A WORLD BANK COUNTRY STUDY

Slovak Republic

A Strategy for Growth and European Integration

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ABSTRACT

This Country Study is based on the findings of missions that visited the Slovak Republic in December 1996, and January 1997. The report analyzes the main economic developments of the past few years and the challenges faced by the country in its EU accession quest, including the ability to take on the obligations of membership, which implies full compliance with the *acquis communautaire*--the set of rules and regulations applicable to all Member States.

The teams that traveled to the Slovak Republic were led by Roberto Rocha (task manager) and included Robert E. Anderson (enterprise sector), Emily Andrews (social sectors), Stanislas Balcerac (capital markets), Tito Boeri (labor markets), Bruce Courtney (macroeconomics), Marinela Dado (enterprise sector and bank performance), Simeon Djankov (enterprise sector), Martin Herman (agricultural sector), Bernard Hoekman (foreign trade), Christian Kirchner (legal framework for enterprises and capital markets), Philipe Lefevre (legal framework for banking operations), Albert Martinez (financial sector), Katarina Mathernova (general legal framework), Witold Orlowski (agricultural sector and macroeconomics), Helmut Schreiber (environment), Patrick Wiese (pensions), and Juan Zalduendo (macroeconomics). Burcak Inel contributed to the capital markets section. Sandeep Mahajan provided research assistance. The report was processed by Andrea Toth.

The Acting Director of the Department was Hans Apitz, the Lead Economist was Luca Barbone, and the Division Chief was Michel Noël. Alan Winters and Nemat Shafik were the peer reviewers.

CURRENCY AND EQUIVALENT UNITS

Currency Unit = Koruny

	1992	1993	1994	1995	1996
US$1 =	28.3	30.8	32.1	29.7	30.7

ACRONYMS AND ABBREVIATIONS

ALMP	Active labor market policies
BAT	Best available techniques
BATNEEC	Best available technology not entailing excessive costs
BOD	Biological oxygen demand
BOE	Bratislava Options Exchange
BSE	Bratislava Stock Exchange
CAP	Common Agricultural Policy
CAR	Capital adequacy ratio
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
CET	Common External Tariff
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
CO_2	Carbon dioxide
CPI	Consumer price index
CSOB	Foreign Trade Bank
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECU	European currency unit
EF	Environmental Fund
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign direct investment
FGDs	Flue gas desulphurization units
GATS	General Agreement on Trade in Services
GDP	Gross domestic product
GNFS	Goods and non-factor services
IAS	International accounting standards
ICOR	Incremental capital-output ratio
IEF	Index of Economic Freedom
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
IPPC	Integrated pollution prevention and control
IRB	Investicna Rozvojova Banka
KB	Konsolidacna Banka
LFS	Labor Force Survey

Acronyms and abbreviations (cont'd)

LR	Listing Requirements
LTU	Long-term unemployment
MFN	Most-favored nation
MOE	Ministry of Environment
MOF	Ministry of Finance
MOL	Ministry of Labor and Social Affairs
MWth	Megawatt hours thermal
NBS	National Bank of Slovakia
NFA	Net foreign assets
NLO	National Labor Office
NO_x	Nitrogen oxide
NPF	National Property Fund
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-as-you-go
PES	Public Employment Service
PM	Particulate matter
PPI	Producer price index
PPP	Purchasing power parity
PSE	Producer subsidy equivalent
PUJ	Publicly useful jobs
RCA	Revealed comparative advantage
REF	Revolving Environmental Fund
SEF	State Environmental Fund
SFMR	State Fund for Market Regulation
SGB	Slovak Guarantee Bank
SIC	Social Insurance Company
SITC	Standard international trade classification
SLF	Slovak Land Fund
SLPF	State Land Protection Fund
SLSP	Slovenska Sporitel'na
SO_2	Sulphur oxide
SOB	State-owned bank
SOE	State-owned enterprise
SPJ	Socially purposeful jobs
SRO	Self-regulatory organization
SSFAA	State Support Fund for Agriculture and Agroindustries
TR	Turnover ratio
UCITS	Undertakings for collective investment in Ttansferable securities
VAT	Value added tax
VUB	Vseobecna Uverova Banka
WTO	World Trade Organization

Fiscal Year
January 1 - December 31

EXECUTIVE SUMMARY

An Overview of Macroeconomic Performance After Independence

The Slovak Republic has registered one of the best macroeconomic performances in Central Europe since its independence from the Czechoslovak Federation in 1993. Inflation has declined steadily to around 6 percent p.a., and is currently one of the lowest among transition economies. Real GDP has grown by more than 6 percent p.a. on average, one of the best growth performances in the region. The recovery has been driven by the private sector, which increased its participation in GDP to around 80 percent, and has been accompanied by a reduction in the rate of unemployment--from a peak of 14 percent in 1994 to around 12 percent more recently. The ratio of gross fixed investment to GDP has been maintained above 30 percent--the highest in Central and Eastern Europe--raising prospects of further capital accumulation and growth.

