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Slovak Republic The Quest for Equitable Growth In The Slovak Republic

A World Bank Living Standards Assessment

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Acronyms and Abbreviations

AAA Analytic and Advisory Activities
ALMP Active Labor Market Policies
ALMP Active Labor Market Program

CE Central European

CIS Commonwealth of Independent States

EC European Commission EU European Union

EUROSTAT European Commission Statistics

FD Family Diary

FDI Foreign Direct Investment
FGT Foster-Greer-Thorbecke
GDP Gross Domestic Product
HBS Household Budget Survey

ISAE "Information System on Average Earnings"

JIM Joint Inclusion Memorandum

LFS Labor Force Survey

LSA Living Standards Assessment LTU Long-Term Unemployment

MICS Multiple Indicator Cluster Survey (MICS)

MOE Ministry of Education

MoLSAF Ministry of Labor, Social Affairs and Family

MSL Minimum Subsistence Level

NAC ENAP National Action Plan on Social Inclusion
NAPE National Action Plan for Employment
NASI National Action Plan for Social Inclusion

NBS National Bank of Slovakia NMS New Member States

OECD Organization for Economic Cooperation and Development

OMS Old Member States
PD Personal Diary
PIT Personal Income Tax
PPP Purchasing Power Parity

PSIA Poverty and Social Impact Analysis
SILC Survey of Income and Living Conditions
SOSR Statistical Office of the Slovak Republic

SR Slovak Republic

STU Short-Term Unemployment

UNDP United Nations Development Programme

VAT Value Added Tax

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CONTENTS

ACKNOWLEDGMENTS	vii
EXECUTIVE SUMMARY	ix
Employment Opportunities Were Slow to React to Growth	x
Labor Market Segmentation Has Been Historically High	xi
What Is the Government's Strategy for Tackling Social Exclusion?	xiii
Has the Strategy Worked To Date?	xiv
Who Are the Winners and Who Are the Losers?	xiv
Can the Effectiveness of the Strategy Be Increased?	xvi
Can the Living Standards of the Most Vulnerable Receive More Support?	.xvii
CHAPTER 1 - SETTING THE SCENE	1
A. Is the Reform Process Bringing the SR Closer to Lisbon?	
B. The Objectives and Scope of This Task	
C. The Structure of the Report	3
CHAPTER 2 - THE "NEW" SLOVAK REPUBLIC	
AND THE LISBON TARGETS	
A. The 2002 Elections Led to a Wave of Far-reaching Reforms	
B. The Lisbon Targets for Employment Remain Distant	
C. The Post-2002 Reforms Were Designed to Bridge This Gap	
D. Is Lisbon Getting Any Closer?	
E. Monitoring Capacity Is Currently Very Limited	16
CHAPTER 3 - A TWO-EDGED SWORD: COMPETITIVENESS	
AND LABOR MARKET DUALITY IN THE "NEW" SLOVAK REPUBLIC	
A. A Growing Labor Force with Relatively Low Skills	
B. Employment Has Grown Relatively Slowly and Unevenly	
C. Unemployment Has Remained Unchanged	26
D. But the Unemployed Are Increasingly Excluded	
E. And Employment Mobility Remains Limited	28
F. But Job Dynamics Are Relatively High	30
G. And Wage Inequalities Remain Low But Are Growing	36
H. Is the Reform Beginning To Bear Fruit?	40
I. Emerging Issues	42
CHAPTER 4 - HAVE RECENT REFORMS WORSENED	
THE ODDS FOR THE MOST VULNERABLE?	47
A. Why Reform the Income Tax and the Benefits System, and How?	48
B. The Milestones of the Reform and Its Main Features	51

C. Have the Reforms Reduced the Income of the Poor?	59
D. What Has Happened to Poverty and Income Distribution?	63
CHAPTER 5 - WHY IT REMAINS IMPOSSIBLE TO ADEQUATELY MONITOR POVERTY AND INEQUALITY IN THE SLOVAK REPUBLIC	71
A. Data Limitations Prevent an Accurate Profile of Poverty	71
B. Assessing the Current Capacity to Monitor Trends in Living Standards	72
C. Areas of Potential Improvement	73
D. Conclusions	78
CHAPTER 6 - CAN COMPETIITIVENESS AND INCENTIVES BREAK THE CIRCLE OF POVERTY AND DEPENDENCE?	81
A. Has the Strategy Worked to Date and for Whom?	
B. Priority Actions Are Needed to Curb Poverty	
C. Improving the Capacity for Monitoring the Impact of Recent and Future Changes Is Paramount	
REFERENCES	93
List of Tables	
Table 2.1: Main Macroeconomic Indicators, 1994-2004	
Table 2.2: Regional Variations in Unemployment Rates in the EU	
Table 3.1: Number of Employed Persons in the Slovak Republic, 2000-04	
Table 3.2: Job Flow Rates by Regions, average over 2000-04 (%)	32
Table 3.3: Job Flows by Industries, Average over 2000-04 (in %)	33
Table 3.4: Differences in Job Flows by Share of Skilled Workers, Average over 2000-04 (in %)	35
Table 3.5: The Share of Excess Job Reallocation Due to Employment	
Shifts within Groups (in %)	36
Table 3.6: Gini Coefficients by Ownership Type and Gender, 1999 and 2003	37
Table 3.7: OLS Estimation Results – All Types of Ownership as a Dummy, 1999 and 2003	38
Table 3.8: Decomposition of the Wage Differential According to Ownership Type, 1999 and 2003	40
Table 4.1: Personal Income Tax in 2004 and 2002	52
Table 4.2: The Flat Tax in Central Europe	53
Table 4.3: Social Assistance Benefits Before and After the Reform, 2004 and 2002	54
Table 4.4: Focus of Active Labor Market Policies in 2004 and 2002	57
Table 4.5: Assumptions of the Benefit Impact Model	60
Table 4.6: Simulated Personal Income Tax by Income Deciles (yearly SKK),	
2002 and 2004	66

Contents v

Table 4.7: Progressivity and Redistributive Impact of the Tax System, 2002 and 2004 67
Table 4.8: Benefits by Income Deciles (yearly SKK), 2002 and 200468
Table 4.9: Impact of Benefits on Income Inequality, 2002 and 2004 (percent)68
Table 4.10: Impact of Reforms on Poverty Indicators (% increase)69
Table 4.11: Poverty Estimates with Behavioral Changes, 200470
Table 6.1: Which Active Market Policies Are Most Likely to Work?
List of Figures
Figure 2.1: International Comparison in GDP Trends, 2000-049
Figure 2.2: Growth and Employment, 1998-2004
Figure 2.3: International Comparisons of Activity and Participation Rates11
Figure 2.4: International Comparisons of Employment
and Unemployment by Education Level, 200412
Figure 2.5: Inequalities in Unemployment by Educational Level: SR and EU, 200415
Figure 2.6: Unemployment Rate and Regional Variance
Figure 3.1: Trends in the Working Age Population and Its Skill Composition,
SR, 1998-2004
Figure 3.2: Trends in the Skill Mix of the Population,
Labor Force and Employment, 1998-2004
Figure 3.3: Skill Composition of the Labor Force and Sources of Its Change, 1991-200421
Figure 3.4: Trends in Economic Activity by Gender, the SR and the EU, 15 <age<64< td=""></age<64<>
Figure 3.5: Economic Activity by Education, the SR and the EU, 2004, 25 <age<6422< td=""></age<6422<>
Figure 3.6: Growth and Employment, 1990-2004
Figure 3.7: International Comparisons of Responsiveness of Employment to GDP Growth
Figure 3.8: Trends in the Employment Rate, 1998-2004
Figure 3.9: Decomposition of Trends in the Employment Rate
and the Employment Level, 1999-200425
Figure 3.10: Trends in Unemployment Rates, 1998-2004
Figure 3.11: Decomposition of Unemployment Rate Changes, 1999-200427
Figure 3.12: STU and LTU Cycles, 1998-2004
Figure 3.13: Unemployment Rates, District Level, 2004 versus 1998
Figure 3.14: Job Creation, Job Destruction and Employment Shares
by Ownership Categories in 2000-04
Figure 3.15: Decomposition of Gender Wage Gap in 1999 and 200339
Figure 3.16: Seasonally Adjusted Trends in Employment by Type41
Figure 3.17: Sources of Growth in the Active Population
Figure 3.18: Negative Correlation Between Employment Rates
and Skills by Districts, 2004

Figure 4.1: The "Poverty Trap" for Different Family Typologies	
under the 2002 Benefits Systems	50
Figure 4.2: Social Expenditures in the Slovak Republic, 2001-04	53
Figure 4.3: Active Labor Market Policy in 2004: Beneficiaries and Costs	58
Figure 4.4(a): Examples of Results of Simulations, 2004 versus 2002: In Material Need for Subjective Reasons	62
Figure 4.4(b): Examples of Results of Simulations, 2004 versus 2002: In Material Need for Objective Reasons	63
Figure 4.5: Effective Personal Income Tax Rates in 2004 and 2002 for a Single Wage-earner	66
List of Boxes	
Box 1.1: The Lisbon Strategy and Employment Targets	2
Box 3.1: Are Regional Inequalities in the Employment Situation a Matter of Skill Composition?	45
Box 4.1: The Milestones of the Reform: Action Plans and New Legislation	
Box 4.2: Average Social Assistance Benefits and Number of Recipients	55
Box 4.3:Reduction in the Number of Recipients of the Social Assistance Benefits between January 2001 and December 2004	56
Box 5.1: Existing Data Capacity for Monitoring Poverty in the SR	73

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EXECUTIVE SUMMARY

- 1. The Slovak Republic (SR) was something of a latecomer to the economic transformation that swept through Central and Eastern Europe in the 1990s. However, since 1998 the country has implemented an extensive and far-reaching package of social and structural reforms which affects areas ranging from public finance to employment, education, health and social benefits. The very demanding political reforms implemented after the 2002 election, in particular, have been praised by many for the depth and speed of the changes and the sharp increase in competitiveness and economic dynamism that they have brought about. Indeed, there is wide agreement that the radical and comprehensive package of reforms implemented by the 2002 government has positioned the SR well—not only in relation to other EU8 countries but also in relation to the EU15—in terms of increased competitiveness and employment opportunities, two of the main aims of the EU Lisbon Strategy for Employment and Social Inclusion.
- 2. However, concerns have also been voiced about the potential negative effect of the reforms on the other dimension of the Lisbon strategy: the drive for social inclusion. The argument is that in view of the pre-existing inequalities in access to employment across regions and individuals, the increased emphasis on work as an individual's right and duty, and as the main route out of poverty, may amplify the economic disadvantages and increase the social exclusion of those who face strong and complex barriers to employment.
- 3. Given these contrasting views and the government's determination to curb social exclusion and reduce poverty, it is somewhat surprising that little systematic effort has been made to monitor the impact of the reform process begun in 1998—and the growth it generated—on the incidence, depth and profile of poverty in the SR. Data limitation is the main reason why such a systematic evaluation has not been attempted. While this is a significant limitation, it is extremely important for the sustainability of the reform process that its effects to date be quantified, even if in an imperfect manner.
- 4. Within this context, this report provides the following:
 - A baseline analysis of the current performance of the Slovak economy in the areas of employment, labor market segmentation and social exclusion, against which future development can be assessed and evaluated.
 - An assessment (to the extent possible, given the data constraints) of the impact of the far-reaching structural reforms implemented after the 2002 elections on (i) the living standards of the most vulnerable; (ii) the distribution of income and welfare; (iii) job creation and employment opportunities; and (iv) the levels of and inequalities in work income.
 - An effort to advise on any actions/policies that may further increase the effectiveness of the recent reforms as a strategy for promoting social inclusion.

