerable jobs may be estimated at around 10 per cent of total employment.
4. The new tax system, with a higher deductible threshold, will increase the take-home pay of low-skilled workers and may exert a moderating impact on wages.
5. OECD *Economic Survey, Slovak Republic*, June 2002.
6. For the year ending 31 December 2002, the National Bank of Slovakia reported a loss of SKK 24 836 million, with revenues of SKK 45 104 million and costs of SKK 69 940 million. The losses originated mainly from foreign exchange transactions (see table below). For 2003, a loss of similar size can be expected.

Revenues and costs of the NBS in 2002-03
(SKK millions)

	2002	January-September 2003
Financial revenues	44 897	30 183
Realised exchange rate gains	15 463	16 294
Unrealised exchange rate gains	–1	17
Financial costs	–67 946	–47 368
Realised exchange rate losses	–31 832	–24 716
Unrealised exchange rate losses	–7 513	–5 098
Operating revenues	207	143
Operating costs	–1 994	–1 315
Total loss	**–24 836**	**–18 357**

Source: National Bank of Slovakia.

7. Among Czech Republic, Hungary, Poland, Slovakia and Slovenia.
8. For the general government sector and on basis of government financial statistics (GFS).
9. The true level of public liabilities in 1993 was probably non-negligible, if one factors in the commitments resulting from bilateral agreements with the Czech Republic on the division of federal liabilities, and the implicit debt of the pay-as-you-go (PAYG) pension system.
10. The deviations of the 2003 expenditure and revenue outcomes from the budgeted and projected magnitudes are unevenly captured by existing methodologies. Certain non-tax incomes are not considered as current revenues and should be treated below the line in the ESA-95 methodology, while the continuing build-up of arrears in the education and health sectors are not properly recorded in the cash accounts. Transparency problems remain in the consolidation of the general government revenues and expenditures under decentralisation, and the quality of the 2002 and 2003 accounts is severely affected. These measurement problems are making difficult the accurate monitoring of the fiscal stance.
11. Historical and recent fiscal data is available on a GFS basis, while government's plans and projections are prepared on an ESA-95 basis.
12. The Ministry of Finance estimates that savings in government non-wage consumption of up to 1.5 per cent of GDP are technically possible within a four years horizon.
13. The authorities sought international assistance in analysing the long-term fiscal pressures and assessing available reform options with an aim to transfer the modern techniques of medium-term fiscal budgeting, functional programming and treasury and debt management in Slovakia. The Ministry of Finance (MOF) announced in April 2003 that the World Bank (WB) will provide a US$5.6 million 4-year loan for fiscal reform. Although its terms have not been specified, the loan will be earmarked for projects aimed at supporting the process of preparation of state budgets. This should include the improvement of the macroeconomic analysis and governance of the state treasury system. The WB equally supports a project to improve the analysis of the "economic impacts of legislation" and a WB judicial expert recently joined the Ministry of Justice. The US Treasury advised the MOF in 2000-2001 for the introduction of functional budgeting and programme budgeting techniques, including through a pilot application in co-operation with the Ministry of Education. European Commission also helps with project grants and "twinning operations" between the Slovak Government and the fiscal authorities of other European Union Member countries. Finally, the International Monetary Fund (IMF) initiated recently a "Public Expenditure Review" for the Slovak Republic.
14. Social security contributions will be reduced from 50.8 to 46.5 per cent of total wage costs as of January 2004. Further cuts will be needed in the future to reduce the high unemployment rate. Both labour tax wedges and labour supply-demand imbalances are largest of the low end of the labour market and need to be urgently addressed (see Chapters Iand IV).
15. Partly hidden in Slovakia because of the off-budget payment arrears in the hospital sector, which are periodically "cleaned" by the government. These arrears reached 1.5 per cent of GDP in 2002 alone.
16. Among Czech Republic, Hungary, Poland, Slovakia and Slovenia.
17. The old-age dependency ratio is at present around 15-16 per cent against more than 20 per cent in other post-transition countries.