The success in reducing inflation to one-digit levels was due to the stabilization package implemented at the time of independence, which included a fixed exchange rate, a very strict fiscal policy, and moderate wage increases. The extent of fiscal support to the exchange rate anchor is revealed by the 12 percent improvement in the General Government budget between 1992 and 1995. This impressive fiscal adjustment was achieved primarily through expenditure cuts, leading to a sharp decline in the ratio of expenditures to GDP--from 58 to 47 percent between 1992 and 1995. This contraction in expenditures more than offset the loss of transfers from the Czechoslovak Federation--7 percent of GDP--and resulted in a small fiscal surplus of 0.1 percent of GDP in 1995.

The fiscal contraction did not prevent the economy from recovering, as it was more than offset by a significant growth of exports and fixed investment. Exports in US dollars grew by 25 percent p.a. in 1994 and 1995, driving GDP growth in those two years. The strong export performance was due to the very competitive levels of the exchange rate at the time of independence, the strong output activity in foreign markets, and initial progress at enterprise restructuring. Fixed investment replaced exports as the main source of GDP growth in 1996, increasing its share in GDP to an impressive 36 percent.

The main question faced by Slovak policy-makers is whether this impressive growth performance can be sustained. The report argues that the answer to this question is positive, provided that the Government is able to meet two conditions. The first is the elimination of the severe external imbalances that emerged in 1996. The second is the completion of the structural reforms initiated in the early 1990s. More specifically, the challenge faced by the Slovak Republic is to reverse the recent deterioration in the current account, which shifted from a surplus of 2 percent of GDP in 1995 to a deficit of 11 percent of GDP in 1996, while continuing the process of enterprise restructuring and strengthening the Slovak Republic's financial system. The central argument of the Country Study is that restoring current account sustainability would imply reducing the ratio of investment to GDP, but the adverse impact of such a reduction on the Slovak Republic's growth performance could be offset by the efficiency gains that would result from further progress in structural reform.

The dramatic deterioration of the current account was due to a slowdown in the growth of exports combined with a buoyant, 25 percent increase in imports. The export slowdown was partly due to cyclical factors (slower output growth in the EU) and partly to structural factors (decline in exports to the Czech Republic, reflecting the disruption of traditional commercial links). The large imports were partly due to one-time factors, such as imports of military equipment and very large imports of small cars (triggered by a temporary and pre-announced reduction in tariffs). However, these factors are not sufficient to explain the large imports and the large external deficit.

In examining other factors, it is natural to investigate the situation in the public finances, as large external imbalances are frequently associated with fiscal imbalances. However, the strong growth in domestic demand and imports during 1996 were not related to strong fiscal pressures--the fiscal deterioration was mild (1.5 percent of GDP), compared with the current account deterioration (more than 13 percent of GDP). Instead, the external imbalance seems to have been associated primarily with an investment expansion. That could suggest that the external imbalance was not so severe after all, as it was being accompanied by a build-up of future output, exports, and debt repayment capacity. Moreover, the Slovak Republic's external debt to GDP ratios do not look excessive by international comparison, providing some headroom for modernizing imports.

There are, however, a number of other indicators suggesting that the current account deficit is indeed cause for concern, despite having been due primarily to an investment expansion. First, current account deficits of more than 10 percent of GDP can hardly be sustained for a long period, as they would soon result in debt to GDP ratios of above 100 percent, even if all investments were of high return and the Slovak Republic were able to maintain very high growth rates. Second, the persistence of large enterprise losses (8.8 percent of GDP in 1996) and the incomplete restructuring of the banking sector provides an indication that corporate governance is not yet consolidated, and that some inefficient enterprises could have borrowed and invested. Third, more than 80 percent of investment has taken place outside the manufacturing sector, and may not help to develop debt repayment capacity. Fourth, the investment expansion may have been partly due to the privatization rules introduced in 1996, which allowed new owners to offset payments to the National Property Fund (the privatization agency) by investing in the purchased enterprise.