Among other sources, the World Bank's *Doing Business in 2005* Report rated the SR as (i) the world's top reformer in improving its investment climate over the past year, and (ii) number 17 among the world economies in terms of ease of doing business, just before Lithuania and well ahead of some of the other EU member states.

• An effort to advise on setting up the institutional structure for the regular and comprehensive monitoring of the dynamics of growth, job creation, employment, living standards and social exclusion in the SR.

EMPLOYMENT OPPORTUNITIES WERE SLOW TO REACT TO GROWTH

- 5. The government that emerged from the September 2002 elections, as a modification of the previous coalition, inherited a country deeply divided between a relatively prosperous majority well equipped to benefit from the growing competitiveness of the Slovak economy and the economic growth that came with it and a relatively small group that in the aftermath of economic transformation had become increasingly trapped in a vicious circle of low skill-low employment opportunities-state dependency-low intensity of job search. A crucial link in this chain was the disincentive to work created by the generous social assistance system of the 1990s, which led to some household typologies (typically, those with large numbers of children and potentially low-earning adults) being financially better off when out of work.
- In an attempt to break this vicious circle, the government undertook a set of politically 6. demanding and far-reaching structural reforms whose main objective was to foster growth and increase average living standards by strengthening the flexibility and competitiveness of the economy and increasing the incentives for individuals to work and acquire human capital. The focus was on employment as the main pillar of a comprehensive growth and poverty reduction strategy. The economy reacted well, with economic growth rising to well above 4 percent in 2003 and reaching an impressive 5.5 percent in 2004—double the EU15 average and well in excess of the average of the Visegrad 4+ countries, 2 although somewhat slower than that of the Baltic States. In addition, the double-digit inflation of the 1999-2000 period began to decline and a clear long-term prospect for good growth performance emerged, conditional on the reform process not being halted or reversed. Moreover, the combination of growing GDP and declining inflation led to an increase in average private consumption per capita (up nearly 3.5 percent in 2004) and a renewal of domestic demand, which suggests a positive trend in the average living standard of the Slovak population.³
- 7. However, a concern sometimes expressed is that the reforms may not have been equally successful in reducing poverty and tackling social exclusion and that the emphasis on the individual's work potential as the route out of poverty may have further increased the social exclusion of those who for whatever reason may not be able to find or seek employment. In addition, in the flexible and competitive economy that has emerged over the last year, the inability of these groups to benefit from the country's high growth rate, the overall improvement in living conditions and the increase in targeted measures such as

The Visegrad 4+ countries are the Czech Republic, Hungary, Poland and Slovenia. The Baltic countries are Estonia, Latvia and Lithuania. Figure 2.1 in Chapter 2 separates the EU8 into these two groups of countries because the Baltic States have growth trends that differed considerably from the other four countries, partly as a reflection of their different initial conditions.

The GDP growth rate, which fell to as low as 1.5 percent in 1999, was 4.6 percent in 2002 and 4.5 percent in 2003 and rose to 5.5 percent in 2004. Thus, the post-2002 reforms have clearly been very successful in promoting growth and in improving the average living standard.

хi

activation programs and other labor market policies (see below) may have increased their economic vulnerability. This concern is reinforced by the finding that labor market outcomes have lagged somewhat behind GDP growth and that, as employment opportunities for the average population have improved, unemployment has become increasingly concentrated among the unskilled and in specific regions.

- 8. Indeed, the high economic growth of recent years has translated into a growth of employment at rates that, with the exception of 2003, are considerably lower than those of the EU15 countries although somewhat higher than the average for the EU8. The slowdown of 1999-2000 resulted in a drop in employment between 1998 and 2000 of 100,000 jobs (or nearly 5 percent of total employment). After 2000, the increase in GDP growth resulted in a mild but much smaller increase in employment. In 2003 the increase in employment was close to 2 percent (less than half of the GDP growth rate for that year) and employment actually fell over the first half of 2004 only to pick up sufficiently in the second half to obtain an overall increase of 30,000 jobs, despite a 5.5 percent growth rate.
- 9. During the same period the working age population continued to increase—slightly until 2003 and then by as much as 2 percent in 2004—and the activity rate of the working age population increased slightly, leading to a growth in the labor supply of 128,000 people (just over 5 percent) over the period 1999-2004. Thus, the small increase in employment was just enough to absorb the increase in the labor supply, and unemployment remained unchanged.
- 10. However, what is particularly striking for the external observer is not so much the recent trends in labor market indicators but the absolute level of some of these indicators. At around 70 percent, the participation rate of the working age population in the SR is very similar to the average for the EU15 countries and considerably higher than the EU8 average of just over 66 percent. Nevertheless, the following considerations are worth noting:
 - At less than 58 percent, the employment rate in the SR is the third lowest in Europe (with only Hungary and Poland having lower rates) and is far lower than the Lisbon target of 70 percent.
 - As a result of the average participation rates and the very low employment rates, the SR has the second highest unemployment rate in the EU after Poland, more than twice the EU15 average. In addition, the unemployment rate among workers with only a basic education is nearly five times higher than in the EU15 and more than double the EU8 average.

LABOR MARKET SEGMENTATION HAS HISTORICALLY BEEN HIGH

- 11. Of particular relevance for policymakers is the fact that much of the difference in labor market indicators between the SR and the rest of Europe is due to the extreme poor prospect of particular groups of workers, with the most striking disparities being across regions and in skill levels. Thus, for example, in 2004:
 - Over half of the workers with only a basic education were unemployed, an increase of over 70 percent since 1998.
 - The unskilled were 2.5 times more likely to be unemployed than the average

- population, by far the second highest differential among the EU25 after the Czech Republic.
- The SR was the EU country with the highest proportion of long-term unemployment (LTU) (65 percent of the unemployed) and the lowest proportion of short-term unemployment (only 10 percent of total unemployment), and a clear link between low skills and LTU was emerging.
- Regional differences in the incidence of unemployment are also very large. At the NUTS3 level, the SR has the second largest variance in regional unemployment rate in the EU25 after Italy. It also has the second highest regional unemployment rate in the EU25 (at NUTS2 level), after Italy.
- 12. Similar conclusions are derived from an analysis of labor market dynamics observed in the Slovak enterprise surveys. These conclusions support the hypothesis of increased labor market duality, with a dynamic "segment" growing in accordance with the growth of the economy and the other segments stagnating or even contracting over the same period. The dynamic part is driven predominantly by foreign companies, which have positive net job creation (i.e., they are creating more jobs than they are destroying), have a growing lead in terms of the productivity-related characteristics of the labor force (especially education), and are paying increasingly higher wages. These jobs are concentrated mainly in the Bratislava region and in other regions with easy access to markets, and they attract the better qualified workers.
- 13. The considerable differentials within regions and types of workers are not a new phenomenon in the SR. On the contrary, it has been a latent feature of the Slovak economy since socialist times, although one that was hidden to some degree by the emphasis on full employment of the pre-transition area. The economic liberalization that followed the 1998 election brought this disadvantage to the surface as the shift in focus from full employment to increased productivity resulted in a sharp reduction in the employment opportunities for low-skilled workers. The incidence of unemployment for these workers grew sharply and became increasingly of a long term nature. However, until the 2004 reforms, the living standards of these workers were, for the most part, maintained by very generous social benefits which for some household typologies exceeded their potential labor income.
- 14. However, these generous benefits substantially reduced the incentives for potentially low-paid unemployed workers to actively seek employment, and many left the labor force entirely. Thus, while successful in preventing households from falling into financial poverty, they were a major cause of social exclusion for these workers and their families. This is what the past 2002 reforms sought to address.

Executive Summary xiii

WHAT IS THE GOVERNMENT'S STRATEGY FOR TACKLING SOCIAL EXCLUSION?

15. With the 2003 "Strategy of Growth in Employment based on the Labor Market Reform" the newly elected government set out a comprehensive strategy to reduce the historically high level of labor market disadvantage faced by some groups. The cornerstone of this strategy was the reforms of January 2004, which were designed to break the vicious circle of lack of skill-poverty-dependence that led to the widening gap between the economic opportunities of the skilled and the unskilled. The strategy was multi-pronged and was based on the principles of (i) "making work pay"; (ii) increasing employment opportunities for everyone but targeting the most vulnerable groups; and (iii) addressing the issue of skill disadvantage by increasing the educational attainments of the most vulnerable groups in general and of their children in particular.

