Slovakia: A story of reforms.
(Change of the socio-economic model with limited liability)

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Introduction

Since the fall of communism in 1989, Slovakia has experienced an exciting story of new democracy and new independent country that went through very turbulent and often almost contradictory periods. After the first six years of an independent state existence, Slovakia got during the years 1993 - 1998 due to illiberal democracy[1] and inexpertness of Vladimir Meciar's governments into international isolation, it was considered to be "European black hole"[2], was excluded from international integration (OECD, NATO, EU) and implemented an economic policy that in 1998 got the country to the edge of collapse.
After the era of Meciar came the era of Dzurinda, a period of his two governments in the years 1998 – 2006. Economic stabilization, catch up of integration deficit and deep structural reforms that made the country one of the reform and economic leaders in region, were the outcomes of that period. After the 2006 elections, a new government of Robert Fico took over and the program of his dominant political party included cancellation of all the reforms implemented by previous government of Mikulas Dzurinda. However, reality is different and except of health care reform, it has been managed to keep the reforms, even though the fate of some is still uncertain. Objective of this paper is to demonstrate how economic policy and reforms in the period of 1998 – 2006 have changed the socio-economic model in Slovakia and what the outcomes are.
Slovakia is a small open economy. With 5,4 million inhabitants it is the smallest out of so called Visegrad Four (V4) countries (Poland, Czech Republic, Hungary, Slovakia), in economic level Slovakia is approximately at the same level as Hungary (behind Czech Republic and ahead of Poland). GDP portion made by private sector is 91,3 %, high openness is characterized by 157,1 % portion of foreign trade on GDP.

1. Development until 1998 (Meciar´s era)

Slovakia as an independent country was formed after the split of Czechoslovakia on January 1, 1993. Significant handicap was non-existence of experience in state governance and incompetent populist representation that led the country to its independence, even though not very consciously and goal-directed.
Six years of governance of this representation resulted in complicated international-political and economic situation. In the mid of 1990s other countries of V4 joined OECD, admittance of Slovakia was denied. The same happened at discussions about joining NATO. Summit of EU decided in December 1997 to start accession talks with nine new member states, among which Slovakia was not present again. From economic point of view the situation was complicated as well. Economy reached relatively high growth rates (5,4% in average in years 1994 - 1998), however this growth had been reached by unsustainable means. Deficit of current account of balance of payments reached in 1996 – 1998 the average annual level of 9% and deficit of public finance almost 6%. Expansive fiscal policy had to be neutralized by restrictive monetary policy of the Central Bank (that has luckily kept its independence from

[1] Fareed Zakaria, 1997
[2] Statement of Madeleine Albright, at that time U.S. Minister of Foreign Affairs

government), which led to enormous rise in interest rates with all the negative impacts on economy, micro sphere and state debit service.
The principal problem of corruption was not combated by the government on the contrary it had been generated mainly through nontransparent privatization for the benefit of people loyal to the government[3] and through tunneling of companies and banks in state ownership. Companies were not usually restructured and restored (profit seeking behavior) but were heisted (rent seeking behavior) and kept over-employed. This status lasted not only in state owned companies but also in companies privatized for symbolic prices by people close to the government (usually companies´ management).
Implementation of such inner policy and foreign position of Slovakia resulted in economic isolation. Direct foreign investments reached in the years 1993 – 1998 only 6,6 billion USD, which represents 1,6 % GDP, while in Hungary it was 5,4 % and in the Czech Republic 3,1 % GDP for the same period.

2. Era of Dzurinda (1998 – 2006)

The situation changed after 1998 elections, when the first government of Mikulas Dzurinda took over. It was a government of a broad coalition of three right-centered and one left-centered (reformed communist) political parties that chose to catch up the integration lag and stabilization of endangered economy to be its main objective. It successfully completed both objectives. Slovakia joined OECD in 2000, NATO in 2004 and EU together with the rest of V4 countries and other six countries in May 2004.
Government fulfilled its priorities also in economic area. Restructuring, recovery and subsequently privatization of banking sector had been realized. It was a challenging and costly operation. Three major state owned banks that had their portion of almost 50% on assets of all banks, were at the edge of collapse in 1998 – 1999. Their recovery through earmarking of bad debts to state agency cost the state budget almost 12% of GDP. Consequently, based on international tenders, foreign investors (Austrian, German and Italian banks) entered into the recovered banks.
Entry of strategic investors into other so called strategic companies (utilities) such as telecommunication, energy distributing companies, gas company and later during second government of Mikulas Dzurinda also into power plants, was realized as well. Government in more steps raised regulated prices that were until then artificially held on lower than economic level and established an independent regulatory office for network industries that sets the prices of these commodities since 2002[4] independently form government.
A new law on bankruptcy and compensation was adopted and strengthened the rights of creditors, increased financial discipline and created pressure on restructuring of business sphere.
Public finance were partially revitalized, a collection of restrictive measurements that led to establishment of sustainable development had been adopted in May 1999.
Business environment improved, inflow of foreign investments increased, restructuring of business sphere began. However, pressure on over-employment decrease together with specific demographic development[5] led to increase of unemployment.

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[3] It is more than symbolic that in 1994 – 1998 there was only one case of sale to foreign investor despite privatizing more than 400 companies, Source: Mikloš: Privatization in Slovakia, 1998, IVO, Bratislava 1999
[4] Regulated prices reached economic level based on justified expenditures and adequate profit only sine 01.01.2004, in the last stage of deregulation
[5] Entry of strong population from 1970´s into working age

Unemployment rate (based on selective determination) increased from 12,6% in 1998 to 19,2% in 2001, when it culminated and Slovakia had the highest unemployment rate in Europe.

Second government of Mikulas Dzurinda

2002 elections outcome resulted [6] in creation of second government of Mikulas Dzurinda, which was in opposite to the first, more homogeneous in its ideas and programs and allowed realization of ambitious reform process. Government consisted of four right-centered parties and was characterized by high degree of program compatibility in economic area. Government parties agreed mainly in the need to realize such economic policy that would create conditions for high and sustainable economic growth. That should be reached with the help of increased level of economic freedom, revitalized macroeconomic framework (mainly long-term sustainable public finance), improved business environment, realized deep structured reforms, foreign investments and admission to Euro zone. These aims were included in the government program declaration and in principle also fulfilled (but some exceptions[7]).

Main areas of significant changes were these[8]:

1. Macroeconomic framework and public finance reform
2. Tax reform
3. Pension reform
4. Health care reform
5. Social reform and labor market reform
6. Public administration reform and fiscal decentralization
7. Business environment improvement

Fundamentally important area, where the changes were mainly only indicated in MINERVA program that was adopted by government in 2005, was the development of knowledge economy.

2.1. Macroeconomic framework and public finance reform

One of the key conditions of long-term high and sustainable economic growth is healthy macroeconomic environment given not only by sustainable public finance but based on our deep conviction also by increasing of economic freedom level and effective functioning of institutions, mainly institutions of public sector (from government responsibility point of view). Coordination and mutual relations between these conditions and well performed reforms are important as well.
The need of mutual and synchronous harmonization of the following objectives appeared to be a challenging task (mainly from political consequences and risks point of view):

- Increasing the level of economic freedom (by decreasing tax and redistributing level)
- Decreasing public finance deficit and setting up long-term sustainable status
- Realizing deep reforms with uncertain impact on public finances (at least from short-term point of view)
- Improving business environment

[6] For majority of observers surprisingly
[7] Such as partial payments for university studies
[8] In text that follows, the first two areas will be described in more details, since the author of the text as Minister of Finance of the Slovak Republic in years 2002 – 2006 was directly responsible for and the other areas that he as Deputy Prime Minister coordinated, will be described more briefly

That was the reason, why coordination of single reforms, done mainly by Ministry of Finance, was so important. The relationship between macroeconomic framework and reforms is mutual. Without reforms, e.g. in social or health care area, it would not be possible to decrease public expenditures and without macroeconomic revitalizing, the economic growth would be lower and again it would negatively influence public finances. From this point of view, fiscal perspective seems to be the key mirror but also a pressure tool for implementation of necessary changes.
Development of the following indicators is an evidence of the fact that ambitious objective of redistribution decrease and revitalization of public finance at the same time was successfully realized.

Table 1

GDP in %	1998	1999	2000	2001	2002	2003	2004	2005
Public expenditures	45,3	47,2	51,7	43,3	43,3	39,4	38,9	37,1
Tax quota II	35,7	34,3	33,0	31,6	32,0	31,1	30,0	29,5
Balance of public finances[9]	-4,8	-6,4	-11,8	-6,5	-7,7	-3,7	-3,0	-3,1
Gross public debt	34,0	47,2	49,9	49,2	43,3	42,7	41,6	34,5

Source: Eurostat

On hypothetic condition of preserving redistribution level at 1998 level during whole functional period of both Dzurinda´s governments[10] would those have by 400 billion SKK more funds available[11]. Of course, it would be a little less in reality, because higher redistribution and higher taxes would lead to lower economic growth and therefore also to higher expenditures and lower incomes. Nevertheless, this comparison testifies enormous growth of economic freedom together with public finance revitalization in Slovakia, which is a very reasonable investment from economic standpoint, but consequently a relatively risky investment into further economic growth and development from political standpoint.

Big question mark was the reaction of economy on restrictive fiscal policy in 2003 and what would be the secondary impacts of regulatory prices and indirect taxes increase in 2003 – 2004. As it is visible from data in Table 2, despite fiscal restriction in 2003 – 2004, economy was well off. It confirms the experience from other countries that fiscal restriction, if connected with structural reforms and improvement of business environment, does not necessarily have to negatively influence economic growth.