In addition to these microeconomic indications that many investments may not have been optimal, there is also strong evidence that investment and imports were excessively stimulated by a liberal monetary and credit policy during 1995 and the first half of 1996--money and credit grew well in excess of the growth of nominal GDP during this period. Finally, the real appreciation that resulted from the use of the exchange rate as a nominal anchor may have also contributed to the current account deterioration during this period.

The clearest indication that private agents had changed their perceptions about the sustainability of the external situation happened in May 1997, when the Slovak crown was subject to a series of speculative attacks, following similar events in other countries with large external deficits, and revealing clearly the need for policy corrections. In response to these adverse developments, the National Bank of Slovakia tightened further monetary policy (a policy initiated in mid-1996), and the Government instituted a 7 percent import surcharge. These measures have generated some improvements in the current account (the deficit should decline to around 7.5 percent of GDP in 1997) and have deflected the speculative attacks, although at the cost of very high real interest rates (around 20 percent p.a. for Government securities) and the introduction of a distortionary trade policy instrument. Moreover, the efforts to generate further improvements in the external accounts have been undermined by the expansionary fiscal policy followed thus far in 1997--despite the introduction of the import surcharge, fiscal policy has shifted to a deficit of more than 4 percent of GDP, partly on account of large investment projects, but also due to low revenues from corporate income and social security taxes.

The report suggests that sustaining growth will require some reduction in investment levels, in order to release the excessive pressures on the current account and avoid financing problems, while making an effort to offset the reduction in investment levels by completing structural reforms and increasing investment efficiency. This strategy is within the reach of Slovak policy-makers. In the macroeconomic area, it requires the central bank's adherence to the tighter monetary policy targets that have been pursued since mid-1996, but also reversing the expansionary fiscal policy adopted in 1997. Although, fiscal policy was not a major cause of the current account deterioration in 1996, it is now making the recent improvement excessively dependent on a restrictive monetary policy and high interest rates and hindering the permanent adjustment which is needed in the external accounts. Reversing the fiscal expansion in 1997 will require, inter alia, a smoother implementation of the ambitious public investment program, containing the growth of real wages in the public sector, avoiding excessive increases in pension benefits, and strengthening tax compliance.

In addition to a return to fiscal discipline, the Government should also avoid the policies that could have led to artificially high levels of investment or to excessive foreign borrowings by enterprises. These would include abstaining from making excessively generous concessions in future privatizations (such as the cancellation of payments in exchange for additional investment), abstaining from making special temporary tariff concessions in the purchase of small cars or any other investment/consumption item, and ensuring that foreign creditors are not extending credits to enterprises on the expectation of guarantees by the National Property Fund or the Government.

In the structural area, there is a variety of issues to be addressed, two of which merit special attention, namely, the persistence of loss-making activities at the level of enterprises, and the large volume of classified loans held by the major banks. Whereas the Slovak Republic has a group of very efficient and profitable enterprises, capable of generating a high ratio of profits to GDP (14 percent in 1996), it also has a relatively large group of inefficient enterprises, as indicated by gross losses of 8.8 percent of GDP in 1996. The weak financial situation of this group of enterprises is reflected in the balance sheet of major banks (most of which remain State-owned), as indicated by the large stock of classified loans held by these banks--18 percent of GDP, of which more than 5 percent of GDP in unpaid interests. These figures suggest that there is still a significant drainage of scarce resources by inefficient firms, and lingering problems in financial intermediation. They also suggest that, removing these structural bottlenecks, and solving other institutional and regulatory problems, could yield significant efficiency gains, and allow the Slovak Republic to maintain growth performance with somewhat lower investment ratios and a sustainable current account.

The Slovak Republic faces the dual challenge of sustaining the impressive growth performance achieved after independence, while preparing the economy for EU accession. The report stresses that these two objectives are closely intertwined, as the measures required to eliminate large macroeconomic imbalances, increase microeconomic efficiency, and sustain growth, would coincide to a large extent with the economic requirements for EU accession. Although the Slovak Republic has already made substantial progress in transforming its economy and approximating its legal framework to EU legislation, the reform agenda has not been fully implemented yet. The report aims at contributing to the Slovak Republic's efforts to meet the dual challenges successfully, by identifying the problems that remain in several sectors of the economy, and providing recommendations for further gains in efficiency.