- 16. For the point of view of this report, the main elements of the reform can be summarized in the following list:
 - The implementation of a new Labor Code, designed to foster labor market flexibility, by:
 - o Introducing the option of a number of non-standard labor contracts
 - o Increasing the employer's flexibility to terminate a contract.
 - The **reform of the welfare system**, designed to (i) eliminate the poverty trap by increasing incentives to work and (ii) improve the targeting of social welfare benefits by:
 - o Replacing the pre-existing two categories of beneficiaries with a single entitlement structure based on current, as opposed to past, individual labor market status and search
 - Reducing the minimum benefit for a single adult to an amount below the subsistence minimum and weakening the link between family size and benefit level
 - Introducing a number of new benefits for the working poor, available to families in which the adults are either working or participating in active labor market programs (ALMPs) and expanding the entitlement to social benefits to the first 6 months of employment
 - Providing subsidies to municipalities (and other stakeholders) for organizing training and targeted employment opportunities for the LTU ("activation programs")
 - o Replacing the previous income-related family benefits with a flat (not income-related) benefit per each child coupled with tax credits for minor children
 - Introducing basic and high-school scholarship schemes in addition to meal and schooling subsidies.
 - The **labor market reform**, designed to improve the employment opportunities and potential incomes of disadvantaged groups and the long-term unemployed through the following means:

- o Individual and targeted work with the unemployed (in-depth interviews, individual action plans for job-seekers, testing and assessment of personal characteristics, etc.)
- The mandatory character of the ALM programs and the reimbursement of travel and child-care costs to job-seekers actively seeking employment and participating in ALM programs
- o Subsidies to employers hiring LTU and to LTU job-seekers planning to start a business
- o Targeted interventions to regions with the highest incidence of unemployment
- o An increase in the minimum wage of around 5 percent in real terms since 2003.
- The reform of the administration of welfare systems, designed to merge the social agenda with the labor market policies in the regional offices.
- 17. The government's strategy for tackling social exclusion is thus comprehensive, radical and imaginative. All of the mechanisms seem to be in place to address poverty and social exclusion in the long term by interrupting the vicious circle that has prevented the poor from breaking out of poverty for generations. However, four questions emerge:
 - Has the strategy worked to date?
 - Who are the gainers and losers in the reform?
 - Can the effectiveness of the strategy be increased?
 - How can the living standards of the most vulnerable be supported without reducing the incentive to participate in the drive to "earn your way out of poverty"?

HAS THE STRATEGY WORKED TO DATE?

- 18. A first assessment of its impact on a number of basic indicators suggests that, overall, the "Strategy of Growth in Employment" has been reasonably effective in achieving the following targets:
 - Eliminating the disincentive to work provided under the old system by the high replacement ratio faced by individuals with a low earning potential
 - Increasing the disposable income of the majority of households that are entitled to benefits
 - Providing better employment opportunities and access to ALM programs for the average worker and for the most vulnerable groups.
- 19. However, questions remain regarding the magnitude of these effects and their sustainability over time. In addition, it is important to note that, given the short time-frame of the analysis, it is difficult to establish whether the recent positive trends in some indicators are the result of the reforms or the effect of short-term trends.

WHO ARE THE WINNERS AND WHO ARE THE LOSERS?

20. Owing to data limitations, the impact of the reform on income and income poverty cannot be evaluated but can only be simulated. This report uses two different approaches. First, it computes pre-reform and post-reform income levels for different household typologies and

Executive Summary xv

calculates the net impact of the reform by comparing these two levels. As a second approach it uses a Tax-Benefit Model to compare for all sample households their income levels before the reform with the simulated post-reform levels so as to identify the gainers and losers as well as the distributional and poverty changes.

- 21. The first approach reaches the following conclusions:
 - The combined effect of the reform of the tax and benefits regime has increased the disposable income of the majority of households that are entitled to benefits
 - The only households that may have lost out are those with three or more children where all of the adults are unemployed, and that were entitled before the reform to a higher benefits schedule
 - Even for the most affected households the maximum potential loss in disposable income is limited.
- 22. These conclusions are confirmed by the findings of the Tax-Benefit Model, which concludes that the reform has only a small potential first-round effect on the incidence of poverty, with the poverty headcount reduced by 2 to 3 percent according to simulations based on the 2003 Microcensus. This is the case despite an overall reduction of around 16 percent in the average transfer paid and thanks to the improved targeting of the social benefits.
- 23. A primary factor behind this result is the reduction of the tax burden on the lower income groups which has been associated with the move to a "flat rate" personal income tax (PIT) combined with a substantial increase in deductions and credits. This is an important result, since it shows that concerns about the potentially negative distributional effect of the tax reform may be misplaced. In the Slovak version, the flat rate tax has not been merely an efficiency measure. Its implementation is likely to have increased the progressivity of the income tax system while replacing five tax brackets (and a fairly steep scale of tax brackets) by a single one. Indeed, in 2004 the PIT burden was reduced for everyone, but particularly for households with lower incomes. This was due to the effect of the increase in deductions and credits which has more than compensated for the reduction in progressivity associated with the move to a single tax rate. However, while the incidence of poverty has declined, its intensity and the related poverty gap have increased considerably—by 81 and 62 percent, respectively— which suggests that the income levels of those in poverty have declined as result of the change in the tax-benefit regime.
- 24. Much of the ultimate impact of the reforms, however, depends on their second-round impact on labor market outcomes. The use of quarterly data suggests that the reform package implemented after 2002 may have been associated with a relatively high increase in employment with a year to year seasonally adjusted growth of 1.7 percent in 2003, driven primarily, but not entirely, by a growth in self-employment, and a subsequent slowdown to 0.3 percent in 2004. This interpretation is, however, biased to the base effects. An inspection of quarter to quarter changes reveals that after a sharp drop in the second half of 2003 (-0.3 percent and -0.4 percent in the third and fourth quarters, respectively) overall employment began to increase in 2004 with a total increase of 46,200 jobs—and a 0.4 percent increase

in the employment rate—in the period from the second quarter of 2004 to the first quarter of 2005 (all seasonally adjusted).

- 25. It is too early to determine to what extent this is the beginning of a trend and whether this is attributable to the success of the 2004 reforms, but the signs are encouraging. The fact that this growth is driven exclusively by the growth in self-employment—in the context of the declining number of employees—is also worth noting, as it points to economic liberalization as the main driver and has important implications for policymaking.
- 26. In contrast, the reforms of 2004 do not seem to have had any significant impact on the participation rates of the Slovak population. The steady growth of the active population (at around 1 percent in 2004) was exclusively the result of the growth in the working age population. Combined with the trends in employment, this resulted in the rate of unemployment peaking during the first quarter of 2004 at 19.5 percent (15-64 age bracket)—the second highest figure in the records (after the corresponding period of 2001). Subsequently, this rate fell rapidly throughout 2004 and 2005.
- 27. Of particular interest is the assessment of the effect of the ALMPs already implemented. The available data show that the "activation contribution" is by far the most popular policy introduced to date in terms of number of beneficiaries and is a very successful measure, despite the lack of employment opportunities in some areas. However, the question of whether participation in this scheme will permanently increase the employment opportunities of the participants remains open. The international evidence regarding the success of these types of interventions is contradictory and country-contingent.
- 28. However, it is also important to realize that, in addition to their potential effect on future employment prospects, ALMPs can play a significant role as a strategy to reduce social exclusion. This is particularly important in a dual labor market such as the SR, where a small pocket of the labor force is at risk of becoming increasingly marginalized and "discouraged". Within this context, the programs can be seen as a way of keeping these workers engaged in the labor market and the economy rather than having them rely exclusively on social assistance. Thus, these policies would act more as an alternative form of social assistance, designed to break the cycle of dependence and social exclusion, rather than as a route to permanent employment.

CAN THE EFFECTIVENESS OF THE STRATEGY BE INCREASED?

- 29. The main messages that emerge from this report in relation to increasing the effectiveness of the reform strategy are outlined below:
 - It is still too early to pass final judgment as to whether the politically demanding strategy adopted by the Slovak government after the 2002 election for reducing poverty and social exclusion has worked. This is partly due to data limitations and partly to the fact that the full impact of the new policies is not yet fully reflected in the available data. Some of these policies will also need some time to show their full effects.
 - However, signs are positive, with many indicators of access to economic opportunities showing clear improvement since the middle of 2004. Whether these positive trends

Executive Summary xvii

- are the results of the reforms rather than of international macroeconomic trends, EU accession or other factors remains to be ascertained.
- In the meantime, it is essential (i) to set up an adequate monitoring system that can provide a reliable baseline against which future developments can be evaluated; (ii) to conduct detailed evaluations of the impact of the reform on a regular basis; and (iii) to institutionalize a system through which the findings of the evaluation are fed back into policymaking. This would add an essential element of evidence-based policymaking that would increase the effectiveness of the reform process as well as enhancing its long-run sustainability.
- 30. In the climate of reform and change that has prevailed over recent years, the government needs accurate, up-to-date and relevant information in order to make sound economic and social policy decisions. It needs to measure and monitor poverty, employment and unemployment, social inclusion and other dimensions of living standards at regular and short intervals. In addition, in the context of increased accountability that characterizes the new SR, analysts need data with which to model economic behavior and to provide answers to questions about whether instituted policies have been successful, and also to see how new policies might affect the population. However, the lack of systematic collection of good quality data on the main indicators of welfare, as well as the limited analytical capacity, makes it impossible to satisfy the government's objective of evidence-based policymaking. Unfortunately, evidence-based policymaking in the SR is presently hampered by the lack of reliable and regularly produced data.
- 31. In short, if the economic transformation of the SR is to be complete, it is essential that: (i) its statistical system is updated to the level of the other EU25 countries and to the minimum level required for adequate monitoring and reporting to the EU on priority indicators; (ii) adequate capacity is built within the government for evidence-based policymaking; and (iii) closer links are established between the Statistical Office (SOSR) and the Slovak government, especially the Ministry of Labor, Social Affairs and Family (MoLSAF) in the case of monitoring living standards. Both the SOSR and the government agree with these conclusions and are working towards improving capacity.

CAN THE LIVING STANDARDS OF THE MOST VULNERABLE RECEIVE MORE SUPPORT?

32. It is also important to recognize that even under the best possible scenario, in which the reform proves extremely successful in promoting employment opportunities and "making work pay", pockets of unemployment and social exclusion will remain, especially in a country with a highly segmented labor market, like the SR. In order to improve the living standards of the most vulnerable, a comprehensive and effective system of social assistance is needed. While the 2004 changes in the tax and benefits structure have potentially increased the disposable income slightly for most low-income households, they seem to have had a negative effect on the income level of poor households with unemployed adults and large numbers of children. These households are highly concentrated at the bottom end of the income distribution (both pre- and post-2004) and thus it is not surprising to find that the 2004 reforms may have left the poverty headcount basically unchanged but increased the intensity of poverty, as the disposable incomes of the poorest households were the only ones negatively affected by the reform.