Table 2

in %	2002	2003	2004	2005	2006
GDP growth	4,1	4,2	5,4	6	8,3
Inflation	3,3	8,5	7,5	2,7	4,5
Unemployment rate	18,5	17,4	18,1	16,2	13,3
Employment growth	0,2	1,8	0,3	2,1	3,8
Real labor productivity growth	4,7	2,3	5,8	4,7	6,0

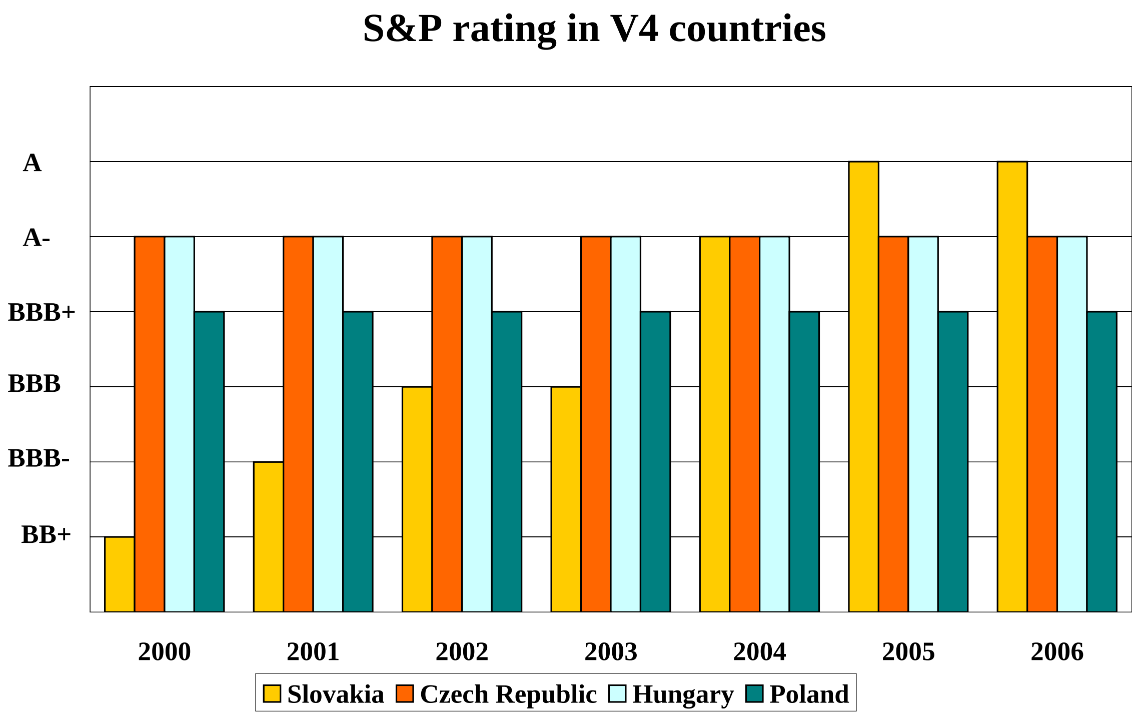
[9] In 2005 without costs of second pillar implementation in pension system
[10] In principle that was reality in other V4 countries
[11] It is a sum approximately equal to average annual public expenditures in given years 1998 - 2005

Current account balance of payments[12]	-7,9	-0,9	-3,4	-8,5	-8,2

Source: Eurostat, Statistical Office of the Slovak Republic, Ministry of Finance of the Slovak Republic

Growth of dynamics in years 2006 – 2007[13] obviously mirrors direct and indirect effects of realized reforms. Important is that high economic growth is reached without significant inflation pressures or unsustainable deficits at current account balance of payments. It is clear that the mix of fiscal, monetary and structural policy was chosen relatively well.
It has been proved also by independent evaluation of rating agencies. While in 2000 Slovakia had definitely the worst rating among all V4 countries, currently Slovakia ranks first in the region.

Graph 1
Long-term rating in foreign currency at the end of the year, S&P



Reform of public finance has brought, from medium-term viewpoint, significant cost-savings in public expenditures. Main objectives of public finance reform in 2002 – 2003 were:

- Transparency of public finance
- Program budgeting and budget for more years
- Improvement of macro economical and fiscal analyses and prognoses
- New budget regulations restricting conditions for use of public resources
- Liquidity concentration into state treasury and professionalization of debt and liquidity management

[12] High deficit of current account in 2005 – 2006 was mainly the result of high investment imports, which are currently reflected into increase of export and also into decrease of current account deficit. In January 2007 export already exceeded import.
[13] In the second half year of 2006 the economy reached growth of 9,7% and prognoses assume another increase of economic growth (more than 10% in the first quarter of 2007)

Implementation of common methodic ESA 95 was the key factor in increasing of public finance transparency. That significantly complicates cover-ups or shifts in deficit reports, which was very common before 2002[14]. ESA 95 methodic enables international comparison of fiscal outcomes and is imbedded in new law on budget regulations, which highlights the deficit of total public finance at accrual basis, while in the past the deficit of public finance at cash basis was crucial. The fact that government completely stopped offering state credit guarantees and eliminated almost all state funds contributed to transparency increase and implementation of tough budget restrictions.

Program budgeting and budget for more years (currently for 3 years) have strengthened strategic planning and effectiveness control of public resource usage. Tough budget restrictions were significantly strengthened as well. In the past, it very often came to uncontrolled indebtedness in some public institutions, mainly in health care, regional education, railroads, radio and television broadcasting[15].

Significant improvement of macro economical analyses and prognoses was reached by strengthening of analytical capacities at the Ministry of Finance, specifically by improving internal but also by involving external capacities. Capacity of Institute of financial policy of Ministry of Finance (IFP), which became central analytical capacity of government for economic area, was strengthened as well. Two committees, Committee for macroeconomic prognoses and Committee for tax prognoses, were founded. Their members are reputable economists and analysts from private and public sector.

Periodic prognoses of IFP (three times a year) are discussed in the committees even before publishing and are published together with standpoints of experts, the committees´ members. Thanks to these changes in 2002 – 2006 it has been managed to persuade all parliamentary political parties (opposition included) that forecast of state budget and public budget income is a professional matter and that scope of deficit (or surplus, respectively) and expenditure distribution that is given by the sum of income and deficit (difference of income and surplus, respectively) should be topics for political discussion.

Since 2005, all the financial flows of public administration with the exception of territorial governance are concentrated in the state treasury. It creates direct and indirect savings for state budget. Direct savings have the form of lower interest margin between paid and received interests (that was collected by banks in the past) and lower expenses for state debt management. Indirect savings result from state position strengthening on financial market thanks to concentration of resources in state treasury and thanks to creation of Agency for debt and liquidity management. This agency realizes operative state debt management, while strategic and concept management of debt is still in competence of the Ministry of Finance.

Organizational and process changes at the Ministry of Finance also contributed to overall improvement of public finance management. During the year 2003, an organizational, functional, process and information audit run at the Ministry and the outcome was process organization of all activities, new organizational structure and decrease of number of systemized job positions by 30% (from 849 to 599). Only in the biggest budget section of the Ministry it represented decrease from 147 to 88 job positions, while a new department of budget analyses was created. In 2004 – 2006 the Ministry continued in improvement of management by implementation of managerial quality system. Since 01.01.2005 the Ministry

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[14] Best evidence are differences between real reported and later by ESA 95 revised deficits that are, until 2002 included, huge

[15] After the government of R. Fico took over, repeated softening of budget restrictions is visible in majority of these areas, mainly in health care in connection with elimination of reform steps

of Finance of the Slovak Republic is a member of EFQM (European Foundation of Quality Management), in October 2005 the Ministry[16] gained the first level of the award (Committed to Excellence) and in May 2006 even second, higher level (Recognized for Excellence).

Main objective of EFQM implementation was creation of conditions, motivation but also pressure on permanent increase of quality management also after changes at political positions in the governing body of the Ministry. Audit and increase of quality management in the Ministry of Finance showed that in the state administration exist huge deficiencies in the area of over-employment and effectiveness of its functioning, since it is generally acknowledged that also until 2002 the Ministry of Finance belonged to one of the best functioning resorts.

2.2. Tax reform

2.2.1. Principles and fundament of tax reform

Tax reform is definitely the most known and also internationally most discussed Slovak reform. It is caused by probably these two factors. Firstly, the new tax system was started in 01.01.2004, which was closely before EU enlargement and that is why it raised broad attention and positive (entrepreneurs and economists) but also negative (mainly politicians) reactions especially in the countries that are, because of inelasticity of their markets and ineffectiveness of their institutions and functioning models (tax models included), not able to cope with consequences of global competition. It is not a coincidence that Slovak tax reform had the strongest response (positive and negative) in countries such as Germany or France. Second reason of interest in Slovak tax reform can be its specificity. It is not based on the implementation of flat tax[17] itself (it had been already implemented in Estonia, Ukraine, Russia and later in Romania). The difference is in principal system character, in distinctive transparency and simplicity of the system, mainly by:

- Elimination of almost all exceptions
- Elimination of all special rates and special regimes
- Elimination of almost all deductible items
- Application of principle of elimination of double taxation of one income where possible (e.g. elimination of dividend tax, inheritance tax, gift tax and real estate transfer tax).
- Elimination of deforming components in tax policy, which were used for other than fiscal objectives

There is not any explicit obligation of government to implement a flat tax in Slovakia in the 2002 program declaration of government, it includes only obligation to consider its implementation. „Government will enforce the increase of tax and contribution collection effectiveness. Simplification of tax legislation and especially updates of those parts of tax legislation that enabled ambiguous interpretation will contribute to increase in tax collection. Government will consider the possibility of unification of income tax rates... Tax burden will be transferred from direct to indirect taxes... Government will unify VAT rates before joining

[16] As the first Ministry in Europe
[17] Flat tax means unified marginal rate of income tax for individuals and legal entities

the EU[18]". Based on the declaration, the objective was to transform the Slovak tax system into one of the most competitive systems in EU and OECD.
Absence of relevant analyses and quantifications of fiscal impacts of implementation of various flat tax rate combinations and indirect taxes (mainly VAT) was the reason of more careful approach to formulation of flat tax implementing obligation in the program declaration of the government.