This Country Study is structured as follows. Chapter I reviews the Slovak Republic's macroeconomic performance after independence and sets the stage for the rest of the report. This is followed by a chapter on trade performance and trade policies in the light of increasing integration with the EU. Chapters III and IV cover the enterprise and financial sectors, respectively, and identify the measures that would reduce loss-making activities and improve financial intermediation. The next chapter examines the performance of the agriculture sector after independence, and identifies the measures required to increase productivity in the sector. Chapter VI analyzes the current situation in the labor market, and assesses the effectiveness of labor market policies and social programs. Chapter VII assesses the recent improvements in the environment, after 40 years of neglect under the former economic regime, and examines the policies and investments that would enable the Slovak Republic to meet EU standards. Finally, the last chapter summarizes the main findings and recommendations of the report, and proposes a framework for sustained growth that would allow the Slovak Republic to converge to the EU's income levels in a reasonable period of time. The main findings of Chapters II through VIII are summarized below.

Trade Developments and Trade Policy

Chapter II examines the Slovak Republic's recent trade performance and makes an evaluation of current trade policies vis-à-vis the EU. The chapter points out that the Slovak Republic is an open economy, with total exports and imports of goods accounting together for more than 100 percent of GDP, and that there has been a reorientation of trade since independence, away from traditional CMEA markets and towards the EU. The chapter also notes that the structure of exports has been changing, and the number of new products exported provides an indication of the underlying dynamism of exports. However, the chapter also notes that these goods are not yet contributing significantly to total exports, and that the share of the more sophisticated EU markets in total exports is still lower than the other Visegrad countries. The report notes that greater opening to foreign direct investment and partnerships with foreign firms may contribute to faster absorption of modern technology and greater access to new markets.

As to trade policies, the report highlights that the Slovak Republic's import regime is already liberal, as indicated by an average nominal tariff of 8 percent in 1996. The effective tariff burden (measured by the ratio of tariff revenues to imports) is even lower, around 3 percent, reflecting the various preferential trading arrangements. The commitments undertaken under the Europe Agreements stipulate further liberalization of industrial imports from the EU, including the reduction in tariffs and the complete elimination of remaining quota restrictions by the year 2002. The impact of this additional liberalization on imports and on fiscal revenues is likely to be moderate, as protection is already low. Use of other trade restrictions is limited, with non-automatic import licensing being applied to only one significant product--coal. Finally, customs administration is close to being harmonized with EU rules and procedures. However, it must be noted that the Slovak Republic has recently deviated from the open trade policies followed after independence--as mentioned before, in May 1997 the Government introduced a 7 percent import surcharge affecting 80 percent of all imports. The surcharge represents a deviation from the Europe Agreements, and will have to be removed in the near future, implying the need for offsetting policy corrections, particularly in the fiscal area.

The chapter highlights that the Europe Agreement and accession agenda will largely determine the shape of the Slovak Republic's trade policy in the next few years. However, the report also stresses that the Government still faces some policy options during the pre-accession period. These include the transition towards the EU's common external tariff, the implementation of instruments to restrict unfair trade, and the liberalization of trade in services. With respect to the transition path towards adoption of the EU's common external tariff, the report stresses that raising tariffs to EU levels before accession would be economically harmful, by reducing competition from imports and raising prices for consumers. As a result, the best option is to maintain an independent tariff policy until accession, and limit any changes in tariffs to reducing those that are now significantly above the EU's most-favored-nation (MFN) level. With respect to instruments of contingent protection, the report points out that anti-dumping laws have been an inefficient and costly instrument in most countries, that upon accession an anti-dumping law will become redundant, as these instruments will be applied by the European Commission, and that the Slovak Republic will benefit from following a less intrusive policy. The report finally recommends that liberalization in the services area should be extended on an MFN basis, without discriminating against non-EU firms.

Progress in Enterprise Privatization and Restructuring

Chapter III examines the progress that has been achieved at enterprise privatization and restructuring, and also assesses the progress achieved in approximating the legal framework for enterprises with EU legislation. The chapter starts by pointing out that the Slovak Republic has achieved significant progress at privatization, as all small enterprises and more than 50 percent of the original equity portfolio of medium and large enterprises have already been handed to the private sector through two different privatization waves. The combination of privatization and the entry of new private enterprises have increased the share of the private sector in GDP to more than 75 percent. Enterprise governance is also tending to improve, because of the increasing concentration of enterprise ownership. Such a consolidation of ownership is being driven by two factors. First, the second wave has focused on standard sales, as opposed to the coupon privatization employed in the first wave. Second, there has been trading of shares of enterprises and investment funds employed in the first wave, as well as the reconfiguration of these funds into holding companies. These trends have resulted in a larger number of voting shares held by fewer individuals or institutions, instead of the more fragmented ownership structure that followed the first wave of privatization.