- 33. To some extent this was the unavoidable consequence of the shift to work incentives and the reduction in the basic benefits which was required to reduce the fiscal pressures generated by the formerly overgenerous benefits system. However, in view of the barriers to employment that remain (at least in the short run) for unskilled workers and for those in the lagging areas, the government may wish to target these groups and communities with short-term measures designed to help them overcome the loss of livelihood.
- 34. In the context of the emphasis on providing the right incentives, any individual/ household level intervention of this type would need to be designed as a *conditional* transfer program (i.e., as one in which entitlement to the benefit is conditional on some form of positive behavior). As the focus of this intervention is likely to be households with large numbers of children, it may be advisable to make the condition related to children. Programs of this type that have proved to be successful in similar contexts have provided transfers conditional on school attendance and regular visits to health clinics.⁴ Such programs directly address the vicious circle of the intergenerational transmission of poverty that is so evident in the SR.
- 35. The 2004 reform has already introduced a number of conditional transfers such as the "activation allowance" and the secondary and higher education scholarships. It has also introduced similarly targeted interventions at the community level via the training and education grants and other interventions. These are steps in the right direction that need to be reinforced in order to have a more perceivable effect and to ensure their long-term sustainability.
- 36. In principle, funding for these additional types of interventions should not be difficult to obtain. The simulations in this report suggest that in its current format the new benefits system maintains a relatively high degree of inefficiency, with benefits being paid not only to the poor but also to households in the top income deciles. This is partly due to the shift away from income contingency of all family-related benefits. While child-benefits tend not to be income related across the EU countries, it is arguable whether this is a choice in a country with limited resources and very deep pockets of poverty. In addition, the removal of income conditionality for the parental allowance is more difficult to justify in the context of limited resources for social assistance. Reverting to a system of income-related family benefits may generate enough savings to finance the increased emphasis on conditional transfers.

Programs of this type that have received particular attention are, for example, Progressa in Mexico and Borsa Escolar in Brazil.

CHAPTER 1-

SETTING THE SCENE

1.1 The Slovak Republic (SR) is one of the eight Central European (CE) countries which joined the European Union (EU) in May 2004 (EU8) and the one with by far the most profound disparities, rooted in a long history of geographical and ethnic inequalities. Somewhat of a latecomer to the process of economic transformation that swept through Central and Eastern Europe in the 1990s, the SR has since 1998 become a strong and innovative reformer.

A. IS THE REFORM PROCESS BRINGING THE SR CLOSER TO LISBON?

- 1.2 Slovak and international observers have increasingly come to praise the depth and speed of the changes and the sharp increase in competitiveness and economic dynamism that have occurred in the SR. Among other sources, the *Doing Business in 2005* Report⁵ rated the SR as the world's top reformer in improving its investment climate over the past year, and number 17 among the world economies in terms of ease of doing business, just before Lithuania and well ahead of some of the other EU member states. Thus, in the eyes of many, the reforms have provided the SR with the possibility of taking full advantage of the new opportunities presented by its recent entry into the EU. In particular, there is wide agreement that the radical and comprehensive package of reforms implemented by the 2002 government have positioned the SR well—not only relative to other EU8 countries but also relative to the EU15—in terms of two of the main aims of the *EU Lisbon Strategy for Employment and Social Inclusion* (as described in Box 1.1): increased employment and competitiveness. Indeed, the spirit of the 2004 reforms was very much in line with the principles underlying the Lisbon Treaty and, in particular, with the objectives of "making work pay" and increasing employment opportunities for the overall population by increasing the competitiveness of the economy.
- 1.3 However, concerns have also been voiced about the potential negative effect of the reforms on the other dimension of the Lisbon strategy: the drive for social inclusion. The argument is that—given the extent of the pre-existing inequalities in access to employment across regions and individuals—the increased emphasis on work as an individual's right and

⁵ World Bank (2004), Doing Business in 2005.

duty and as the main route out of poverty may amplify pre-existing economic disadvantages and increase the social exclusion of those who face strong and complex barriers to employment.

1.4 Given these contrasting views and the government's determination to curb social exclusion and reduce poverty, it comes as something of a surprise that little systematic effort has been made to monitor the impact of the reform process begun in 1998—and the growth it generated—on the incidence, depth and profile of poverty in the SR. Data limitation is behind the failure to produce regular poverty profiles that are reliable and comparable over time. Until the release of the Microcensus data last summer, the latest quantitative indicators referred to 1996, well before the beginning of the reform process.⁶

Box 1.1: The Lisbon Strategy and Employment Targets

The 2002 Council meeting in Lisbon was set up to make the EU the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion (EC[2003a]). The strategy that followed had three main dimensions—employment targets, competitiveness and social inclusion—and was designed to enable the EU to regain the condition of full employment and to strengthen cohesion by 2010.

In order to anchor the policies, the EU set ambitious targets for all EU countries at a horizon of 2010. In the case of employment, the target is an employment rate of 70 percent on average and 60 percent for women. New targets have been added in Stockholm: namely, to have an employment rate of 50 percent for older workers by the same time, and in Barcelona: to delay by five years the exit age from the labor force. In 2004 and 2005 the European Commission concluded a mid-term review of the Strategy and noted that progress had been slow to date: while there was some improvement in employment rates, particularly for women, with net job creation waning recently, the 70 percent target will be "difficult to reach" by 2010 (EC [2003b]). Progress was also disappointing on many other fronts. These failures were attributed to a too broad scope of the strategy and, most important, to a lack of political commitment.

As a result, the Commission is trying to reinvigorate the Lisbon process. In particular, it intends to make it more selective and focused on growth, jobs, competitiveness and knowledge economy. In terms of labor market policies, this would mean implementing the recommendations of the EC's Employment Taskforce. In its report, the Taskforce has identified four key requirements on which success in job creation will depend. These are: (i) increasing the adaptability of workers and enterprises; (ii) attracting more people to the labor market; (iii) investing more and more effectively in human capital; and (iv) ensuring the effective implementation of reforms through better governance.

To address the commitment problem, the Commission intends to strengthen ownership through putting more explicit responsibilities on countries. Tasks and accountabilities are to be clearly assigned between the EU and the national level. According to the proposal, governments will be expected to prepare and discuss with their parliaments a single National Action Program for growth and jobs as well as taking ownership of this implementation.

However, for the moment, the 2010 deadline has not been lifted.

1.5 In a rapidly changing environment, the expectation is that the poverty profile is likely to have changed considerably since 1996. However, owing to the absence of regularly produced

⁶ World Bank (2002), Slovak Republic: Living Standards, Employment, and Labor Market Study.

Chapter 1 3

nationally representative data on income and consumption, the 2003 Microcensus provides the only potential source of information on poverty and inequality in recent years. However, this dataset has several limitations as a source of information for both a static poverty profile and an adequate evaluation of the impact of the reform process. It is unsuitable for deriving a reliable poverty profile for 2002 because: (i) owing to the way the sample is selected and to the very low response rate, the data are likely to be strongly biased towards an under-representation of the poorest groups in the Slovak society; (ii) it does not contain information on consumption or other wealth indicators; and (iii) the income information is highly unreliable and differs considerably in the individual and the household files.⁷

- 1.6 In addition, the data cannot be used to evaluate the impact of the reform process on poverty and social exclusion because they refer to 2002, and thus they precede the most radical reforms which were implemented in January 2004. In addition, the sample of the 2004 Microcensus is derived from the 2001 Census. While this makes the data in principle more representative of the population of the SR than the data in the 1996 Microcensus—with a sample drawn from the obsolete 1991 Census—it also makes the two samples highly incomparable. Therefore, changes in poverty indicators over the two datasets do not necessarily reflect the impact of the reform.
- 1.7 Nevertheless, despite the data limitation, given the speed of change and growth in the SR over recent years and the government's focus on curbing poverty and social exclusion via improved labor market opportunities, it is paramount to attempt at least a partial evaluation of the impact of the reforms with the available data, however limited. The sustainability of the reform process and its success rely heavily on the ability to carry out this evaluation on a regular basis and to feed the findings into policymaking.

B. THE OBJECTIVES AND SCOPE OF THIS TASK

1.8 Within this context, the aim of this report is to provide an initial evaluation of the impact of the reform process on those areas which it was most designed to address: labor market outcomes and social exclusion. The focus of the labor market analysis is on the two distinct phases of the reform as highlighted above: (i) the 1998-2003 period, during which changes were relatively small and the focus was primarily on macroeconomic and fiscal sustainability; and (ii) the post-January 2004 period, when radical changes to the Labor Code were combined with far-reaching reforms of the tax and social benefits systems in an attempt to boost both the demand for and supply of labor. However, given the short interval since the implementation of the 2004 reforms, the following limitations should be taken into account:

The difference between the income values in the individual and the household files may be the source of the wide differences in poverty indicators for the SR reported by different sources. For example, within the space of a couple of months EUROSTAT and the European Commission came up with two very different poverty rates (for the same poverty line and both based on the Microcensus 2003). The range was from 5 percent (which made the SR the country with the lowest relative poverty in the EU) to 21 percent – the highest poverty incidence in the EU.

- The report can, at best, pick up only the short-term impact, which—given the complexity of the reform package and its focus on creating the right incentives—is likely to be an underestimation of the cumulative long-term impact
- Any conclusion is necessarily tentative, as it may reflect cyclical variations rather than medium-term trends and thus it is difficult to derive firm conclusions on the basis of such a short time span.
- 1.9 Data limitation prevents a reliable analysis of the effect of the reforms on living standards and social exclusion, as data on these aspects of individual and social wellbeing are only available at a point in time (namely, 2002) and even then they suffer from important limitations. The approach followed in this report is to use the 2002 data to construct counterfactual pre- 2004 and post- 2004 income levels using simulation techniques.
- 1.10 Within these limitations, the main objectives of this task are the following:
 - To provide a baseline analysis of the current performance of the Slovak economy in the areas of living standards, employment and social exclusion—against which future development can be assessed and evaluated
 - To advise on any actions/policies that may further increase the effectiveness of the recent reforms as a strategy for promoting social inclusion
 - To set up the institutional structure for the regular and comprehensive monitoring of the dynamics of growth, job creation, employment, living standards and social exclusion in the SR.
- 1.11 The scope of this task was decided in close consultation with the government of the SR, civil societies, Slovak think-tanks and academic institutions, and its focus reflects closely the interests and requirements of the government. The choices were to focus on the limited number of issues highlighted above with particular reference to the link between promoting competitiveness and enabling reforms on the one hand, and improving labor market outcomes and the living conditions of the most vulnerable groups on the other.
- 1.12 The report fits into a broader program designed to provide technical assistance to the Ministry of Labor, Social Affairs and Family (MoLSAF) and other relevant ministries in the following ways:
 - Evaluating the impact of the SR's recent economic success and the impact of its comprehensive and cross-cutting package of reforms on the economic opportunities and living standards of the most vulnerable groups
 - Enhancing the current capacity for (i) monitoring poverty and social exclusion, (ii) evaluating the impact of economic reforms, and (iii) delivering evidence-based policymaking.
- 1.13 Thus, this task goes beyond a traditional report and has the combined characteristics of Analytic and Advisory Activities (AAA) and technical assistance. Adopting this non-standard and highly participatory approach has allowed the team and the task to be more responsive to the specific needs of a high middle income country in the midst of profound transformation.