Concept of the tax reform was based on principles of justice, neutrality, simplicity, exactness, effectiveness and elimination of double taxation. Thus on principles that are highlighted in almost each tax theory textbook but hardly any country adhere to these principles in its tax system.

Horizontal justice is protected by unified taxation of equal subjects of taxation. Vertical justice ensures that subject with higher income, property or consumption pays also higher tax but with proportionality maintained, which means that taxation rate limit should not increase with increased tax base.[19] Neutrality principle ensures that taxation only minimally distorts economic processes and influences economic decision making of subjects.

In intentions of simplicity and exactness principle, the taxation rules have to include only inevitable minimum of clearly conceived norms that do not allow other interpretations. Effective tax does not allow legal ways of tax payment avoiding, does not ease illegal tax evasion and does not indirectly motivate subjects to tax evasion by inadequate taxation. Elimination of double taxation results from requirement to tax income only once at transfer from production to consumption, respectively re-investment (this relates especially to property taxes and dividend income taxes).

After the program declaration of government was passed, a new working team for preparation of tax reform led by Minister of Finance was created at the Ministry of Finance. The team elaborated calculations and forecasts of fiscal impacts in several variations in two basic alternatives: with flat tax implementation and without flat tax implementation. Decision about its implementation was the outcome, mainly because it enabled more effective and exact fulfillment of those objectives and principles that are listed above and which were included also in the program declaration. Higher uncertainty in fiscal impact forecasting and higher political risk of unavoidable VAT unification at higher level than in the alternative without flat tax were the risks connected to the alternative of flat tax implementation.

Since 01.01.2004, a new tax system is valid in Slovakia. The system is based on 5 key measures:

1. Implementation of flat personal and corporate income tax rate f at the level of 19% (before: 5 tax brackets form 10% to 38% for individuals and 25% for legal entities plus huge number of exceptions and special rates)[20]
2. Unification of VAT rates at the level of 19% (14% and 20% before)
3. Elimination of dividend tax
4. Elimination of gift tax, inheritance tax and real estate transfer tax
5. Elimination of almost all exceptions, deductible items, special regimes and special rates

[18] Program declaration of the Slovak government, 2002
[19] It will be visible that also after flat tax implementation, the progressive character of income tax from dependant activities was preserved but it does not have prohibitive character anymore
[20] There existed 37 various personal and corporate income tax rates in the original tax system

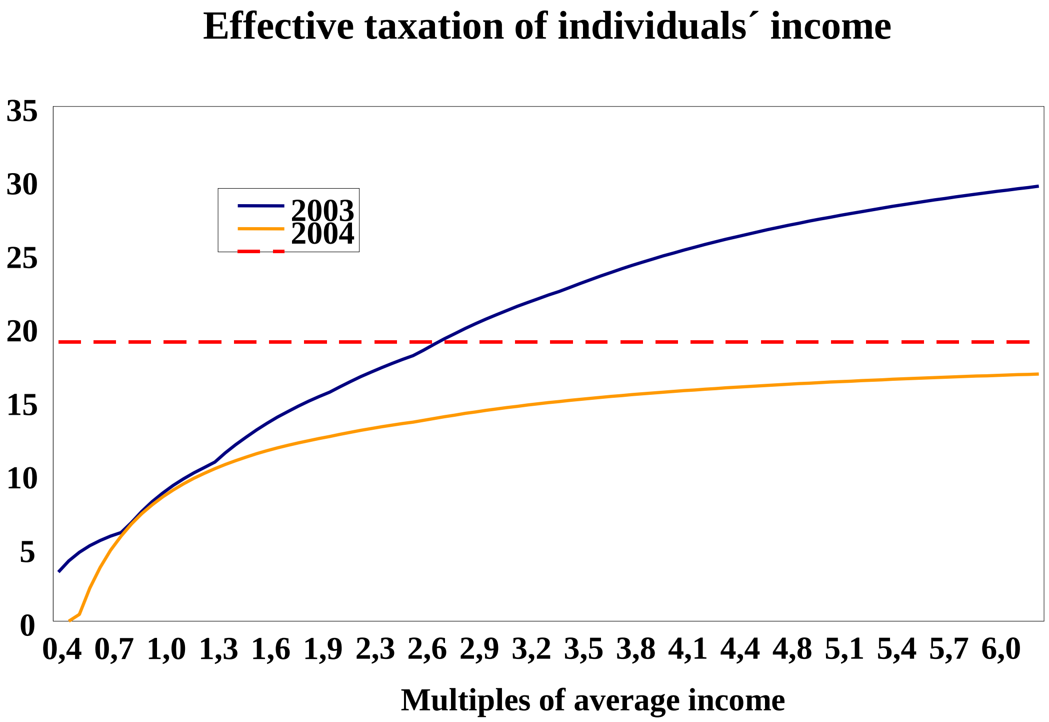
Figure 1
Comparison of old and new tax system

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

Precautions in the area of direct taxes were popular because of the decreases. However, it was necessary to decrease tax burden of high income groups (because the rates for highest income groups decreased even by half, from 38% to 19%) and the lowest income groups, where on the contrary the rates increased from 10% to 19%. This objective that ensured also political pass of tax reform was ensured by significant almost 2,5 times higher increase of nontaxable income[21], which in addition is valorized. In result of this precaution, the real effective tax burden decreases also to the groups with low income. Effective rate is therefore still progressive; people with low income do not pay anything, while high incomes are taxed almost with 19%.

Graph 2
Effective tax rate in 2003 and 2004

[21] Increased from 38 360 Sk in 2003 to 80 832 Sk in 2004



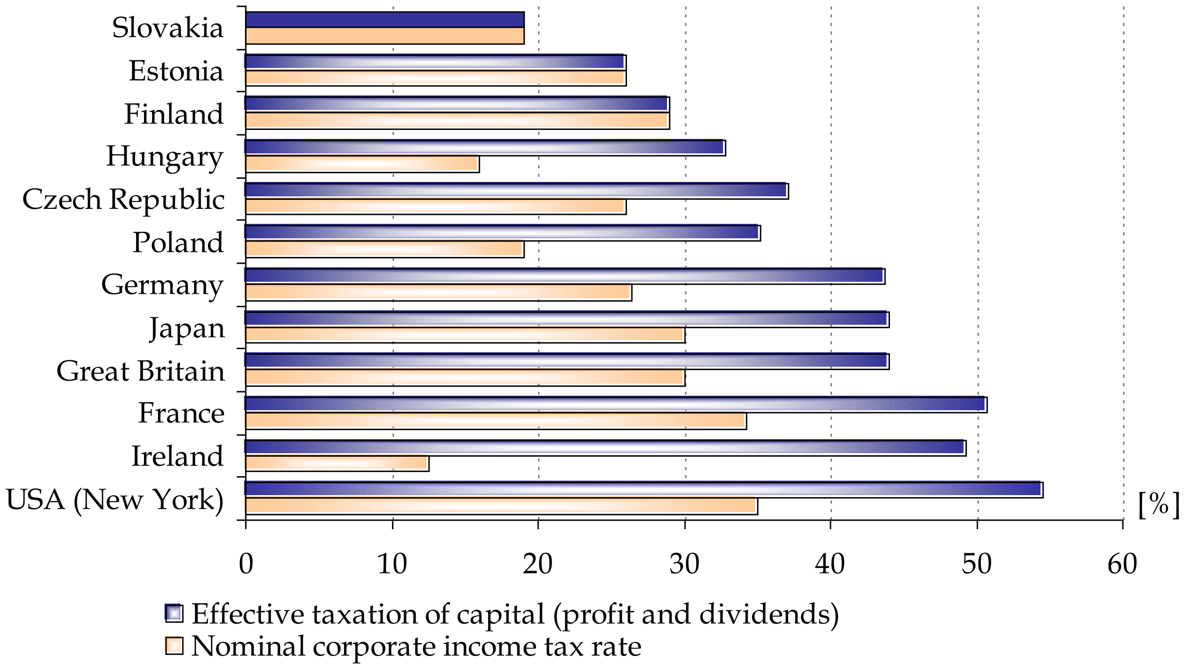
As it is visible from the picture, in the first year of the new tax system people with income up to 42,6% of average income did not pay any tax and from this level up their effective tax rate continuously rose from zero to 19%. Payment of any taxes applied to approximately 7,7% of employees.