18. The country has a small size and no natural obstacles fragment the territory. Should transportation shortcomings be remedied, eastern regions could rapidly be fully integrated in the national economy and share its attractiveness as an investment location in Central Europe. Latest investor surveys confirm the discouraging impact of the transportation bottlenecks.
19. The health status of the population depends only partially on the quality of health services. It is equally influenced by factors such as income levels, education, nutrition, working conditions, etc.
20. World Bank monograph, 2002.
21. In the ESA-95 methodology and excluding bank restructuring costs. The deficit was planned to decrease from 4.7 to 3.3 per cent of GDP with bank restructuring costs.
22. According to a recent assessment of the road infrastructure by the World Bank "undermaintenance is eating away at the stock of transport infrastructure". To correct the current backlog in maintenance and to adapt capacities in both basic and high standard network would require a 2.3 fold increase in funding. The world Bank estimates that this situation is "unsustainable in anything more than the very short term".
23. See OECD *Economic Surveys of Slovakia*, 1996, 1999.
24. Specific chapters are created for state treasury and debt, these can be exceeded if financial circumstances require it.
25. Information by the State Audit Office.
26. Social security spending is subject to the largest overruns, notably in the health area. Health insurance funds clear their fiscal projections with the Ministry of Health, but unbudgeted cost increases, unfunded pharmaceutical bills and ex-post deficits of hospitals have became common.
27. Expenditures in the electoral year 2002 were massively exceeded by pension and wage increases voted in the course of the year.
28. In 2003, the government could use part of its limited privatisation revenues to reduce debt.
29. "Old environmental burdens" (OEB) were estimated to reach SKK 21 billion, or around 2 per cent of GDP, by the Ministry of Environment, of which SKK 12 billion for contaminated territories and SKK 0.34 billion for the sanitation of former Soviet military bases. There are also other higher estimates of environmental commitments (see section below on Sustainable Development).
30. The parameters of the pension system are not stabilised and make the calculation of pension liabilities hazardous (see below).
31. These guidelines were based on the US and European experiences with functional budgeting and on the advice given by these countries' budgetary authorities.
32. Including the Ministry of Education, the Supreme Court and the Academy of Sciences.
33. This scheme requires tariff increases of 40 per cent in residential electricity and of more than 100 per cent in residential gas. Because of the expected impact on inflation and real incomes (administered prices account for nearly 20 per cent in the consumer basket) a gradual adjustment paths is planned.
34. In exchange of the lump sum subsidies received ZSR committed to stop all informal borrowing and arrear-building, and to close 25 regional lines. It is early to tell if outcomes are conforming the terms of the agreement – as loopholes remain numerous in the railway system.

35. High risk guarantees will be conservatively reported at 100 per cent of face value.
36. See Diamond (2002).
37. Sub-central governments obtain only a very limited share of total tax revenues. This share amounted to only 5 per cent for municipalities in 2001.
38. As they do in many Slovak regions.
39. Over-reliance on central government grants may shift the focus of sub-central government actions on negotiating and bargaining for additional subsidies rather than achieving savings. The problem is frequently faced in countries using earmarked grants based on ex-post actual costs to fund local public services, notably in health, education and employment assistance areas, such as Ireland, Switzerland and until recently Italy (see Joumard and Kongsrud, 2003).
40. There is mounting evidence of arrears accumulation and unauthorised debts in the education and health sectors in 2002 and 2003, when the governance of these sectors has remained in a limbo between central, regional and local governments. Political pressures to re-open the 25 loss-making local railway lines, often mediated by regional authorities, have also intensified during the same period.
41. This is best illustrated by the transportation and communication links between Northern Hungary and Southern Slovakia which remain very weak. The first region is labour-constrained while the second suffers high unemployment. Their labour markets are not integrated and interregional mobility is low. Policy coordination for road infrastructures and labour market schemes could enhance regional welfare.
42. A senior official from the Ministry of Interior in charge of staff reductions reported that the latest amendment to the Civil Service Act creates new bureaucratic obstacles to layoffs because each case has to be consulted with the Civil Service Office.
43. The decentralisation reform in the Czech Republic is faced with the same problem.
44. In the absence of consensus with teachers' unions, the concept of a performance-based pay system for primary and secondary school teachers was abandoned in 2003. Tertiary education teachers and their institutions have been given a choice between classical and performance-based pay systems.
45. OECD, *Education at a Glance*, 2003.
46. A recent OECD assistance programme for the introduction of Internal Financial Control Systems in Slovak public administration stressed the need for re-training: "Many of our recommendations, if implemented, would represent further complex and significant changes to current working practices…In principle, a budgetary organisation will need an accounting system with much the same capabilities as a medium-sized business company… The accounting system will not only be a system for financial control but also an important tool for the management of the budgetary organisation." Need for re-training was also underlined for fighting fraud: "There is very little experience to effectively investigate fraud. Attention is to be given to adequately resourcing investigation teams and to have them provided with appropriate training" (OECD, 2003f).
47. The Central Bank recently issued a warning on the excessively optimistic character of the projections associated with the pension reform.
48. Part of recent privatisation revenues, amounting to 6 per cent of GDP, have been set aside to finance this reform. Reserve needs are larger, however, as more than 1 per cent of GDP will be diverted away every year during a 20-30 years transition period.