Chapter 1 5

However, compared to a traditional Living Standards Assessment (LSA), it does not attempt to quantify standard indicators of poverty, to derive a poverty profile or to analyze its dynamics. This decision is motivated by the persistent lack of reliable, nationally representative data on income and consumption and the total absence of information on other dimensions of poverty and vulnerability. These limitations have been highlighted repeatedly in the past but never fully addressed. This LSA has made a deliberate attempt to move forward by increasing the quality of the data and creating the necessary institutional capacity to make full use of the improved data in policymaking.

C. THE STRUCTURE OF THE REPORT

- 1.14 The format of this report is also somewhat unusual. It consists of three separate economic notes presented in two volumes. Volume I is a Briefing Note that presents the main findings and their policy implications. The remaining volume contains a set of Policy Notes designed to address the priority policy issues selected jointly by the government and the team.
- 1.15 The choice of this format responds to the need (i) to react more quickly and provide more timely policy advice to a country experiencing rapid and deep transformation, and (ii) to set the timing of the different pieces so as to meet the requirement of the reform process rather than being conditioned by the availability of all of the material. Indeed, for the most part our Slovak partners have had early access to the Policy Notes, and early discussions have taken place between the team and the government on each of these components. In addition, follow-up activities have already been put in place by both the World Bank team and the government of the SR. This is particularly true of the Technical Note *Building Capacity for Systematic Monitoring of Poverty and Social Exclusion in the Slovak Republic*, which led to follow-up activities with the Statistical Office of the SR (SOSR) via the Statistical Capacity Building Trust Fund and within the MoLSAF and the Ministry of Education (MoE) via a technical assistance loan.
- 1.16 After consultation with the government of the SR and the World Bank Country Team, three self-standing Policy Notes of high policy relevance were included in this report:
 - An analysis of trends and dynamics in the labor market with special reference to a
 profile of employment and job creation and an analysis of the barriers to better labor
 market indicators at the national, regional and individual levels
 - A Technical Note on data limitations and suggestions for capacity building in the area of poverty monitoring and impact evaluation
 - A Poverty and Social Impact Analysis (PSIA), looking at the distributive effects of the recent reforms of the personal income tax and benefits systems.
- 1.17 An additional component of his programmatic task has been postponed until the end of 2005 owing to delays in obtaining the necessary data. This final Policy Note is intended to respond to the lack of nationally representative data on different indicators of welfare by compiling a multidimensional profile of poverty in vulnerable communities. The profile is to

be based on a statistically representative survey of selected vulnerable communities, jointly financed by the World Bank and the UNDP. The multidimensional household survey, currently in its final stage, focuses on the communities covered by the *Socioeconomic Mapping of the Roma Communities*.

1.18 Volume I begins by describing the rationale for the report, its scope and objectives. It then moves on to give an overview of the macroeconomic climate and its changes over the last decade, with particular reference to the period of economic liberalization that began with the 1998 election. Chapter 3 analyzes in some depth the main trends in the labor market in an attempt to explain why the rapid economic growth experienced over recent years has not resulted in equally positive trends in employment. Chapter 4 assesses the impact of recent reforms to the tax and benefit systems on poverty and income inequality, while Chapter 5 describes the limitations of the data currently available and the system currently in place for monitoring poverty and social exclusion in the SR. Finally, Chapter 6 makes a number of suggestions on how the current strategy for employment and social inclusion can be rendered more effective.

CHAPTER 2-

THE "NEW" SLOVAK REPUBLIC AND THE LISBON TARGETS

2.1 Much has taken place in the SR both politically and economically over the last decade, and much of the changes occurred after the 1998 elections, which brought a wave of key liberalization policies, growing inflows of foreign direct investment (FDI) and large-scale industrial restructuring, triggering a significant productivity growth. The introduction of measures designed to reduce the high current account deficit in the balance of payments led to a period of economic slowdown during 1998-2000, in sharp contrast to the impressive but unsustainable growth rates of the mid-1990s. Although by 2001 the economy was on a recovery path with a 3.8 percent real GDP growth, the inequalities in economic opportunities, which had grown larger over the 1990s, showed no signs of declining.

A. THE 2002 ELECTIONS LED TO A WAVE OF FAR-REACHING REFORMS

- 2.2 Thus, the government that emerged from the September 2002 elections, as a modification of the previous coalition, inherited a country profoundly divided. For the most part the population was relatively prosperous and well equipped to benefit from the growing competitiveness of the Slovak economy and the economic growth that came with it. However, in the aftermath of economic transformation, a relatively small group had become increasingly trapped in a vicious circle of low skill, low employment opportunities, state dependency, low intensity of job search. A crucial link in this chain was the disincentive to work created by the generous social assistance system of the 1990s, which led to some household typologies (typically those with large numbers of children and potentially low-earning adults) being financially better off when out of work.
- 2.3 In an attempt to break this vicious circle, the government undertook a set of politically demanding and far-reaching structural reforms with the objective of fostering growth and increasing average living standards by strengthening the flexibility and competitiveness of the economy and increasing the incentives for individuals to work and acquire human capital. The focus was on employment as the main pillar of a comprehensive growth and poverty reduction

strategy. The economy reacted well, with (i) economic growth rising to well above 4 percent in 2003 and reaching an impressive 5.5 percent in 2004; and (ii) the double-digit inflation of the 1999-2000 periods declining.⁸

2.4 In 2004 the growth performance of the SR closely approached that of the high-growth years of the mid-1990s (see Table 2.1) and was more than double the average for the EU15 and EU25 countries (growth rates of 2.3 and 2.4, respectively). Indeed, after a sharp turnaround in 2001, over recent years the growth rate of the Slovak economy has been consistently double that of the EU15 and well in excess of that of the *Visegrad 4+* countries, although somewhat slower than that of the Baltic States (see Figure 2.1).

Table 2.1: Main Macroeconomic Indicators, 1994-2004

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP real growth	6.2	5.8	6.1	4.6	4.2	1.5	2.0	3.8	4.6	4.5	5.5
Private consumption real growth	1.0	5.0	8.2	5.8	6.0	2.7	-0.9	4.9	5.5	-0.8	3.5
Gross fixed investment real growth	-2.5	0.6	29.1	15.0	11.0	-19.6	-7.2	13.9	-0.6	-1.5	2.5
Unemployment rate, registered	14.4	13.7	12.6	12.9	13.8	17.5	18.2	18.2	17.8	15.2	14.3
Unemployment rate, LFS	13.7	13.1	11.3	11.8	12.5	16.2	18.6	19.2	18.5	17.4	18.1
GG expenditures, % of GDP (ESA95)	57.8	54.1	61.5	65.0	60.8	56.9	59.9	51.5	50.9	39.2	38.5
GG budget deficit, % of GDP (ESA95)	-6.1	-0.9	-7.4	-6.2	-3.8	-7.1	-12.3	-6.0	-5.7	-3.7	-3.3
Real wage growth	3.2	4.0	7.1	6.6	1.6	-3.0	- 4.9	1.0	5.8	-2.0	2.5
Consumer price inflation, y/y	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5	7.5
NBS refinancing rate (end-year)	12.0	9.8	8.8	8.8	8.8	8.8	8.8	8.8	6.5	6.0	4.0
Current account balance, % of GDP	4.9	2.6	-9.4	-8.6	-8.9	-4.8	-3.5	-8.4	-8.0	-0.9	-3.5
Foreign direct investment, % of GDP	1.8	1.7	1.8	1.7	2.6	2.1	8.7	5.7	7.2	2.8	1.8
External debt, % of GDP	23.5	21.1	30.6	33.1	34.0	47.2	49.9	48.7	43.3	42.6	43.6
SKK/USD (average)	32.0	29.7	30.7	33.6	35.2	41.4	46.2	48.3	45.3	36.8	32.3

Source: Statistical Office of SR, Labor Office, Ministry of Finance, NBS, and EUROSTAT.

It is worth noting that the significant decline in headline inflation after 2000 was largely a result of a cautious approach and ultimately a freeze in regulated prices in the pre-election period, hence the pick up in 2003. Thus the reduction attributable to earlier structural reforms is smaller than generally thought.

Only the Baltic States had higher growth rates, with Ireland and Poland coming very close with 5.4 and 5.3, respectively.

The *Visegrad 4+* countries are the Czech Republic, Hungary, Poland and Slovenia. The Baltic countries are Estonia, Latvia and Lithuania. Figure 2.1 separates the EU8 into these two groups of countries because the Baltic States have growth trends that differed considerably from the other 4 countries, partly as a reflection of the different initial conditions.

Chapter 2

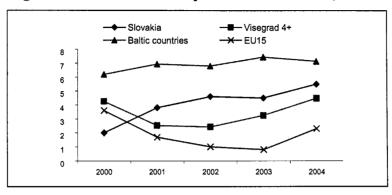


Figure 2.1: International Comparison in GDP Trends, 2000-04

Source: EUROSTAT.