In the area of indirect taxes it was necessary to increase them, what of course was neither popular nor simple. Increase of consumption taxes was inevitable for arriving at the minimum EU level that Slovakia had not reached before. Unification of VAT rates at 19% was the most delicate area, since sensitive commodities such as groceries, pharmaceuticals, books, health aids or newspaper were in the decreased 14% rate before the reform. Unification of VAT rates did not have only fiscal objectives (elimination of dropout from decreased direct taxes and canceled taxes) but was also objectively reasonable. It eliminated economic deformations connected to different taxation of various goods consumption. Decreased VAT rate was reasoned by social aspects, which means non-fiscal objectives. Its aim was to improve availability of goods and services for low income groups. However, it also benefited high income groups at least at the same level and moreover it created risk of tax evasion and complicated tax management. Social objectives are far more effective and righteously reachable with social policy than with tax system deformations.

2.2.2. Results of tax reform after first three years of its functioning

Government assumed that the tax reform would contribute to improvement of business environment, increase of motivation to work, start business activities and invest, increase of foreign investments and decrease of tax evasions. Today, after more than three years from new tax system implementation, we can state that these assumptions were fulfilled and in some areas the development even exceeded expectations. The tax reform became an important marketing asset of Slovakia and played an important role in attracting foreign investors. It is connected not only its simplicity and low level of taxation but also with the fact that overall taxation of capital in Slovakia is the lowest among all EU countries due to elimination of dividend tax.

Graph 3
Income tax of individuals and dividend tax in EU countries



Fiscal outcomes of the tax reform are positive as well. The Ministry of Finance was very careful when conceiving the reform, because its objective was not only to create tax competitiveness but also macroeconomic stability and decrease public finance deficit.
Level of uncertainty in forecasting of fiscal impacts of tax changes in the first year of implementation was high due to depth of changes and because it was the first step of our EU membership, which is connected to other uncertainties (mainly in connection with new regime of VAT enforcement after joining the EU).
High uncertainty level was confirmed also by significant differences in forecasting of fiscal impacts of the tax reform that were prepared by the Ministry and other external institutions included international institutions. Reality of the first year of the reform functioning showed that the approach was accurate and overall forecast of the Ministry was relatively correct, even though in a slightly different structure. The forecast for direct taxes (that decreased) was worse than reality and for indirect taxes (that increased) it was vice versa. Overall, we can state that the tax reform in its first year of functioning was fiscally rather neutral.

Table 3
Tax income in 2003 - 2007, in % GDP, ESA 95

(ESA95, in % HDP)	2003	2004	2005	2006	2007
Direct taxes	**6,7%**	**5,5%**	**5,6%**	**5,7%**	**5,7%**
Income tax – individuals	3,3%	2,6%	2,7%	2,6%	2,5%
Income tax – corporate	2,6%	2,4%	2,7%	2,8%	2,8%
Tax collected through withholding	0,8%	0,4%	0,3%	0,3%	0,3%
Indirect taxes	**11,2%**	**12,2%**	**12,6%**	**11,5%**	**11,4%**
VAT	6,6%	7,7%	8,0%	7,7%	7,4%
Consumption taxes	3,3%	3,3%	3,7%	2,9%	3,2%
Property taxes	0,1%	0,2%	0,0%	0,0%	0,0%
Local taxes	0,7%	0,7%	0,9%	0,8%	0,7%

Other taxes	0,5%	0,3%	0,1%	0,1%	0,0%
Total tax income	**17,9%**	**17,7%**	**18,3%**	**17,2%**	**17,0%**

Table 4
Tax income in 2003 – 2007, in thousands of SKK, ESA 95

(ESA95, in thousands of SKK)	2003	2004	2005	2006	2007
Direct taxes	**80 839**	**73 961**	**82 703**	**92 913**	**102 336**
Income tax - individuals	39 680	35 122	39 310	42 215	46 046
Income tax – corporate	32 016	33 164	39 538	45 839	51 268
Tax collected through withholding	9 143	5 675	3 855	4 859	5 022
Indirect taxes	**136 378**	**165 919**	**185 981**	**188 126**	**205 708**
VAT	80 455	104 859	117 332	126 018	134 599
Consumption taxes	40 527	44 596	54 466	48 265	57 115
Property taxes	1 489	2 734	0	0	0
Local taxes	8 420	9 119	12 692	12 878	13 250
Other taxes	5 487	4 611	1 491	965	744
Total tax income	**217 217**	**239 880**	**268 684**	**281 039**	**308 044**

2003, 2004, 2005 – reality
2006, 2007 forecast of the Ministry of Finance of the Slovak Republic

It can be assumed that the forecast of the Ministry of Finance for the years 2006 and 2007 is too conservative. Definite numbers for 2006 will be available in the mid of 2007 but the fact that reality of 2005 and significantly higher growth (in comparison to forecast) in 2006 and 2007 lead to conclusion that reality will be more favorable for all important taxes. Despite these facts, the trend of tax burden decrease proportionally to GDP will remain because also GDP growth is higher than expected.

2.2.3 Tax reform and its foreign critics.

As it was stated at the beginning of this chapter, Slovak tax reform evoked relatively strong response in foreign countries. It was predominantly positive but some critical evaluations pointing at alleged tax dumping respectively unfair tax competition appeared mainly from the side of some West European politicians[22]. They reasoned that low taxes led to missing incomes that should be compensated by EU subsidies, which are financed by wealthier countries. These should suffer from the fact that investors leave the old member countries and entry new member countries thanks to alleged tax dumping. That reasoning shall be considered incorrect and clearly politically purposed. As shown on fiscal results of Slovak tax reform displayed above, the reform was in principle fiscally neutral, which means that there were not any missing incomes resulting from the reform. The structure of incomes changed in advantage of indirect taxes (from which, the consumption taxes had to be increased in line with EU rules) and disadvantage of indirect taxes. Total tax income in the first year of the new system functioning (2004) was even by 22 billion SKK higher than before the reform in

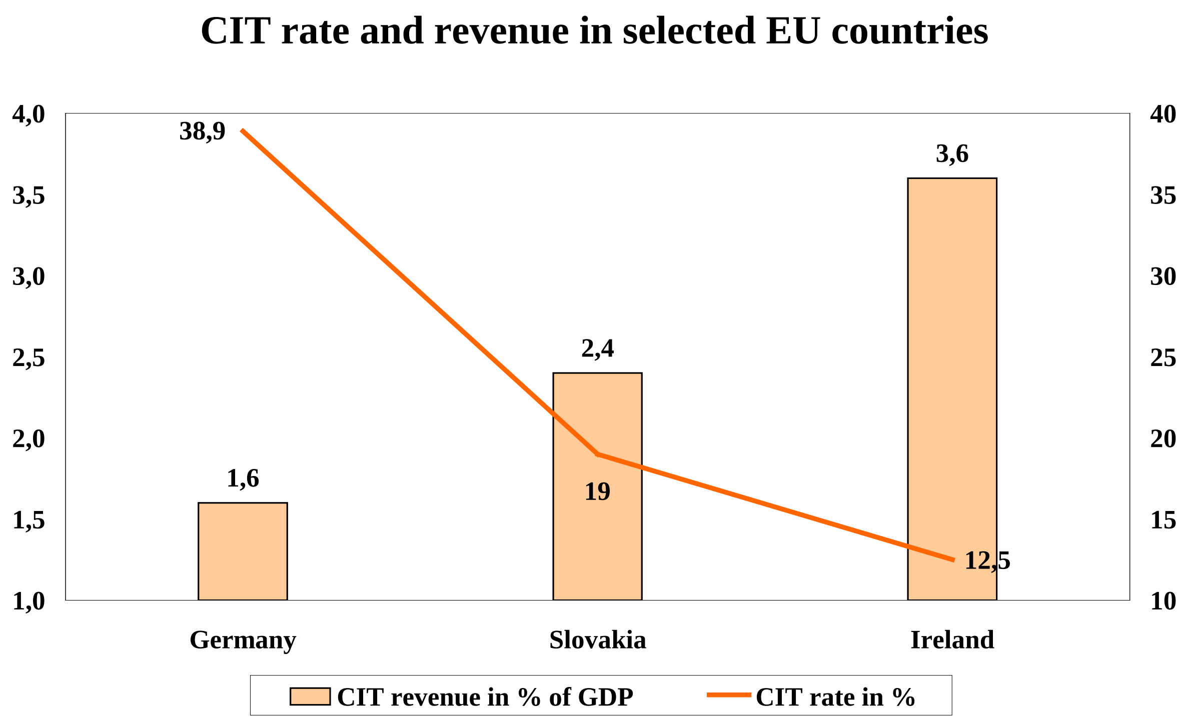
[22] Politicians of that time: German Chancellor G. Schroder, French Minister of Finance N. Sarkozy, Swedish Prime Minister Persson. However, those politicians did not comment specifically Slovak tax system, they talked in general about new member countries, but in the context of discussions that were evoked mainly by changes in Slovak tax system

2003 (239,9 billion SKK vs. 217,2 billion SKK). A slight decrease of tax burden measured by portion of tax income on GDP (from 17,9% to 17,7%) was caused by economic growth that was faster than tax income growth.

Not even the profit tax, which is the object of criticism connected to tax dumping or alleged unfair tax competition, decreased but on the contrary in increased. While in 2003 we collected at 25% rate 32,016 billion SKK from this tax, in 2004 at 19% rate it was 33,164 billion SKK, which means by 1,1 billion SKK more. In 2005 the increase in tax income was even significantly higher, e.g. from profit tax by 7,7 billion SKK or 23,2% more. Where are then the missing incomes?