The chapter examines progress at enterprise restructuring, and notes the significant progress achieved between the 1993-95 period, as indicated by a 6 percent of GDP reduction in enterprise losses--from 11.5 percent of GDP in 1993 to 5.6 percent of GDP in 1995. Such a reduction can be attributed not only to privatization, but to the initial environment in which enterprises operated. In the macroeconomic area, enterprises faced a situation of fiscal discipline, open trade, a competitive exchange rate, and moderate wage pressures, which created an overall environment of financial discipline and enabled an early export-based recovery. Financial discipline was further strengthened by an overall decline in real bank credits to troubled enterprises. However, the chapter also stresses that the restructuring task is unfinished, as indicated by the increase in enterprise losses to 8.8 percent of GDP in 1996, half of which are in manufacturing. These numbers suggest that the drainage of scarce resources by inefficient enterprises may still be substantial, and that further efforts at restructuring (involving liquidation in many cases) may yield significant efficiency gains to the Slovak economy.

The report recommends that the Government remove the legal and institutional obstacles to further improvements in governance and further progress at enterprise restructuring. More specifically, the government needs to: (i) complete the privatization of the bulk of enterprises that remain in State ownership; (ii) refrain from interfering in the operations of the so-called "essential" or "strategic" enterprises; (iii) adopt more competitive and transparent privatization methods that will encourage the best possible owners (including foreigners) to purchase Slovak enterprises; (iv) refrain from limiting or restricting the transfer of ownership of those enterprises already privatized to new investors, both domestic and foreign, that are likely to have a better strategy for restructuring these enterprises; (v) improve the legal framework, in particular, minority shareholder protection, the bankruptcy system, and accounting standards; and (vi) repeal the 1995 Price Law which opens room for interference in the price system.

This chapter also argues that the above recommendations are superior to any attempt by the Government to manage the restructuring of these enterprises directly. In this regard, the report stresses that the recently enacted Enterprise Revitalization Act, whose objective is to encourage further enterprise restructuring, may fail to accomplish such a desirable goal, because it may involve excessive political interference in a process that should be conducted exclusively by enterprises and their creditors (especially the banks, as the main creditors). Whereas it would be desirable to elaborate a strategy to facilitate the joint restructuring of enterprises and banks loaded with bad loans, the report suggests that this strategy should involve as little direct interference from the Government as possible, and should not harm the development of a legal framework supportive of a market economy. The report stresses that a more effective approach would involve improving the bankruptcy framework, and strengthening the banks' conditions to recognize their losses and work out their bad loans with debtors.

Progress in Financial Sector Reform

Chapter IV examines the progress achieved in reforming the banking sector, developing the capital market, and approximating the regulatory framework for banks and capital market institutions to EU legislation. The chapter starts by examining the structure of the banking sector and noting the significant number of new entries into the sector since 1990, mainly private sector banks with foreign participation. As a result of the new entries, by end-1996 the 25 new private banks accounted for 43 percent of the assets in the banking system, and the 5 remaining State-owned banks accounted for the remaining 57 percent, a marked change in shares relative to the years prior to independence. The Slovak financial system is relatively deep, as indicated by a ratio of broad money to GDP of 70 percent. To enhance confidence in the new banks and improve competition in the retail market (still largely dominated by the State Savings Bank), a deposit guarantee scheme was established in mid-1996, although the impact of this measure cannot be assessed yet, since the State will continue to insure citizens' deposits in the major State banks until the end of 1997.

Despite these positive developments, the report stresses that there is much that the Government can do to deepen reform in the banking sector. For one, the major State banks continue to suffer from a weak financial condition, as indicated by the large stock of classified claims (principal and interest) at mid-1997--Sk117 billion, the equivalent of 21 percent of total balance sheet claims and 18 percent of GDP. The large residual core of loss-makers in the Slovak Republic (as indicated by gross losses of 8.8 percent of GDP in 1996) and the large stock of the banks' classified claims, provide clear evidence of an unfinished restructuring program, and lingering problems in the process of financial intermediation. Also, the report stresses that the banks' lack of assertiveness in handling problem debtors is revealed not only by the large losses and the large stock of classified loans, but also by the very low number of completed bankruptcy and liquidation cases.