- 2.5 In addition, if the reform process is not halted or reversed, the growth rates of the SR seem set to remain high in the years to come. This conclusion is based on four important differences between the "new" Slovak economy and its transition counterpart, namely: (i) after 2000, structural reforms replaced over-investment as the main drivers of growth; (ii) following an overall reduction in government expenditure, greenfield investment¹¹ replaced fiscal expansion as the main source of growth in domestic demand; (iii) the country continued to integrate into the global production networks of European multinational corporations and its pattern of trade specialization shifted away from unskilled labor-intensive products into more advanced productions; and (iv) privatization receipts, rather than international borrowing, financed the country's widening current account deficit. All these factors suggest that (i) the economic climate is now in place for sustainable long-run growth, but (ii) as the most radical reforms were only implemented in January 2004, it is important to give the new economic system enough time to realize its full potential and achieve a new high productivity-high employment equilibrium.
- 2.6 The combination of growing GDP and declining inflation led to an increase in average private consumption up nearly 3.5 percent in 2004 and a renewal of domestic demand, which suggests a positive trend in the living standards of the Slovak population. Thus, the post-2002 reforms have clearly been very successful in promoting growth and in improving the average living standard of the population.
- 2.7 However, the concern is that they may not have been equally successful in reducing poverty and tackling social exclusion. On the contrary, the argument is that the emphasis on the individual's work potential as the route out of poverty may have further increased the social exclusion of those who for whatever reason may not be able to find or seek employment. In addition, in the highly flexible and competitive economy that has emerged in the SR over the last year, the inability of these groups to benefit from the high growth rate, the overall improvement in living conditions and the increased number of special targeted measures such as activation programs and other labor market policies, may have increased their economic

A firm enters a foreign market via foreign direct investment (FDI) either by setting up an entirely new plant (greenfield investment) or acquiring an existing indigenous firm.

vulnerability. This concern is reinforced by the findings that, the growth in GDP has not been fully reflected in more favorable labor market outcomes and that unemployment is increasingly concentrated in particular groups of the population and in specific regions.

2.8 Indeed, the high economic growth of recent years has not fully translated into employment growth. As is evident from Figure 2.2, the slowdown of 1999-2000 reduced employment by 100,000 jobs between 1998 and 2000 (a drop of nearly 5 percent) despite what, by European standards, is a perfectly respectable GDP growth of around 2 percent. After 2000, the acceleration of growth resulted in a mild but much smaller increase in employment, which only in 2003 was close to 2 percent (less than half of the GDP growth rate for that year). Despite a 5.5 percent GDP growth rate in 2004, the annual increase in employment was minimal.

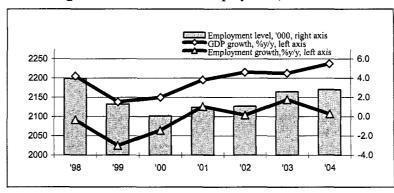


Figure 2.2: Growth and Employment, 1998-2004

Source: Authors' calculations.

- 2.9 Unfortunately, the mild increase in employment experienced after 2000 was more than compensated by the increase in the active population. This resulted from the combination of the following:
 - A steady increase in the working age population which was slight until 2003 but then reached 1.5 percent in 2004
 - A slight increase in the activity rate of the working age population in 2003 which led to a growth in the labor supply over the last five years.

Thus, the increase in employment experienced to date has been just enough to absorb the increase in the labor supply, and unemployment has remained grossly unchanged.

B. THE LISBON TARGETS FOR EMPLOYMENT REMAIN DISTANT

2.10 However, what is really striking for the external observer is not so much the recent trends in labor market indicators but the absolute level taken by some of these trends. Figure 2.3 shows the following:

- At around 70 percent, the participation rate of the working age population in the SR is very similar to the average for the EU15 countries and considerably higher than the EU8 average of just over 66 percent.
- However, at less than 58 percent, the employment rate in the SR is the third lowest in Europe (after Hungary and Poland) and is far lower than the Lisbon objective of 70 percent.
- Much of the difference in employment rates between the SR and the rest of Europe is linked to the very low employment rates of Slovak workers with low skills, especially males. Working age males with only a basic education in the SR are employed at a rate that is less than half that of the EU15 (Figure 2.4).
- As a result of the average participation rates and the very low employment rates, the SR has the second highest unemployment rate in the EU after Poland, more than twice the EU15 average. In addition, the unemployment rate among workers with only basic education is nearly five times higher than in the EU15 and more than double the EU8 average.

Uneployment rates, 2004 Employment rates, 2004 Participation rates, 2004 DNSUPT FIESTSENER LYTSE PKT 8 SEGVER FB 10 T T S S T C T N DSELVET PET 5 ZESKY ERTES GE PLT HU GR IT Employment rate, Participation rate, 2004, % of working-2004, % of working % of the labor force -age population -age population 6 8 10 12 14 16 18 20 4 60 65 70 75 80 85 50 60 65 70

Figure 2.3: International Comparisons of Activity and Participation Rates, 2004

Source: EUROSTAT.

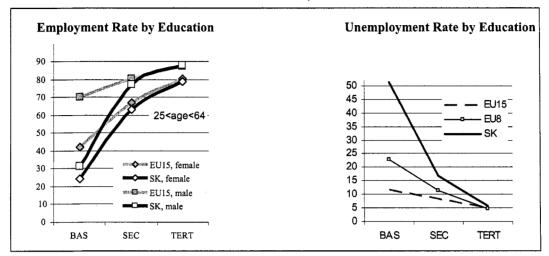


Figure 2.4: International Comparisons of Employment and Unemployment by Education Level, 2004

Source: EUROSTAT.

C. THE POST-2002 REFORMS WERE DESIGNED TO BRIDGE THIS GAP

- 2.11 The considerable disadvantage of unskilled workers in the SR is not a new phenomenon. On the contrary, it has been a latent feature of the Slovak economy since socialist times, although one that was somewhat hidden by the emphasis on full employment of the pre-transition area. The economic liberalization that followed the 1998 election brought this disadvantage to the surface as the shift in focus from full employment to increased productivity resulted in a sharp reduction in the employment opportunities for low-skilled workers. Unemployment for these workers increased sharply and became increasingly long term. However, until the 2004 reforms the living standards of these workers were, for the most part, maintained by very generous social benefits which for some household typologies exceeded their potential labor income.
- 2.12 While successful in preventing households from falling into poverty, these generous benefits substantially reduced the incentives for potentially low-paid unemployed workers to actively seek employment, and many left the labor force altogether. The government that emerged from the 2002 election set itself to addressing this issue by reversing the incentive structure and creating a substantial financial incentive to seek and find employment. It did this with an extensive, far-reaching, but also internally consistent, reform package that focuses on fostering growth and improving the average living standard of the population by fostering job creation and making work pay. Thus, the reforms addressed the need to (i) introduce more flexibility into the labor market; (ii) reduce the existing disincentive to work and provide an incentive for the long-term unemployed to join the labor market; (iii) make the taxation and regulatory frameworks more supportive of new enterprise creation and business sector development; and (iv) make the public education system more efficient, effective and responsive to the needs of the twenty-first century environment.

- 2.13 The main elements of the reform can be summarized as follows:
 - The implementation of a **new Labor Code**, designed to foster labor market flexibility by:
 - o Introducing the option of a number of non-standard labor contracts
 - o Increasing the employer's flexibility to terminate a contract
 - o Redefining the rules for workers' representation.
 - The **reform of the welfare system**, designed to increase incentives to work and improve the targeting of social welfare benefits by:
 - o Reducing the minimum benefit for a single adult to an amount below the subsistence minimum and introducing a ceiling for the maximum benefit payable to a family with more than 4 children
 - Introducing a number of new benefits for the working poor, available to families
 where the adults are either working or participating in active labor market
 programs (ALMPs) and expanding the entitlement to social benefits to the first 6
 months of employment
 - Providing subsidies to municipalities (and other stakeholders) for organizing "activation programs"
 - o Replacing the previous income-related family benefits with a flat (not income-related) benefit per each child coupled with tax credits for minor children
 - Introducing basic and high-school scholarship schemes in addition to meal and schooling subsidies.
 - The **labor market reform**, designed to improve employment opportunities for disadvantaged groups and the long-term unemployed and their potential income via the following means:
 - Individual and targeted work with the unemployed—i.e., in-depth interviews, individual action plans for job-seekers, testing and assessment of personal characteristics, etc.
 - The mandatory character of the ALM programs and the reimbursement of travel and child-care costs to job-seekers actively seeking employment and participating in ALM programs
 - Subsidies to employers hiring LTU and to LTU job-seekers planning to start a business
 - o Targeted interventions to regions with the highest incidence of unemployment
 - o An increase in the minimum wage of around 5 percent in real terms since 2003.
 - The **reform of the administration of welfare systems**, designed to merge the social agenda with the labor market policies in the regional offices.
- 2.14 The rationale for the reforms is clear and is fully consistent with the overall objective of increasing employment opportunities and strengthening the incentives to take up a job for the

overall population. However, the concern of their critics is that, by emphasizing individuals' work potentials, the reformed welfare system has penalized the most vulnerable groups in the Slovak society who, for whatever reason, may not be able to seek and/or find employment. This is the case despite the fact that the reforms provide for special targeted measures for those who may find it difficult to find a job (i.e., "activation of job-seekers" and other labor market policies).

D. Is Lisbon Getting Any Closer?

- 2.15 Figure 2.4, above, clearly emphasizes one of the growing concerns emerging in what is otherwise a very bright picture of development in the SR: the fact that, despite the attempts by the 2002 government to include them more actively in labor market activity, parts of the Slovak society are still struggling to join in the drive for economic growth and higher living standards. In 2004 over half of the workers with only basic education were unemployed (see Figure 2.5), an increase of over 70 percent since 1998. The second panel of Figure 2.5 also shows that in 2004 the unskilled were 2.5 times more likely to be unemployed than the average population, by far the second highest differential among the EU25 after the Czech Republic.
- 2.16 Additional warning signs regarding the welfare of the most vulnerable are given by the following observations:
 - Over the same period, long-term unemployment (LTU) had nearly doubled, and in 2004 the SR was the EU country with the highest proportion of LTU and the smallest proportion of short-term unemployment. In addition, a clear link between low skills and the occurrence of LTU is emerging. ¹²

Unemployment is defined as long term if its duration exceeds 12 months and short term if its duration is shorter than 12 months.

Chapter 2

Figure 2.5: Inequalities in Unemployment by Educational Level: SR and EU, 2004

Source: EUROSTAT.

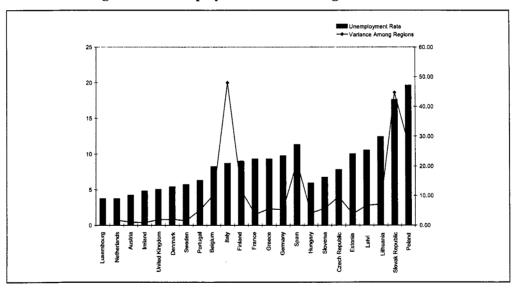


Figure 2.6: Unemployment Rate and Regional Variance

Source: EUROSTAT.