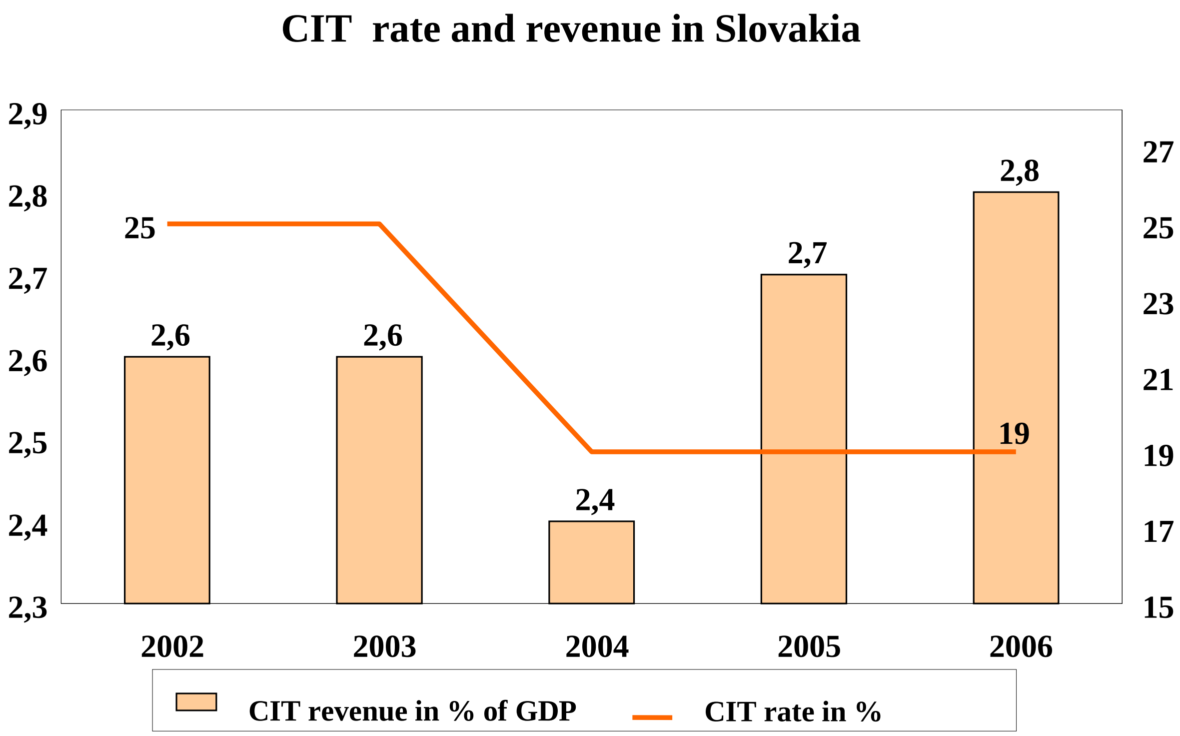
Moreover, there cannot be drawn any conclusions only from comparison of tax rates in the area of direct tax. Real revenue from these taxes, mainly corporate income tax, depends also from width of tax base and amount of exceptions and other possibilities that enable tax evasion. Best example is comparison of percentage profit tax rates and their collection as portion on GDP in Germany, Ireland and Slovakia.

Graph 4



As it is visible from the graph, the higher the rate is, the lower the collection and vice versa. In Slovakia, the development in period 2002 – 2006 is also interesting (shown in graph 5).

Graph 5



The comparison of revenues and corporate income tax rates in Slovakia before and after the reform implementation leads to the same conclusion as from international comparison of Ireland, Slovakia and Germany – the lower the rate, the higher the revenue.

Argument about compensation of missing income (that, as it was shown, do not exist) with funds from net contributors is unfair also from the other side. Thanks to reforms including tax reform, net contributors will pay to new countries (net receivers) less. It is derived from trivial fact that reforms lead to faster economic growth and that leads to faster loss of position of net receiver of EU funds.
Efforts of some countries to restrict tax competition by harmonization of tax rates should be considered harmful. Tax competition[23] leads to higher pressure on realization of inevitable changes and reforms, market flexibility, increase of public administration effectiveness and to pressure on realization of needed structural reforms. And here lays also the base of the problems of many Western European countries. Tax and other competition from new EU member countries only hold up a mirror of preparedness to face severe global competition. European commission currently does not urge harmonization of income tax rates, but it has started an initiative for unification of tax base of income tax. Commission reasons that it would simplify business conditions and decrease transactional costs of companies that have their business activities in several member countries and it would also lead to decrease of court trials emerging from existing differences. These effects would probably really appear, but Slovakia (together with Baltic States, Ireland and Great Britain) is and will be

[23] Good example of tax competition efficiency is Austria, neighbor of Slovakia. Discussions about the need to decrease income tax from original 35% took years and nobody assumed that the decrease would be lower than 29%. Immediately, literally in few weeks after adoption of tax reform that decreased the tax from 25% to 19% in Slovakia, the tax was decreased to 25% also in Austria. That led to increase of pressure on the tax decrease in Germany.

fundamentally against it. There are two reasons. Firstly, there is a potential risk that it would be just the first step on the way to harmonization of rates that we strongly refuse, while rate harmonization cannot be realized without base harmonization. Secondly, even more important reason is that such harmonization of tax bases that would not harm Slovakia, would not mean necessity to narrow tax base, implement various exceptions, special regimes and deductible items and disturbing system transparency, simplicity, exactness and neutrality of our tax system, is in practice absolutely unreal. Moreover, narrower base would mean inevitability of rate increase (due to elimination of fiscal impacts)[24].
Influence of the tax reform on living standard was one of the important discussion questions, including political, before the reform preparation but also after its implementation. We will deal with this question later in context of the tax reform and all the other changes and measurements realized in last years.

2.3. Pension reform

„Reform objective is to halt demographically conditioned increase of inner debt of continuously funded pension system and increase involvement of citizens in their living standards in pension age.“[25]
Achievement of these objectives was realized with the help of so called three-pillared system of pension scheme, while the first pillar is formed by continuous system, the second (new) capitalization pillar is based on pension savings and is obligatory for everybody, who enter the labor market after 30.06.2005 for the first time and for those who already were on the market and voluntarily chose to enter the second pillar until that date. The third pillar lies in various forms of voluntary pension savings, respectively insurance.

There were 5 key measurements in the pension reform:

1. Implementation of strong capitalization pillar. New system is defined by contributions, which means that the sum of disbursed pension is not known in advance and will depend on total sum of savings and rate of appreciation from the pension fund management companies (PFMC). The level of contributions into the second pillar represents 9% from assessment base (salary). These funds are in personal ownership of saver, they will be transferred to personal pension accounts of savers in PFMC, they are not subject to taxation and become subjects of heritage after death of savor. There exist strict rules of state supervision, risk transfer from the side of the state and PFMC and risk diversification and payment regulation. Interest in entering the second pillar was enormous, more than 1,5 million people entered until 30.06.2006, while the original forecast was by 200 – 300 thousand lower. Six PFMC got the license after fulfilling legal conditions.
2. Strengthening the merit principle in the first, continuous pillar. New system ensures direct ties between sum of contribution and final sum of pension. System is set up to ensure that saver earning average income for 40 years will get pension in the sum of 50% of average income.
3. Implementation of new valorization mechanism. In contrast to former annual political decision making on pension valorization level, a so called Swiss valorization

[24] When author of this text in 2004 – 2005 at the meetings of Council of Ministers of Finance reasoned with these facts he did not receive any counterargument from his colleagues with the exception of argument to take the Slovak base as the common base of this tax. But in response to author's question if they can imagine to eliminate almost all exceptions, special regimes and deductible items in all 24 EU member states, the answer of all ministers was negative.
[25] Program declaration of government, 2002

mechanism was implemented that ensures annual increase of pensions by 1% that is the average of last year inflation growth and nominal income.
4. Increase of retirement age. Original retirement age for men 60 and 53 – 57 for women (relative to number of children) was increased to 62 years of age. Increase is realized in the pace of 9 month a year.
5. Enlargement of tax advantages in the third pillar. A possibility to apply deductible item from income tax base up to 12 000 SKK annually was implemented. It is the only exception in the tax system and the objective was to motivate people to decide for long term pension savings. Another change was in taxation: from original 10% of the total sum to 19%, but only from revenues.

Impact on long term sustainability of public finance is important factor of pension reform. Thanks to the reform implicit debt[26] should decrease from original 400% GDP in 2003 to approximately 170% in 2080. Positive fiscal impacts of the second pillar implementation will appear in the long term horizon. In forthcoming years, the reform will decrease public finance revenues by approximately 2,0% GDP annually.

2.4. Health care reform

It was probably the most complicated reform from technical and political viewpoint. Before the reform, system was ill-functioning, was characterized by weak services, dissatisfaction of all participants, high level of corruption, increase of new debts, soft budget restrictions, wasting and ineffective functioning as a result of excessive demand and supply (redundant and ineffectively used capacities). Another problem was that the state did not act as an effective regulator but as an active participant of health care system.
Reform objective was to eliminate these imperfections with the help of these measurements:

- Heath care debt discharge
- Implementation of fees for services connected to health care performance
- Transformation of health insurance companies into joint-stock companies, transformation of health care institutions into non profit or joint-stock companies
- Implementation of strict budget restrictions for all subjects into the system
- Clear separation of so called basic package of health care funded from the system of public insurance and health care exceeding this package funded by additional insurance or cash payments

The reform had been realized in two basic phases. The first was connected to decrease of excessive demand by implementation of fees (basically symbolic) for some services (doctor visits, prescriptions, ambulance transport, stay and food in hospital). That contributed to decrease of excessive demand in the form of needless visits at doctor and medicament waste, decrease of corruption and increase of co-responsibility of patients for their health. A process of health care debt discharge had been activated as well.