49. Two of these three acts have already been passed. The one which will re-define the universal benefit package is in the inter-ministerial review process and is expected to be voted on early 2004.
50. Competition in social health insurance markets has not delivered the intended cost improvements for a range of reasons. Notably, insurers, even if they are allowed to do so, have not engaged in selective contracting with providers or negotiated with them improvements in quality or better managing of care, particularly in countries where historically insurers had an obligation to contract with all providers.
51. This process will be further accelerated by the integration with the EU markets in pharmaceuticals, medical equipment and health professionals. A recent estimation of the prospective fiscal cost of wage and price equilibration in the health sector projected sizeable spending pressures from this process in the neighbouring Czech Republic. See OECD *Economic Survey of the Czech Republic*, 2003.
52. Recent surveys on perceptions of corruption by the business sector are available on the website of the Slovak chapter of Transparency International (*www.transparency.sk*).
53. In contrast, the Czech authorities appear to have been more successful to date in their combat with economic crime. A number of former high-level officials, including a former Minister of Finance, were convicted. Although both countries share high levels of corruption, the Czech legal system appears to be more robust in terms of the quality of legislation and enforcement. This may well result from the lack of a genuine legal tradition in Slovakia prior to the split of the Czech and Slovak Federal Republic at the end of 2002; until then, Czech and Slovak jurisprudence was mostly Prague-centred. The most experienced law-enforcement authorities were also based in the Czech part of the former Federation.
54. To improve the situation, the government hired 400 officials in 2003 to process routine court cases and another 200 are to be employed in 2004.
55. The government has prepared legislation to streamline appeals procedures that should become effective within a year.
56. One recent manifestation is the relatively low proportion of Slovak adults (36 per cent) who believe that the planned conflict-of-interest legislation should also apply to regional governments (*www.transparency.sk*).
57. According to the research commissioned by Transparency International Slovensko, foreign-invested corporations introduce higher standards of business ethics to Slovakia than those prevailing among domestic firms. Such demonstration effects are valuable. They are likely to be reinforced by the declining relevance of one-off "games" such as privatisation and the growing influence of repeated "games" such as continuous business activity where the mutual adherence to rules is associated with positive payoffs. See "Ako vnímajú korupciu podnikatelia", Hospodárske noviny, 27 August 2003.
58. The new regime ought to liberate the Commercial Register staff from the time-consuming burden of examining the material substance of the documents submitted, enabling them to focus instead on procedural aspects of the registration process. This implies that the market actors engaging in transactions with the newly registered firms will incur the costs of collecting information on the background of new entrants.
59. See the discussion of vulnerable jobs and the related methodological note in Chapter I.
60. See the interview with the Minister of Justice, Trend, 3 July 2003.

61. This framework is based mainly on the legislation that entails a simplification of ownership transactions (Act 175/1999), investment incentives similar to those in neighbouring countries (Act 565/2001), tax relief (Act 366/1999), job creation and retraining subsidies (amendments to Act 387/1996), support for industrial parks (Act 193/2001), and state aid (Act 434/2001).

62. In addition to SE, the group of strategic companies include entities partly sold to strategic investors (Slovak Gas Company, Transpetrol, Slovak Telecom, Slovak Insurance Company, Slovak Savings Bank) as well as fully state-owned entities (Slovak Water Company, Slovak Post, Slovak Railways and State Forest Enterprises) and state-controlled regional bus operators. The government decided recently to privatise strategic firms on a case-by-case basis, reserving the right to sell all shares. The relevant amendment to the Strategic Companies Act is yet to be approved by Parliament.

63. See Bella and Durkovic (2003) for a detailed discussion. See also "Dispute Between Slovak Telecom and eTel Continues", ISI News, August 2003.

64. See "Ability of Telecommunications Office to Use its New Powers Doubted", ISI News, September 2003.

65. In July 2002, the Telecommunication Office of the Slovak Republic granted Profinet.sk (an internet service provider) a GSM and UMTS license, after it was the only bidder for the combined GSM/UMTS license and thereby becoming the third mobile operator in the country. However, in September 2002 both the GSM and UMTS licenses were revoked as Profinet.sk failed to come up with the first installment of the license fee in time.