The chapter recommends that the Government deepen the reform of the banking sector along three main directions. First, the privatization of State banks should be completed. That includes the privatization of banks still under majority State ownership and the sales of minority shares in the banks that have been partly privatized. Privatization should involve the participation of strategic investors and should exclude large bank debtors. The best approach would be to engage an investment bank and charge this institution with the task of identifying potential buyers, and examining the restructuring that has to take place in order to enable successful privatization. Second, legal, institutional, and taxation issues will have to be addressed, to increase the ability of banks to play a more active role in enterprise restructuring. In particular, deduction of loan loss provisions from the taxable base of banks would enable banks to build provisions faster, and create more room for the restructuring of enterprises. Third, the regulatory and supervisory framework should be further upgraded. In this regard, the chapter provides a detailed analysis of the extent of approximation of the regulatory framework to EU legislation, and the steps that must be taken to achieve full conformity with EU directives in this area.

The chapter ends with an analysis of the performance of capital markets in the Slovak Republic. In particular, the chapter notes that as of end-1996 there were 970 equities and 91 bonds registered with the Bratislava Stock Exchange (BSE). Most of these securities are also registered in the parallel RMS market, which deals mostly with small retail investors and operates as an off-exchange market. The number of registered shares is more than 20 times that of other transition economies, partly the result of the privatization method used by the former Czechoslovak Federation. In sum, the market is fragmented, illiquid, and overburdened with a large number of registered shares that do not fit the profile of a publicly-traded company. The bond market is also plagued by structural deficiencies, resulting in low turnover and a predominance of short maturities. The report stresses that the lack of an independent regulatory and supervisory body aggravates these problems, as it leads to a weak enforcement of regulations, and opens room for politically-driven interventions. Failure to address these issues will hinder the future development of the capital market, and deprive enterprises from a potentially important source of investment finance.

In this framework, the report suggests policy recommendations in three major areas: (i) increasing market transparency by, inter alia, reducing the number of publicly traded firms and implementing strict information disclosure requirements for those firms that remain registered; (ii) developing a strong and independent regulatory and supervisory body; and (iii) introducing targeted legal and regulatory changes aimed at supporting capital market development. That includes introducing adequate protection for minority shareholders, enhancing market transparency and liquidity through the integration of the operations of the BSE and RMS markets, ensuring better quality of disclosed information, and removing regulatory and taxation barriers, as these hinder the development of capital markets and are not consistent with EU accession requirements. As to the insurance sector, the report suggests that much remains to be done to harmonize the Slovak legislation with EU regulations and to prepare it for cross-border competition and future EU integration.

The Agriculture Sector in Transition

Chapter V reviews recent developments in the Slovak Republic's agricultural sector and evaluates alternative policies that could serve to strengthen the sector's competitiveness prior to EU accession. Primary agriculture and food processing represent in the Slovak Republic a relatively small share of total GDP (8.5 percent) and employment (9 percent). There was a sharp deterioration in the agriculture terms of trade, following the price liberalization in the early 1990s, and this shift in relative prices contributed to a 30 percent decline in agricultural output in the early stages of the transition. However, output stabilized in 1995 and even registered a small increase in real terms during 1996. Important for this recovery has been the legal transformation of ownership through the re-establishment of individual rights to land and non-land assets. The deterioration in the terms of trade also induced the Government to introduce minimum price regulations for some commodities in an attempt to soften the impact of the transition. The report stresses, however, that the aggregate level of support to Slovak farmers has declined by more than 50 percent in real terms since 1989, making the producer subsidy equivalent about half as generous as the support extended to EU farmers. While privatization of the food processing industry has been completed, a number of related input industries still have a large share of Government involvement, particularly in fuel production, farm chemicals, and farm equipment.

Despite these transformation efforts and the recent output recovery, the report highlights that more needs to be done to increase productivity of primary agriculture and agroindustry, which remain significantly below the respective EU averages. Any significant increase in the efficiency of primary agriculture will depend on further transformation of cooperatives into profit-oriented farms, and more efforts by new owners to adjust to domestic and foreign competition. Land ownership remains fragmented in cooperatives, although land use is less fragmented, as cooperatives retain about 70 percent of farm land in large contiguous plots and most owners lease land to cooperatives. However, leasing has not eliminated all the problems resulting from fragmented ownership, since most lease contracts have a one-year termination clause and this insecurity of tenure undermines long-term investment plans. There are other obstacles to the development of a land market, such as the exclusion of foreigners from land purchases.

Similarly, many problems in the agroindustry sector linger unsolved, because of fragmented ownership, weak management and the lack of capital.