In the second phase, a health care supervision was established independently from government, it also came to a setup of strict budget restrictions for all subjects, transformation of public insurance companies into joint-stock companies and definition of basic package of health care. These measurements led to creation of economic pressure and motivation on decrease of excessive capacities and increase of system functioning effectiveness. It came to

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[26] This debt is defined as sum of actual accumulated funds and those funds that current savers would be entitled to in case of total suspension of continuous pillar

economic stabilization of the system and at the end of functional period of second Dzurinda´s government the indebtedness of the system significantly decreased[27].

2.5. Social system reform and labor market reform

High unemployment rate (in 2002 the highest in Europe) and low motivation of people to solve their living situation on their own were the most significant motives for implementation of these reforms. Reforms were realized under the motto „working will pay off" and had to ensure that active job seeking should really pay off. Moreover, the reforms should also eliminate the obstacles that limited employment and employers, ensure effective help and support in job seeking activities for long-term unemployed people and limit frequent misuse of the system. The main change tools were:

- Flexible labor code and labor market
- Implementation of activation benefits and activity support system
- Decrease of tax and payment burden of labor
- Transfer of sick-benefit during the first 10 days of sickness from the state to employer together with adequate decrease of payments
- Transfer of part of children allowance claimable for each child on tax bonus, which can be claimed only by those, who have taxable income
- Increase directness of help for disabled

A principle of income differentiation between those who work and those who do not and also between those who want to work and be active and those who do not was a significant part of the reform.

Labor market did not and still does not create (even though a significant improvement was reached) enough working opportunities, mainly for long term unemployed people with low education. Therefore, activation benefits were implemented in the area of social care and the benefits could be claimed only by those, who actively participated on projects of active labor market policy, public works, re-qualification projects and so on.

Various new direct social benefits that were aimed at solution of specific problems of employment of long term unemployed, low-income families with small children and support of school attendance was implemented as well. It had positive impact on solution of specific problems but on the other hand, it had even more complicated already complicated social system.

Flexibility of labor market was connected to the following areas:

- Deregulation of working time adjustment, increase of ordered overtime limits and overtimes agreed with employer
- Simplification of layoffs in case of economic problems of employer or his dissatisfaction with work of employee
- Simplification of employment establishment
- Elimination of all restrictions for working pensioners

Table.5

Unemployment development and employment growth in Slovakia in 1998 – 2006

in %	1998	1999	2000	2001	2002	2003	2004	2005	2006
Unemployment rate	12,6	16,4	18,8	19,2	18,5	17,4	18,1	16,2	13,3
Employment growth	-0,4	-2,7	-1,8	0,6	0,2	1,8	0,3	2,1	3,8

[27] More information on Slovak health care reform at Health Policy Institute site *www.hpi.sk*

Data in table 5 clearly show that development in the area of employment and unemployment was significantly positive in 2002 – 2006, which is partially contribution of social system reform and labor market reform[28].

2.6. Public administration reform and fiscal decentralization

It was a very important reform that had been realized during both election periods of Dzurinda´s governments in 1998 – 2006. Its main objective was to adjust the relationship state – region – community in the public administration area based on the principle of subsidiarity. Territorial structure of the country was changed through implementation of a 3-level model of public administration, local and regional communities were strengthened and competencies connected to offering local and regional public services and estates were transferred to local and regional governance.
The last realized phase of the public administration reform was fiscal decentralization that had been prepared during 2003 – 2004 and implemented since 2005 under the sponsorship of the Ministry of Finance.
Fiscal decentralization brought significant strengthening of independence, foreseeability and criteria of local and regional governance funding. Fundamental principle of the change was the transfer from state budget funding of governance (the sum was determined on the base of negotiations annually) to funding from tax income, where the sum is guaranteed by the law.

Communities get by the law 70,3% of personal income tax revenue and self-governing regions 23,5% of this tax revenue annually. These funds are then divided among individual self-governmental units based on criteria that are given by governmental order, are agreed with self –governmental units and are related to their competencies and serviceability of the territory (e.g. number of children and elderly, area of the region, criterion of size, temperature and climatic zone, and so on).[29]

2.7. Improvement of business environment

All the realized reforms directly or indirectly influenced improvement of business environment. Probably the most important was the influence of the tax reform, labor market reform, macroeconomical stabilization and public finance reform.
Except these, government had realized also some other measurements, mainly in the area of justice, legislation simplifying, speeding up the process of entry into register of commerce and land register.
Inefficient law enforcement, ineffectiveness of public administration and bureaucracy remain the prevailing insufficiencies and the biggest weak points of business environment.

3. Change of social-economic model.

During the past eight to ten years, Slovakia had gone through deep changes related to realized reforms and basic model of functioning. Simply said, Slovakia, from the eight post-

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[28] More on these reforms, tools and results in Beblavý, M: Social Reform and Labor Market Reform

[29] More on the public administration reform and fiscal decentralization at www.mesa10.sk

communist countries that joined EU in the first enlargement, is the only country that had realized the transfer from predominantly continental social economic model to predominantly Anglo-Saxon economic model[30]. While Baltic countries (Estonia, Latvia, Lithuania) were from the beginning building their system more or less based on Anglo-Saxon principles, Poland, Czech Republic, Hungary, Slovakia (V4) and Slovenia built their system more to the Picture of Germany and Austria, which means that they were inspired by European continental model. It is also given by historical heritage and geographical neighborhood.

Table 7
Comparison of groups of countries

	GDP growth	Employment growth	Portion of R&D on GDP	Tax quota II	Soc. Exp./ GDP	ALMP/ GDP	ALMP/ Unemp. Exp.
Germany	0,9	-0,3	46,8	40,2	29,5	0,85	24,7
France	1,6	0,3	53,8	45,8	31,2	0,73	27,0
Belgium	1,9	0,4	49,9	47,7	29,3	0,92	25,9
Austria	1,9	0,1	49,9	43,6	29,1	0,43	21,6
average	1,6	0,1	50,1	44,3	29,8	0,73	24,8
Poland	4,0	-0,2	43,3	34,2	20		
Czech republic	4,4	0,3	44,1	36,3	19,6	0,13	25,8
Hungary	4,3	0,2	49,9	38,6	20,7	0,21	30,1
Slovenia	4,0	0,5	47,2	40,7	24,3		
average	4,2	0,2	46,1	37,5	21,2	0,17	28,0
Great Britain	2,5	0,9	44,7	38,5	26,3	0,16	20,0
Ireland	5,1	2,9	34,1	32,2	17	0,49	30,9
Average	3,5	1,4	39,4	35,4	21,7	0,36	33,2
Estonia	9,0	1,2	33,2	31,0	13,4	0,04	17,2
Latvia	7,9	1,9	33,6	29,2	13,3	0,15	50,2
Lithuania	9,0	1,5	36,0	29,6	12,6		
Average	8,6	1,5	34,3	29,9	13,1	0,10	33,7
Slovakia[31][32]	5,6	1,1	37,1	29,5	17,2	0,07	15,2

GDP growth = average 2002 to 2006; employment growth = average 2002 to 2005; R&D and tax quota for 2005; social expenditures and ALMP for 2004.   Source: Eurostat

With respect to data in tables above and actual economic results that already include direct and indirect effects of realized reforms, Slovakia did a quite significant turn in functioning system. Result is that Slovakia joined the fastest growing economies In Europe. Economic growth reached 8,3% (in the second half year 9,7%) and employment growth reached 3,8% in 2006. Number of unemployed has decreased by 20% between years at the same time with indispensable labor productivity growth that largely exceed real income growth. Forecasts for first quarter of 2007 predict 10% exceed of economic growth limits. The growth is based on

[30] See Sapir, Andre (2005)
[31] Current indicators that already mirror direct and indirect effects of reforms are similar or even better than in Baltic countries, e.g. economic growth in 2006 8,3% (in second half year 2006 9,7%), employment growth in 2006 3,8%

healthy foundation, proven by decreased deficit at current account[33] and decreased deficit of public finance. It is not a coincidence that Ireland and new EU countries that apply Anglo-Saxon economic model are the fastest economies in Europe. Exactly these countries significantly increased the level of economic freedom and realized structural reforms that improved business environment and stimulated investment and growth.

4. Impact of reforms on living standard

Political passage of reforms is one of the key problems of reform process in each country. Problem lies mainly in the fact that reforms mean change and people are afraid and deny the changes. It is valid all around the world, even though somewhere less and somewhere more. Change by itself means uncertainty created by new conditions regardless of the real impacts of the change. Moreover, reforms are very often connected to higher expenditures than revenues in the short-term. This leads to denial of reforms and to the situation when impacts of reforms (mainly social) are perceived to be more negative than they really are. Experience from Slovakia is a proof.
Opinion of the majority in Slovakia is that the reforms, even though necessary and in many areas correctly applied, were socially unbearable. According to majority of population, they represented enormous ballast for the people and negatively influenced mainly lower income groups. Public opinion polls confirm these standpoints and the evidence was also the outcome of parliamentary elections in Jun 2006, when party of current Prime Minister Robert Fico, which built its agenda primarily on strict and exact criticism and denial of all reforms,[34] won with prevalence.
What has been the reality? Significantly different.
Let’s look at how transformation process, which is being described in this text, has influenced living standards based on real income development.