• Regional disparities are very large (see Figure 2.6 and Table 2.2). Table 2.2 shows that, using the NUTS3 level of disaggregation, the SR has the second largest variance in regional unemployment rate in the EU25 after Italy. It also has the second highest regional unemployment rate at NUTS2 level in the EU25, after Italy, but it ranks only number 7 among the EU25 in terms of the percentage difference between the region with the highest and the region with the lowest unemployment rate at the NUTS2 level.

Table 2.2: Regional Variations in Unemployment Rates in the EU

	Highest Regional UR (NUTS2)	Lowest Regional UR (NUTS2)	Difference (%)	Variance Across Regions (NUTS3)
Luxembourg	3.7	3.7	0	
Italy	23.4	2	1070	48.00
Slovak Republic	21.8	7.1	207	44.68
Poland	26	16	63	27.39
Spain	18.6	5.5	238	21.37
Belgium	15.6	4.2	271	10.41
Czech Republic	14.8	4.2	252	9.63
Lithuania	12.4	12.4	0	7.04
Latvia	10.5	10.5	0	6.68
Slovenia	6.7	6.7	0	5.70
Greece	16.1	6.8	137	5.56
Germany	21.3	5	326	5.22
Portugal	8.2	3.6	128	5.14
Hungary	9.7	4	143	4.08
Estonia	10	10	0	3.81
France	12.5	6.4	95	3.67
Denmark	5.4	5.4	0	2.00
United Kingdom	7.6	2.7	181	1.90
Netherlands	4.9	2.5	96	1.67
Sweden	7.3	4.4	66	1.55
Austria	7.7	2.3	235	1.04
Ireland	5.5	4.5	22	0.87
Malta	7.6	7.6	0	0.18

Source: EUROSTAT.

2.17 However, it is important to note that the fact that the Czech Republic is the only EU country with similar levels of disadvantage for the unskilled reinforces the conclusion that this is a problem that the SR has inherited from its past and definitely not the result of recent reforms. Indeed, to some extent the large disparities that emerge across regions and across skill levels are likely to overlap with the existing inequality across ethnic groups. Unfortunately, owing to data limitations, it is currently impossible to disentangle these effects and to statistically quantify the extent to which ethnicity interacts with skill level and geographical location in increasing the vulnerability of some individuals. The issue than becomes one of whether or not the reforms have succeeded in reducing this disadvantage by increasing competitiveness and incentives to work. Unfortunately, it is still too early to arrive at firm conclusions on this issue, but the first signs are encouraging, as described in the next chapters.

E. Monitoring Capacity Is Currently Very Limited

2.18 The reference to data limitations brings this introductory chapter to its last point. Within the context of extensive and rapid change and deep socioeconomic inequalities, it comes as something of a surprise that little systematic effort has been made to monitor the effects of

Chapter 2

recent growth and structural reforms on the incidence and depth of poverty in the SR. Data limitations are behind the failure to produce regular poverty profiles that are reliable and comparable over time, and that can be used to evaluate the impact of the reform effort and the growth that it has generated.

- 2.19 In the absence of regularly produced nationally representative data on income and consumption, the 2003 Microcensus—with data for 2002—provides the most recent source of information on income and the only one since 1996. This prevents any analysis of the trends in these variables over the last two years and an adequate evaluation of the impact of the 2003 and 2004 reforms. This is in addition to the fact that the 2003 data are not representative of the Slovak population (see Chapter 5 for more details).
- 2.20 The government of the SR, the Statistical Office of the SR (SOSR), and the academic community are fully aware of this and are beginning to work together to address these issues. Within this context, and upon the request of both the government and the SOSR, the Technical Note (Volume II) describes the limitations of the data and suggests ways in which the quality of social statistics can be improved and their use for policy design and monitoring enhanced.¹³

More details are provided in the Technical Note, Building Capacity for Systematic Monitoring of Poverty and Social Exclusion in the Slovak Republic in Volume II of this report.

CHAPTER 3-

A TWO-EDGED SWORD: COMPETITIVENESS AND LABOR MARKET DUALITY IN THE "NEW" SLOVAK REPUBLIC

- 3.1 In the absence of national representative information on living standards which can be compared over time, recent developments in labor market outcomes can be taken as an indication of the extent to which the "new" SR has been successful in adopting the Lisbon agenda. It is important to point out that the SR entered the EU with a substantial disadvantage in terms of employment rates compared to both the EU15 and the other EU8 countries, with the exception of Poland. This was the combined result of the following:
 - Two periods of large declines in employment: (i) the recession of the early transition years of 1990-93; and (ii) the second round of restructuring that followed the macroeconomic crisis of 1998
 - The relatively slow response of employment to recent high growth (see Figure 2.2 in Chapter 2)
 - The growing labor force.
- 3.2 The SR was also at a disadvantage in terms of having a relatively unskilled labor force, a comparatively high incidence of unemployment among the unskilled and very high differences in unemployment rates across regions. All these indicators suggest a very high degree of labor market duality. This chapter analyzes these issues further and discusses recent trends.

A. A Growing Labor Force with Relatively Low Skills

3.3 In comparison with other EU countries, the Slovak labor force is relatively young and unskilled. The average age of labor market participants is around 37 years, compared to about 39.5 years in the EU15 and about 38 years in the EU8. Moreover, only 13 percent of the labor force has a tertiary education, compared to 20 percent for the EU15 and 16 percent for the EU8.

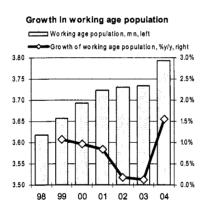
The Working Age Population Is Growing

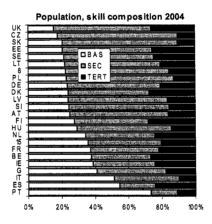
3.4 The working age population (aged 15-64) has been growing consistently for the past several years at an average annual rate of around 1 percent (see Figure 3.1, left panel), reflecting a wave of younger workers entering the labor market. This growth has a two-sided effect. On one hand it has put considerable pressure on the unemployment rate, but on the other hand it has kept adding new skills to the labor force, as newcomers to the labor market had, on average, better education than their elder counterparts.

Education Levels Remain Relatively Low

3.5 However, compared to other EU countries the education level of the working population remains relatively low, with the second lowest share of university graduates in the EU (10.5 percent of the population and 13 percent of the labor force). Perhaps surprisingly, however, the proportion of the population (or the labor force) with only a primary education is relatively small by EU standards (see Figure 3.1, right panel), with a relatively larger proportion of the population having attended—but often not completed—secondary school. ¹⁴

Figure 3.1: Trends in the Working Age Population and Its Skill Composition, SR, 1998-2004





Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

3.6 Fortunately, however, the trends are encouraging, with (i) the share of individuals with only a primary education falling from 14 percent to 8.5 percent between 1998 and 2004, and (ii) the proportion of those having completed tertiary education increasing from 11 percent to 13 percent (as presented in Figure 3.2). As is evident from Figure 3.3, the main source of these changes was the general upgrading of skills in the population with an increase in the share of Slovaks with a tertiary education, which more than offset the falling participation rates of those with a higher education.

¹⁴ It is, however, important to point put that around half of those classified as having an education higher than basic (ISCED level below 3) have only so-called "incomplete secondary" qualifications and/or vocational education.

Share of basic education in: Share of tertiary education in: Population 30 ■Labor force 25 **△** Em plo ym ent 20 10 15 Labor force --**Δ**----Employment '01 '02 '03 '98 '99 '00 '01 '02 '04 '03

Figure 3.2: Trends in the Skill Mix of the Population, Labor Force and Employment, 1998-2004

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

Skill composition of labor force, 2004 Decomposition of changes in highskill share of the labor force CZ SK LT □ drop out of other skills, %p □ participation growth of high-skilled, %p BAS SEC I skill upgrade of population, %p EE PL 8 growth in high-skill share in labor force, %p ■ TERT 1.2% LV HU DE 1.0% SI SE 0.8% 0.6% AT DK FI 0.4% BE 0.2% 1.5 0.0% NL IE -0.2% FR G -0.4% -0.6% 00 01 02 0% 20% 40% 60% 80% 100%

Figure 3.3: Skill Composition of the Labor Force and Sources of Its Change, 1991-2004

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

Activity Rates Are Relatively High

- 3.7 The economic activity of the Slovak population compares favorably with that of its European peers. In 2004 the total participation rate for the working age population was 70 percent, higher than the EU8 average of 68 percent and exactly at the average EU15 mark. Moreover, owing to the relatively high enrollment of young Slovaks in secondary education, the relative advantage of the SR becomes more evident when only the 25-64 age bracket is considered. Then the total participation rate in the SR rises to 78.9 percent, higher than the EU15 average of 75.4 percent and that of the EU8 (76.9 percent).
- 3.8 The main factor behind the relatively high activity rates is the exceptionally high economic activity of Slovak women (Figure 3.4). For the 25-64 age bracket, the total female

participation rate stands at 71 percent compared to 66 percent in the EU15, and participation rates are particularly high in the ages between 30 and 54, after which economic activity plummets, partly because of their lower retirement age (see Figure 3.4).

72 67 Total Women Men EU8 80 70 65 63 78 68 66 61 76 FU15 59 -EU8 EU15 SK 72 57 EU8 SK 55 60 '00' '01 '02 '03 '04 198 '99 100 '01 102 '03 '04 '99 '00 '01 '02 '03

Figure 3.4: Trends in Economic Activity by Gender, the SR and the EU, 15<age<64

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

But a Large Proportion of the Unskilled Are Excluded

3.9 However, the unskilled, especially men, do not seem to partake in this high participation. As Figure 3.5 shows, on average the participation rate of persons with secondary and tertiary educations is slightly higher than the EU average. However, the picture for the unskilled is totally different, with only a little more than 50 percent participating in the labor market. The situation is particularly striking for unskilled men, nearly 40 percent of whom are neither employed nor looking for a job, compared to just over 20 percent in the EU15.