In this context, it is necessary to consolidate land ownership, resist pressure of various interest groups for protection against foreign competition, refrain from excessive government intervention, and continue to strengthen the business environment. Ownership consolidation is one of the most critical improvements required, as it would allow the more effective exploration of economies of scale, the activation of the land market, and acceptance of land as collateral. The report proposes to give active members of cooperatives more options to buy out land owners. Another possibility is to restructure Government subsidies to support ownership consolidation as a policy objective. Agroindustries are particularly vulnerable to foreign competition and ways to facilitate productivity growth should be considered. For example, the report stresses that large investments are needed to improve logistics in food distribution and to overcome an excessive market fragmentation at the wholesale and retail levels. The chapter also suggests that minimum prices should be gradually reduced and de-linked from production costs. The report recommends that income support payments to disadvantaged areas be gradually modified from a per hectare basis to targeted support programs, such as capital grants for development of rural infrastructure. Access to rural credit should be improved using market-based instruments, such as a warehouse receipt system, and the development of mortgage finance. The report also recognizes that new instruments might need to be introduced to comply with the EU's Common Agricultural Policy (CAP). However, since the CAP is likely to evolve prior to accession taking place, the Government should postpone for the time being the implementation of related policies.

Labor Market and Social Policies

Chapter VI examines the current situation in the labor market, analyzes the status of labor policies and social programs, and identifies the progress in meeting EU accession requirements in the social areas. The chapter starts by reviewing labor market developments since independence, and notes the improvement in labor market conditions after three years of strong economic growth, as indicated by the decline in the rate of unemployment, from 14 percent in 1993 to around 12 percent in 1996. Despite the decline in unemployment, however, the problem of long-term unemployment has worsened further--the share of the unemployed out of work for more than one year increased from about 40 percent in 1994 to more than 50 percent in the first three quarters of 1996. The persistence of substantial regional differences in unemployment rates is also worrisome--unemployment rates ranged from 4 to 24 percent, and vacancies reported to the labor exchanges continue to be concentrated in low unemployment regions, revealing the low degree of labor mobility.

A considerable effort is being made to adjust the regulatory framework to EU accession requirements. The effort has included the introduction of regulations on collective redundancies providing for advanced notification of planned dismissals, the introduction of a guarantee fund to pay employees in case of employer insolvency, and a law on occupational safety. In addition, provisions on health and safety in the workplace, equal employment opportunity, working time, and consultation of employees in Community-scale undertakings, are contained in the draft Labor Code, which the Slovak authorities hope to have approved by Parliament in 1998.

While recognizing the effort at approximation with the EU, the chapter recommends that the Slovaks avoid introducing measures that are not really required for EU accession, and that could prove detrimental to the creation of jobs. For example, there are no proposals to exempt small employers from some of the more rigid restrictions contained in the labor code, such as the obligation to reinstate workers who have been unfairly dismissed. Such exemptions are usually granted in EU countries. As small and medium-sized firms represent the engine of employment growth, it would be highly undesirable to hinder their expansion. The report also points to the need to increase the scope for decentralized bargaining (also the current trend in the EU), in order to ensure a greater adjustment of real wages to productivity and local conditions. Another impediment to a successful labor market lies in the resistance of employers to high payroll taxes, which in the Slovak Republic amount to 50 percent of gross wages, whereas the average contribution rate for the EU countries is 36 percent.

The chapter reviews the status of unemployment benefits and recommends greater coordination between unemployment insurance and social assistance, in order to restrict the possibility of multiple recipiency of benefits and the resulting work disincentives. The chapter also recommends stricter enforcement of job search and availability-to-work tests for individuals receiving social assistance, in order to enhance incentives to work. The chapter indicates the very large size of the Slovak Republic's active labor market programs (participants amounted to almost 5 percent of the labor force in 1995), noting that programs of this size are only found in Sweden, and that some of these programs (e.g. employment subsidies) have not proven to be effective.

The social chapter proceeds to evaluate the performance of Slovak social insurance programs. It notes that if the Government avoids excessive increases in pension benefits and tax evasion does not occur, pension fund deficits should not occur in the next few years. However, the report also notes that contribution rates are excessively high--27 percent of gross wages--with adverse effects on the labor market. In addition, these high contribution rates are not enough to make the system sustainable in the long-run. By the end of the next decade the pension system will run deficits, and these deficits are projected to increase to 6 percent of GDP by 2050. The chapter recommends a reform package that would allow the Slovak Republic to restore long-run balance and reduce contribution rates by 6.5 percent points, in line with the European average. The recommendations include the elimination of early retirement, the phase-out of partial disability pensions, the switch from wage indexation to a Swiss formula (comprising wages and prices with equal weights), and the gradual increase in retirement age to 65 for both men and women, in line with those of Western Europe.