Table 8
Pace of real income growth in national economy, 1993 – 2006

in %	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Pace of real income growth	3,2	4,0	7,1	6,6	2,7	-3,1	-4,9	1,0	5,8	-2,0	2,5	6,3	3,3

As it is visible from the data in the table above, Slovakia experienced two decreases of real income in the last ten years. The first, by 7,9% during 1999 - 2000 and the second by 2,0% in 2003. The first is related to coping with the heritage of “meciarism” in economy (see above in part 1) and the second to the solution of budget liberalization impacts in the election year 2002 and reform of public finance management and transfer to strict budget restrictions (see

[33] After continuous decrease of foreign deficit went this in January 2007 into surplus despite Slovak crown appreciation that from its entry to ERMII in November 2005 appreciated by 12% to March 2007. In reaction to this, a decision about revision of central parity in framework of ERMII from original level of 38,455 to a new parity of 35,4424 SKK/EUR. After Ireland in 1998, it is the first occurrence of that kind of parity appreciation in the ERMII system
[34] In reality, after the government forming phase with dominancy of Smer, the pre-election promises of reform elimination have not been fulfilled, with the exception of health care reform, where the reform steps and measurements are deformed but with the absence of any alternative vision and strategy

part 2.1)[35]. Years 1999 – 2000 were even more difficult because decrease of real income by 7,9% was connected to the decrease of employment (by 4,4%), while in 2003 the 2,0% decrease of real income was already connected to increase of employment by 1,8%.

Majority of the reforms (tax, social, pension) was implemented at the beginning of 2004 and even though the deterioration of living standards is generally bound to the reforms, the data in table 7 show that it is not true. Temporary deterioration of living standard was not caused by reforms but by the inevitable macroeconomic stabilization together with saving measurements that were necessary for elimination of previous incorrect economic policy.

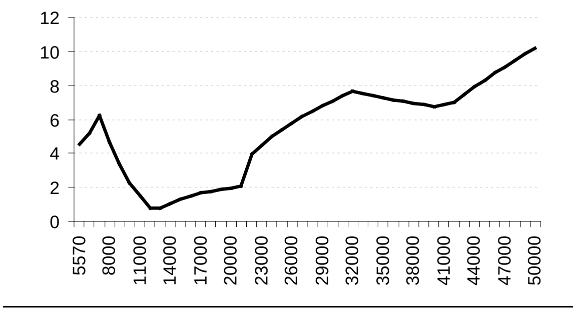
Let’s look at the development of real income of individual income groups in 2004, which was crucial from the viewpoint of implementation of almost all reforms. Besides, since 01.01.2004 the last important phase of prices deregulation of energy, gas, transportation costs, water rates and rents[36]. From the same date on, the tax reform was started, what meant decrease of direct taxes but public perceived mainly increase of consumption taxes and unification of VAT that caused overall increase of the rate of this tax. From psychological point of view, the unpopular part of the tax reform was more visible because it was projected to the increase of prices that was visible immediately after January 1, while decrease of direct taxes was projected at salary checks, less visibly and with delay.

Despite these facts, already in the first year of reforms, even though connected to the last phase of price deregulation, majority of employed people did not experience decrease of their living standard. On the contrary, increase of prices due to their deregulation and increase of indirect taxes was more than eliminated in all income level groups, mainly by decrease of direct taxes, growth of nominal income but also by decrease of groceries prices after Slovakia joined EU on May 1, 2004[37].

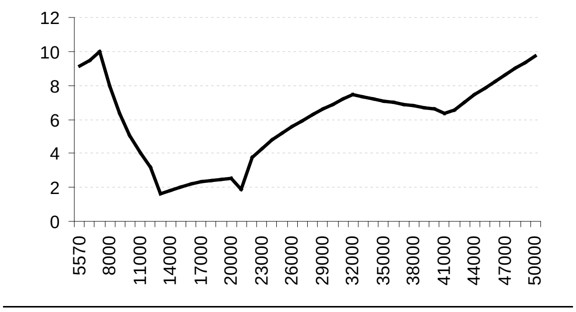
The following graphs show development of real income of individual income level groups in 2004.

Graphs

Real growth of net income of a taxpayer in 2004 (in %; based on gross monthly wage in 2003)



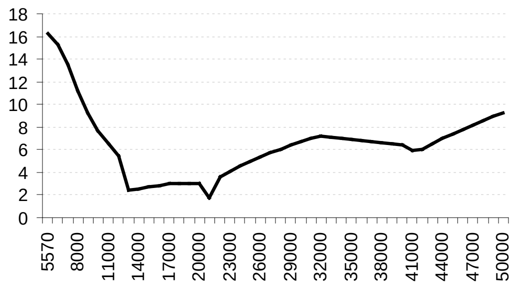
Real growth of net income of a taxpayer with one child (in %)



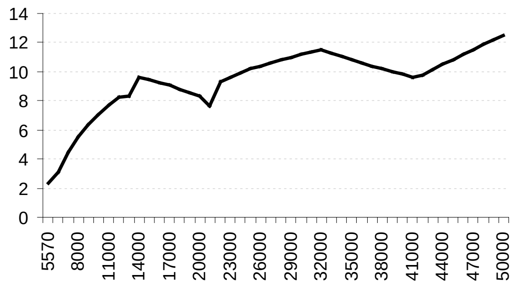
Real growth of net income of a taxpayer with two children (in %)

Real growth of net income of a taxpayer with unemployed wife in 2004 (in %)

[35] Both decreases of real income were closely connected to the inevitable increase of regulated prices that, despite increase of expenditures, were not increased during Meciar´s era in 1994 – 1998 at all.
[36] It was significant increase, e.g. gas prices for households increased in average by 35%
[37] Opposition of that time forecasted completely opposite development of groceries prices after joining EU. Opposition leader Fico frightened the public that after joining EU we would have Slovak salaries and European prices.



Source: Ministry of Finance of the Slovak Republic



Source: Ministry of Finance of the Slovak Republic

The graphs show that already in the first year the tax reform, even though connected to price deregulation, had positively reflected on real incomes of all income level groups that have incomes from working activities. Data from the graphs are evidence that change of net income depended from two factors – level of income and number of children. The relatively highest increase of net income was noted by higher and low income groups, the lowest improvement was noted by people with income close to the average income. High incomes gain on decrease of tax rate to 19% (from 38% at highest incomes), low incomes gain on increase of deductible item. Middle incomes are relatively worst off because decrease of tax rate is minimal (from 20% to 19%) and impact of deductible item increase is relatively lower. Influence of number of children is given by the implementation of tax bonus on children.

While average real income in national economy increased by 2,5% in 2004, real net income of an employee with minimal income increased by 3,1%, employee with average income by 1,0% and employee with triple average income by 8,3%.
A couple of employed, both working for a minimal wage, with two children improved by 9%, a couple working for average wage, with two children by 5,9%. The year 2004 did not brought worsening of the situation even fore pensioners, whose real income increased by 0,4%.[38] Remained are the unemployed, social cases and so on. In their case, a change in overall philosophy occurred, when new mechanisms stimulating activity and participation were applied and the result is differentiation of income based on activity and personal approach. It is assumed that mainly passive unemployed people and those, who misused the system and used it as an additional source of income experienced decrease of real income from public sources.

In following years, the influence of the tax and other reforms on living standards will be evidently positive, even in more significant way as it was in 2004. The evidence is rise of real wages by 6,3% and increase of employment by 2,1% in 2005 and 3,3% rise of real wages and 3,8% increase of employment in 2006.

European Union measures and compares so called risk of poverty that is estimated based on percentage of inhabitants that have their income after social transfers lower than 60% median of national income. The name of this indicator is quite deceptive, because more than poverty it expresses income differentiation[39].

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[38] In all these data, we consider inflation for individual income groups. A more specific analysis of the first year of the tax reform see „The first step of the tax reform or 19% in use“ IFP MF, 205, Economic analysis 8, www.finance.gov.sk

[39] We could probably talk about relative poverty because otherwise we would have to say that in Ireland, with 20% or in Great Britain with 19%, the poverty is higher than in Bulgaria (15%) or in Slovakia (13%). Even

Based on currently published data for 2005 (Eurostat), Slovakia has its risk of poverty at the level of 13%, which is lower poverty rate than in the majority of EU countries. According to Eurostat, the situation is as follows:
9% Sweden
10% Czech Republic
11% Netherlands
12% Denmark, Finland, Austria
13% France, Luxembourg, Hungary, Germany, SLOVAKIA
15% Belgium, Malta
16% Cyprus
18% Estonia
19% Latvia, Italy, Great Britain
20% Greece, Ireland, Portugal, Spain
21% Lithuania, Poland

Data showing that 13% of Slovak inhabitants have their income after social transfers lower than 60% median already includes the impact of reforms because it reflects the reality of 2004. Therefore, this data already reflects all the changes, tax and social reform included. It proves that deep structural reforms realized in Slovakia during 2002 – 2006 did not lead to significant increase of income differentiation. On the contrary, they led to higher dynamics of the economy and to creation of conditions for higher income growth, living standards and employment.