66. With an annual consumption of more than 40 GWh.

67. As of 30 June 2003.

68. Actually, some households have apparently experienced large price increases along with deteriorating service standards. The plight of consumers dealing with monopolistic energy distributors has often been described in the Slovak daily press. See *e.g.* "Energetika zostáva monopolom", H*ospodárske noviny*, 7 May 2003.

69. This persuasion by the competition authority was successful in the case of the power industry where the transmission grid was split from the dominant generator and controlling stakes in regional distributors sold to different strategic investors. However, the gas utility (SPP) was privatised as a whole.

70. For instance, this highest court of appeal reversed in June 2003 a competition authority decision detecting an abuse of dominant position by the incumbent telephone operator (ST).

71. This distribution is based on NBS statistics pertaining to newly drawn loans in the non-financial business sector for the first 4 months of 2003. No comparable data are available for earlier periods.

72. For details of the loan programme schemes see National Agency for Development of Small and Medium Enterprises (2002), pp. 46-7.

73. The completion of this project has been time consuming because of consultations and co-operation between existing supervisory authorities.

74. Kontinuita had 5 per cent of the life insurance market in June 2003.

75. The maximum compensation awarded to a car accident victim in Slovakia last year was about 4 times higher than the maximum amounts awarded by courts in Germany or the

United Kingdom, 10 times higher than the maximum amount in Spain and more than 20 times higher than in the Czech Republic. See Trend, 12 June 2003.

76. As of 30 June 2003.
77. In no-fault auto insurance regimes, there is no fault assigned in the case of an accident. The drivers involved submit claims to their own insurance companies and receive immediate compensation from them without any involvement of lawyers, courts and judges. Interpretable damages (pain, emotional distress, etc.) are usually not covered while compensation for injuries is restricted by pre-determined limits. No-fault auto insurance regimes are operated in some states of the US and British Columbia in Canada.
78. The mandatory buyout price cannot be less than the average stock value during the last 6 months preceding the takeover. In the Slovnaft case, the average share value was boosted from SKK 1 093 to SKK 1 379 by a single transaction taking place five days before MOL bought the majority stake. MOL asked Financial Market Authority for the approval of the takeover bid with the price of SKK 1 200 per share; this offer was rejected by the Financial Markets Authority. MOL subsequently asked Financial Market Authority for the approval of the takeover bid with the price of SKK 1 379 and this offer was accepted on 29 October 2003. However, MOL had not initiated the approved takeover bid by December 2003.
79. "Conservative", "Balanced" and "Growth-Oriented" pension funds are distinguished. Funds with higher risks will only be accessible to contributors with a long-term investment horizon, *i.e.* those remote from retirement. Persons near retirement will be allowed to invest in the safest instruments only.
80. Rather than creating a new and necessarily less experienced authority.
81. The previous OECD *Economic Survey of the Slovak Republic* (2002) included a special chapter on the labour market, focussing on high unemployment and the development of human capital.
82. The same ratio in other OECD countries with large government sectors amounts to 14.5 per cent in Spain, 16 per cent in Italy, 18 per cent in Portugal and 18 per cent in Belgium, all below Slovakia. France has a slightly higher ratio at 23 per cent.
83. The share of disability benefit recipients in the working-age population observed in Slovakia exceeds the comparable proportion in the Czech Republic, a country with similar rules, by 3½ percentage points.
84. The Slovak authorities now require at least one verified job application in the two-week reporting period. Many small businesses have reportedly reacted to the influx of unemployed job seekers by refusing to accept their job applications to reduce processing costs; others have started to provide bogus attestations in exchange for illegal side-payments.
85. According to a report prepared by the Trexima company (*www.trexima.sk*) for the Ministry of Labour, Social Affairs and Family, the share of the minimum-wage earners in the final quarter of 2002 ranged from 0.8 per cent in the Bratislava region to 1.5 per cent in the Presov and Trnava regions.
86. 2 per cent of households live in apartments that are subject to rent regulation.
87. See "Informácia o nákladoch na dopravu a ich vplyv na flexibilitu pracovného trhu a územnú mobilitu pracovnej sily" 25.03.2002, *www.employment.gov.sk*.
88. The insufficient capacity of Slovak universities has resulted in growing enrolment of Slovak students in academic programmes available in the neighbouring countries, especially in the Czech Republic. The 1999 bilateral treaty has provided Slovak citi-

zens with non-discriminatory access to Czech universities, which means that they do not pay any tuition fees. Given the absence of a serious language barrier, this has resulted in a rapidly growing number of Slovak university students in the Czech Republic. Improving business environment conditions could motivate many of these students to return home after graduation. In the past, many Slovak graduates found employment in the Czech Republic, taking advantage of the 1993 labour market treaty that provides free access for Slovaks to the Czech job market and *vice versa*.