The chapter also provides a number of recommendations that would improve the cost-effectiveness of social insurance and assistance programs. The recommendations include the transfer of initial responsibility for sick leave from social insurance to the employer, and the introduction of more stringent medical conditions for the granting of sick leave. In the case of maternity benefits, the chapter recommends a reduction of the six month period of paid maternity leave for small firms, as the costs of hiring and training replacement employees are relatively higher for these firms. The chapter ends with an evaluation of social assistance programs, noting that the bulk of payments are directed towards families with children, and that the focus of reform should rest in this area. The chapter suggests that child benefits be targeted to the lowest quartile of the income distribution, in order to reduce expenditures while providing a floor of protection. Other recommendations to improve cost-effectiveness and reduce work disincentives include means-testing of allowances for one-earner families, and greater coordination of the various programs to eliminate multiple recipiency of benefits.

Environment and EU Accession

Chapter VII reviews the progress already achieved in improving the environment, examines the implications of EU accession for environmental policy, and presents preliminary estimates of the investments required for compliance with EU requirements in this area. The chapters starts by noting that the amount of pollutants emitted into the air has been substantially reduced since the late 1980s. The resulting improvement in air quality has been due both to the initial contraction of economic activity and to emission reduction measures. Ambient air quality has also improved in the Slovak Republic since the start of the transition. In addition, 86 percent of waste water is currently discharged to treatment plants, 87 percent of which have biological treatment, and about half of all the households were linked to sewer systems. Produced waste has decreased by close to 30 percent between 1992 and 1995, enabling a reduction in the number of landfill sites.

Notwithstanding these positive developments, much more remains to be done. The improvement in air quality has been very modest since 1995, revealing the difficulties of achieving additional progress in the environment in the context of a growing economy. In fact, the main challenge facing the Slovak environmental authorities is to ensure additional improvements in environmental quality in a scenario of continued economic recovery. Also, the Slovak Republic and other transforming countries are now observing a shift in pollution sources. Heavy industry, which used to be the major cause of pollution, is retrenching and is being overtaken by traffic and chemical waste from a large number of small and medium-sized enterprises. These new sources are far more difficult to control and supervise.

Complying with EU environmental legislation is a challenge faced by all CEE countries, and The Slovak Republic is no exception. The report points out that compliance involves not only legal harmonization issues, but also a strategy that will enable the Slovak Republic to meet EU standards as rapidly and as cost-effectively as feasible. Although there has been significant progress in legal harmonization, there are some areas, such as the Integrated Pollution Prevention and Control directive, where Slovakian law still needs to be modified. This directive represents a shift from a focus on emissions, which involves reliance on end-of-pipe controls, to one on waste minimization, for which clean technologies and good management are usually critical. The country's basic water infrastructure falls short of what would be required by EU directives, since the quality of drinking water often does not meet EU standards. This is not a matter of microbiological contamination which might pose a serious threat to health. Rather, the problem is linked to the presence of minerals and pollutants, either because of the quality of the water source used, or because of the contamination that arises during distribution as a result of neglected infrastructure maintenance. Thus, investments will be required to improve raw water quality, upgrade treatment facilities, and replace parts of the water distribution system. Meeting the directive on urban waste water treatment will require sewer systems with at least secondary treatment of sewage for most villages, towns, and cities with a population equivalent of 2,000 or more.

Preliminary estimates suggest that total investments would amount to around US$5-6 billion, including US$2.5 billion of investments in water, US$1.5-2.5 billion of investments in air quality, and US$0.9 billion of investments in waste management. This would imply annual investments of around US$300 million distributed over a period of 20 years, or approximately 1.5 percent of GDP. These amounts are significantly above the ones prevailing in CEE countries, indicating the need for developing least-cost strategies. Financing environmental projects through Environmental Funds (EF) is suggested by the report. However, these funds are only effective if the environmental problems are simultaneously tackled at the policy level and strong efforts are undertaken to strengthen environmental regulations and enforcement. Although the Slovak Republic has undertaken considerable efforts to set environmental priorities, the report stresses that more work is needed in this area.

A Framework for Growth and EU Accession

Chapter VIII reviews the main recommendations of the report, and proposes a framework for growth and EU accession centered in the completion of structural reforms and the achievement of efficiency gains. The chapter starts by arguing that the very high investment ratios have also been increasingly accompanied by current account deficits financed in a disproportionate amount by increased indebtedness.