5. Fico´s era (2006 - ?)

After Meciar's (1993 – 1998) and Dzurinda's era (1998 – 2006), the Fico's era started after the 2006 elections in Slovakia. How long, in the viewpoint of reforms will it take and what possible consequences in might have?
The 2006 elections won the political party Smer, whose chairman Robert Fico became also the Prime Minister. They created a new government together with HZDS (where Vladimir Meciar is still the chairman) and SNS. Both these political parties, (even with the same chairmen) were members of the coalition during the Meciar´s era. They did not make any significant movement forward in terms of values and intellect. Their positon in the government is only minor and the program focus of the government is designated by the strongest party in power - Smer.
Smer has based its entire election campaign on strong criticism of government and governmental politics, especially critique of the reforms. Smer essentially refused them and promised to cancel all the reforms. The reality after the first nine months is unclear. In principle deformed, even destroyed has been the health reform. The fees have been cancelled, weak budget restrictions are being implemented, the independence of the Health Care Surveillance Authority has been restricted as well and an obligatory insurance for state policyholders in the state insurance companies is being prepared. The consequences are already visible. The system is unavoidably heading toward already solved problems, creation of new debt, insolvency, inefficiency and corruption is increasing. Even though public resources are added to the system, there is no real effect visible.
The tax reform has been left without any changes even though it was the main target of Smer's election campaign, where they promised its revision. Only cosmetic changes have

better illustration of this incorrect interpretation of this indicator is the fact that based on this indicator the risk of poverty is lower in South Korea than in North Korea.

been made. At higher income (approximately from three times average wage), the nontaxable base is being gradually decreased to zero (from approximately five times average wage). Besides that, a reduced VAT rate for pharmaceuticals and sanitary goods was implemented. Pressure was also put on the second pillar of the pension reform (its essential part). The Prime Minister announced intent to decrease contributions to the second pillar by one third (from 9% to 6%). The reason is the fact, that it would result in fiscal costs decreased by approximately 7 billion SKK (approximately 0,5% GDP). Under pressure of the public[40], he has decided to postpone his plan.

Another reform, which destiny is still unclear, is the labor market reform. The government has submitted a proposal of a new Labor Code, which was created in the headquarters of the labor unions[41] and which significantly decreases already achieved flexibility of the labor market and provides various privileges for the labor union officials. Nowadays, there is a serious fight between employers and the labor union, but also between the political party Smer and the opposition. The result is still uncertain also because the remaining governmental parties (HZDS and SNS) have expressed their unwillingness to support this law.

Very important tool, which keeps the government in reasonable fiscal limits, is the commitment to join the Euro zone. Even during Dzurinda's government, in November 2005, Slovakia entered the ERMII system with the goal to implement Euro on 01.01.2009. Fico hesitated at the beginning, but under the pressure of depreciation of Slovak currency after announcing creation of the coalition in July 2006, he decided to follow the Euro and this objective became a part of governmental program. Therefore, the Maastricht's criteria serve as an effective protection against fiscally irresponsible increase of public expenditures spent on fulfillment of unrealistic election campaign promises, some of which became a part of the governmental program.

The question related to the post-election situation in Slovakia is not whether Slovakia is going to grow in the next three – four years. It will, and it will grow fast regardless what the government will do. The economy is strongly excursive and even the persistence of the economic processes is very large and strong. The question is, whether this positive development is sustainable in the long run, if Slovakia takes the chance and will grow in the long term faster then its neighbors and will reach or even overtake more developed, so called old EU member states. It is possible, and Slovakia has created good initial conditions to reach such goal. The question is, if Slovakia will use this chance.

The example of Ireland could serve as an inspiration. When Ireland entered EU in 1973, economically it was at 50% of level of EU at that time, similarly like Slovakia in 2004. Nowadays, Ireland with 140% GDP, compared to the EU average, is the second most economically developed EU country after Luxemburg. Estonia is on a good way to follow this success. While at the beginning of the 1990´s Estonia was only at 50% of economic level compared to the Czech Republic, in 2010 it will reach the same level. For a better illustration, if the Czech Republic would be growing as fast as Estonia, it would reach the level of Austria in 2010, because the Czech Republic was only at 50% level of Austrian's economy in the early 1990´s. Since it is not growing that fast, the Czech Republic will reach „only" 75% of the Austrian economy level in 2010.

So what are then the necessary conditions for Slovakia to be able to reach Ireland and Estonia? It depends on three groups of conditions.

At first, the macroeconomic stability should be remained and the reforms should not be deformed neither canceled, since they significantly contribute to the rapid growth. It doesn't mean that they should not be modified and improved, but not cancelled or deformed. The

[40] Since it would negatively impact more then 1,5 million people, who joined the Second Pillar.

[41] Smer closely cooperated with labor unions before elections and promised them, among others, change of the Labor Code

health care reform is being canceled, with a negative impact on public finance and business environment, the destiny of labor market and pension reforms is still unclear. In the tax reform, there have been only minor, cosmetic changes made, however not in the right direction. It will be also very important not to surrender to the pressure of some other EU countries to harmonize direct taxes, specifically harmonization of rates or tax base. Unfortunately, there might be some change in the standpoint of Slovakia in this area as well[42].
Secondly, the government should focus on solving the problems in those areas, which are the biggest weak points of our future competitiveness. It is mainly connected to the improvement of law enforcement, effectiveness of state and public administration, decrease of the corruption rate, excessive regulations and bureaucracy. Moreover, it should be continued in liberalization of network industries and the concentration should be targeted towards solution of the Roma problem[43].
Thirdly, the key condition is the development of knowledge economy. Education, science, research, innovations and information systems will become very tight area and that will be the reason of decreasing competitiveness of Slovakia, if these issues will not become priority today.
They should become the priority not only due to the usage of public resources (local, regional, state or European budgets), but also a priority from the point of view of change in the mechanism of system functioning in these areas, in the way that increased resources would reflect in better and more effective functioning.
It is very difficult to say today what the chances to fulfill these three conditions are. The prognosis that does not suppose optimal development is highly possible.

6.1. Will Fico change the socio-economic model?

R. Fico repeatedly declares that building of strong social state is his top priority and it differentiates him from the previous government (today's opposition). The same objective is in the program declaration of government, where it states that „the government of the Slovak Republic will broadly support real direction of the Slovak Republic towards fulfillment of social state characteristics".
Are these objectives real? Can we assume that they will be fulfilled?
The most important economic characteristics of a strong social state are high level of redistribution and taxation. Changes that have so far been realized did not increase the level of redistribution but vice versa. Decrease of deductible item for higher income groups slightly increased overall tax burden but decrease of VAT tax for pharmaceuticals and sanitary goods had opposite and even stronger effect. Interferences of Fico´s government into the tax system resulted in decrease[44] and not in increase of the tax burden.
Convergence program that based on unified methodic and structure is elaborated by all EU member countries and which contains basic objectives and parameters of economic development for next four years, is a relevant document. Fico´s government voted on its first convergence program in December 2006, almost a half year after it took over. Despite repeated rhetoric about strong social state building, not even this program does not indicate

[42] R. Fico on March 9, at the EU summit in Brussels, softened his previous denying attitude that shared together with Baltic countries, Great Britain and Ireland
[43] Slovakia has high rate of Roma citizens (6 – 8%), large portion of them is socially inadaptable and forms the core if long-term unemployed people
[44] Decrease of deductible item brings annual increase in income by 1,1 billion SKK, while decreased VAT rate for pharmaceuticals will decrease annual income by 2,8 billion SKK (forecast of the Ministry of Finance)

any significant change in the Slovak economic model functioning. Moreover, measured by the most important and complex indicator, which is the level of redistribution and taxation, convergence program of Fico´s government predicts its further decrease.
While in 2006, the portion of public expenditures on GDP was 37,9%, convergence program[45] adopted by Fico´s government in December 2006 assumed that this indicator will in 2010 reach 33,6%, what means significantly strong decrease (!!!) of redistribution.
This trend is supported by the fact that the only change in the tax system announced so far is potential enlargement of the goods and services list with lower VAT rate.
These facts prove that thesis of strong social government is rather a political marketing tool than real objective. One of the reasons is that government does not want to implement any unpopular measurements and increasing taxes will definitely be one. Moreover, government lacks sufficient expert and administrative capacity for realization of any deep system changes.
The conclusion is that with high probability, the model of functioning will not be quickly changed but rather gradually eroded due to growing statism, corruption and deformation of some reforms. Long term competitiveness can be decreased also by neglected solution of tight areas and problems in business environment and especially insufficient support and development of knowledge economy.

Conclusion

The story about Slovak reforms is an evidence of the fact that there exist efficient tools for overcoming economic problems and backwardness, for revitalization and stabilization of disrupted economy and for starting its high and healthy growth. Usually, it is related to generally known priorities, principles, measurements and tool. The more known they are, the more difficult it is to implement them in reality. Therefore, it is essential to summarize them. Based on our Slovak experience, I consider these to be the most important:

- Increase of economic freedom level , decrease of redistribution, decrease of taxes
- Economic and political integration, membership in EU, NATO, OECD
- Macroeconomic stabilization, fiscal consolidation
- Strict budget restriction, for both public institutions and business sector
- Revitalization, restructuring and privatization of banks
- Privatization of utilities, entry of strategic investors into these companies
- Prices deregulation, creation of independent regulators
- Solving the problem of population aging (pension reform)
- Flexible markets, especially labor market
- Simple, neutral, effective and fair tax system
- Improvement of business environment
- Social system that does not de-motivate and helps those, who really need it
- Decentralization on the principle of subsidiarity

These are the most important priorities and tools that demonstrated a strong positive result in the Slovak conditions. Undoubtedly, there exist also other that we were no table to use sufficiently but we are persuaded that they are important. Specifically, it is better law enforcement, more effective public administration and quality education, science, research and development, and informatization.

The example of Slovakia could serve as an inspiration for some countries, Western European, Balkan or Eastern European included. This text will hopefully contribute to it as well.

[45] Convergence program of the Slovak Republic, December 2006, p. 53

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