89. Unfortunately, Slovakia did not participate in the 2000 student performance assessment in 28 OECD countries so that there are no reliable comparative data on the quality of its education system. Results of the 2003 comparative assessment of the OECD countries, including Slovakia, are not available yet.
90. Many Roma have been scholarised in primary education institutions specialised in the education of children with difficulties.
91. See Ministry of Environment (2001).
92. Air pollution issues in the Slovak Republic are discussed in greater detail in OECD (2002a).
93. For example, the cost of air pollution in the EU countries was estimated to be as high as 5 per cent of GDP in the early 1990s.
94. UNECE (United Nations Economic Council for Europe) is the secretariat for the Convention on Long-Range Transboundary Air Pollution. It addressed some environmental problems of the UNECE region and has been extended by eight protocols which identify specific obligations or measures to be taken by Parties and so lays down the general principles of international cooperation for air pollution abatement.
95. Directive "Euro III" No. 98/70 of 2000.
96. This degradation of the fiscal position relates to pensions only. Ageing will put additional pressure on public finances because of increasing health care expenditure.
97. New benefit formula based on "personal wage development points" reflecting the ratio of the employee's wage to the average wage during the contribution history will tighten the link between benefits and contributions.
98. In an early estimation based on simplifying assumptions, the Ministry of Labour and Social Affairs calculated that once the new benefit calculation system becomes fully applicable, up to 4 per cent of retiring men and up to 18 of retiring women may fall in the social safety net and qualify for additional social transfers.
99. Even the increase in pensions by 6 per cent for an additional year of work would not suffice to offset the costs of foregoing pensions for one year and paying contributions at the rate of 28 per cent.

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BASIC STATISTICS OF THE SLOVAK REPUBLIC (2002)

THE LAND

Area (sq.km)	49 035	Inhabitants in major cities (end-2001)	
Agricultural area (sq. km)	24 440	Bratislava	428 094
		Kosice	236 036
		Presov	92 720
		Nitra	87 308

THE PEOPLE

Population (thousands)	5 379
Inhabitants per sq. km	110
Average annual population growth (1990-2002, per cent)	0.1
Infant mortality (per thousand live-births, 2000)	8.6
Life expectancy (2000) : Males	69.2
Females	77.4
Registered unemployment, % of the labour force	18.0
LFS unemployment, % of the labour force	18.5
Employees (thousands, Labour Force Survey)	2 127

PRODUCTION

GDP (billion SKK)	1 096.4
GDP per capita (in US$, market exchange rate)	4 406
Gross domestic investment (% of GDP)	29.8

THE GOVERNMENT

		Composition of the National Council of the Slovak Republic (elections of September 2002):	
Per cent of GDP			
General government revenue	43.6	Movement for a Democratic Slovakia	35
General government expenditure	50.8	Slovak Democratic and Christian Union	27
Public debt	38.2	SMER	24
Official foreign debt of the government		Hungarian Coalition Party	20
and the National Bank of Slovakia	15.3	Christian Democrat movement	15
		Alliance of New Citizen	14
		Communist Party of Slovakia	11

FOREIGN TRADE

Exports of goods and services, % of GDP	71.8	Imports of goods and services, % of GDP	78.9
Main exports of goods, % of total		Main imports of goods, % of total	
Machinery and transport equipment	39.6	Machinery and transport equipment	38.2
Manufactured products	41.0	Manufactured products	28.8
Chemical products	6.9	Chemical products	10.7
Others	12.5	Others	22.3

THE CURRENCY

Monetary unit: Slovak Koruna	
Currency units per US dollar (period average)	
Year 2002	45.3
December 2003	33.5

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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The economic situation and policies of The Slovak Republic were reviewed by the Committee on 24 November 2003. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 16 December 2003.

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The Secretariat's draft report was prepared for the Committee by Rauf Gönenç, Peter Walkenhorst and Jaromir Cekota under the supervision of Yutaka Imai.

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The previous Survey of The Slovak Republic was issued in June 2002.