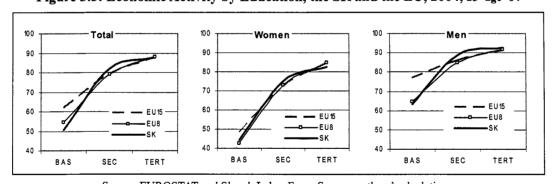


Figure 3.5: Economic Activity by Education, the SR and the EU, 2004, 25<age<64

 ${\it Source}: \hbox{EUROSTAT and Slovak Labor Force Survey, authors' calculations}.$

B. EMPLOYMENT HAS GROWN RELATIVELY SLOWLY AND UNEVENLY

3.10 The growth in the labor force over recent years has not been accompanied by an equivalent increase in employment. Indeed, as shown in Figure 3.6, the two rounds of restructuring that occurred at the beginning of transition and then after 1998 resulted in a sharp reduction in

employment. Despite a continuously positive growth rate in GDP, total employment bottomed out in 2000 at close to the 1994 level (just under 2.1 million) and nearly 15 percent lower than in 1990. Since 2000, employment has begun to grow but far more slowly than GDP growth rate.

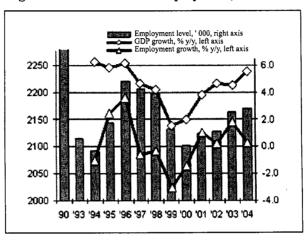


Figure 3.6: Growth and Employment, 1990-2004

Source: Slovak Central Statistical Office (CSO).

3.11 Indeed, the responsiveness of employment to GDP growth in the SR, with the exception of 2003, has been considerably lower than in the EU15 countries although somewhat higher than the average for the EU8 and the Baltic States in 2002 and 2003, as shown in Figure 3.7. It also seems to have gone back to being negative in 2004, owing to the slight reduction in employment at a time of high economic growth. Despite the mild growth in employment, the employment rate has remained grossly constant at around 57 percent, a rate that is well below the EU average of 65 percent and is even lower than the low EU8 average of 60 percent (see Figure 3.8, left panel).¹⁵

¹⁵ Only Poland and Hungary have lower employment rates.

Employment Growth/GDP Growth 1.00 0.80 0.60 0.40 0.20 0.00 2003 2000 -0.20 -0.40 -0.60 -0.80 -1.00 × EU15

Figure 3.7: International Comparisons of Responsiveness of Employment to GDP Growth

Source: Authors' calculations based on EUROSTAT.

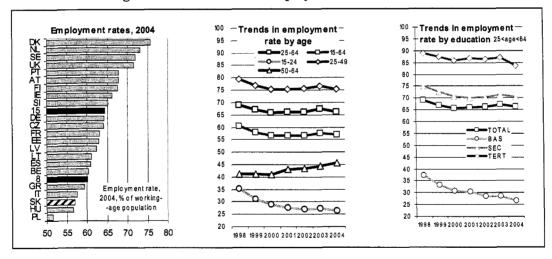


Figure 3.8: Trends in the Employment Rate, 1998-2004

 ${\it Source} : {\it EUROSTAT} \ and \ {\it Slovak} \ Labor \ {\it Force} \ {\it Survey}, \ authors' \ calculations.$

3.12 This is due to the increase in the working age population, described above. Figure 3.9 decomposes annual changes in the employment rate into two main components: the change in employment and the change in population. Over the whole period, the growing working age population continued to put pressure on the employment rate. In 1998 and 1999 a fall in total employment reinforced this effect, resulting in an overall reduction in the employment rate. By way of contrast, in 2000 and 2001 the growth in employment was barely sufficient to offset the effect of the population growth. In the exceptional year of 2003, strong job creation in the economy boosted the employment rate. The trend in 2004 was for the most part driven by the increase in the working age population with a consequent reduction in the employment rate.

25

Large Inequalities Exist in Employment Opportunities

3.13 The average trends in employment hide significant disparities in the magnitude and direction of the changes experienced by different groups of workers. The post-1999 period has seen a significant increase in the employment of older workers at the expense of the youth. While this trend is in accordance with the Lisbon targets, it is a concern in a country with a relatively young labor force (see Volume II for more details) and relatively high youth unemployment.

3.14 Similarly, of concern is the sharp decline in the employment of unskilled workers – especially males. The decomposition of employment growth into high/medium/low skill components, presented in the left panel of Figure 3.9, shows this trend clearly. The shedding of low skilled workers explains most of the decline in employment experienced over the post-recession years to 2000 and employment opportunities for the low skilled continued to decline even in subsequent years despite the overall increase in employment. In contrast, the employment of university educated people grew consistently after 1999.

Decomposition of employment Decomposition of employment rate growth % points, (15<y<64) growth, thous, people 40 1.0 0.5 20 0 -0.5 -20 -1.0 -1.5 ■TERT empl. growth SEC empl. growth 🗖 po pulatio n growth effect -60 employment growth effect BAS empl. growth -2.5 em ployment rate increase TOTAL empl. growth -3.0 -80 1999 2000 2001 2002 2003 2004

Figure 3.9: Decomposition of Trends in the Employment Rate and the Employment Level, 1999-2004

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

3.15 As a result of the substantial shift in employment opportunities for different skill groups over the 1998-2004 period, average employment rates for unskilled workers declined by over 10 percentage points or nearly 30 percent. By 2004 the employment rate for Slovak male workers with only a basic education was only 30 percent, less that half of the EU15 average. Unskilled female workers scored slightly better compared to their EU15 counterparts. At around 25 percent, their employment rate was well over half of that of EU15 women.

C. UNEMPLOYMENT HAS REMAINED UNCHANGED

3.16 In the SR significant discrepancies exist between the registered unemployment figures and those reported by the LFS. Chapter 3 in Policy Note I in Volume II discusses this issue to some extent. This Policy Note focuses on the unemployment figures that emerge from the LFS. In 2004 the LFS gave an unemployment rate of 18.3 percent, more than double the EU15 rate (Figure 3.10, left-hand panel).

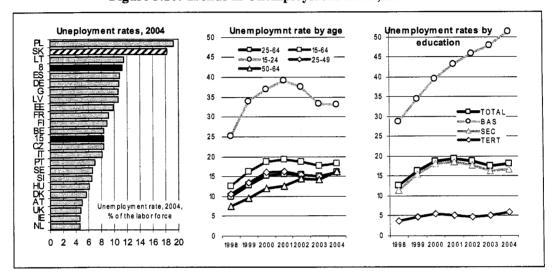


Figure 3.10: Trends in Unemployment Rates, 1998-2004

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

3.17 After a sharp increase in the early 1990s, the unemployment rate remained relatively flat at around 12 percent until 1998, only to increase to almost 20 percent after the 1998 crisis and to ease slightly only after 2002. These trends are not surprising given those in the labor force and employment. Figure 3.11, which decomposes the 1999-2004 changes in unemployment rate into their main determinants, points to the growth in the working age population as a major factor behind the increase in the unemployment rate (demographic effect). This pressure was particularly strong in 1999, 2000 and 2004. Growth in economic activity (participation effect) worked in the same direction, with the exception of 2002 and 2004, when the average activity rate fell. Finally, in 1999-2000, employment contraction was a main cause of the increase in the unemployment rates, while in the subsequent period of 2001-04 growth in employment contributed to the unemployment reduction. Nonetheless, in 2001 and 2004 employment growth, although positive, was insufficient to offset demographic and participation effects.

Unsurprisingly, Unemployment Is Increasingly Concentrated among the Unskilled

3.18 The right-hand panel of Figure 3.11 shows differences in trends in unemployment across different educational groups. From the discussion it is somewhat to be expected that unemployment may have increased more among the unskilled than among the rest of

the labor force. However, the extent of the differential is striking. The unemployment rate for the unskilled nearly doubled over the last six years, while that of workers with higher education remained grossly unchanged. In 2004 over 50 percent of the unskilled labor force was unemployed, compared to the average EU15 and EU8 rates for this population of 12 percent and 23 percent, respectively. The unskilled unemployment rate in 2004 was almost three times higher than the rate for the entire population, compared to a value of this ratio of 1.4 and 2 in the EU15 and EU8, respectively.

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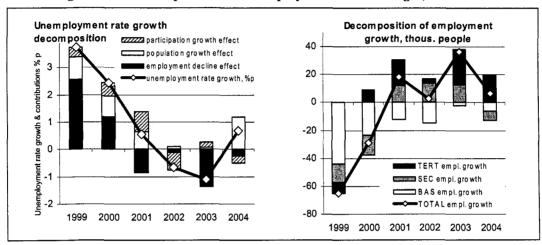


Figure 3.11: Decomposition of Unemployment Rate Changes, 1999-2004

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

D. BUT THE UNEMPLOYED ARE INCREASINGLY EXCLUDED

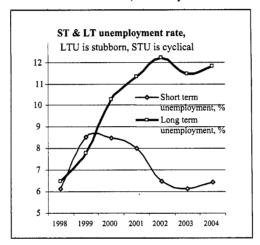
3.19 Of particular concern among recent trends is the growth in the share of unemployment that is long term, as the long-term unemployed are far less likely than others to find employment and are at a particularly high risk of becoming excluded from the labor market and the society at large. It is therefore worrisome to find that in the SR nearly 65 percent of the unemployed are unemployed for more than a year, and that nearly 12 percent of the labor force has been unemployed for at least that length of time—a share that is double the average for the EU8 (6 percent) and nearly four times that for the EU15 (3.5 percent). Thus, unsurprisingly, the average unemployment duration in the SR in 2004 (27 months) was well above that of the EU15 and the EU8 (17 and 20 months, respectively).

To some extent the high incidence of LTU can be related to the relatively high participation rates of the Slovak labor force. The argument here would be that Slovak workers have a higher propensity to remain unemployed than in other countries where workers that have been unemployed for any length of time would leave the labor market thanks to workers generous disability or early retirement schemes. While this is indeed a possibility, the relatively low participation rates of unskilled males—exactly the category of workers with the highest incidence of LTU—in the SR would argue against this hypothesis.

3.20 Moreover, the long-term unemployment (LTU) pool is increasingly stagnant and unresponsive to economic recovery. Figure 3.12 shows increasing at an almost constant rate until 2002, when it reached the 12 percent mark and stabilized around that value. Thus, while short-term unemployment (STU) shows an obviously cyclical nature, LTU seems to grow at times of increasing unemployment but does not decline when employment opportunities improve. This conclusion is further strengthened by the analysis of labor market dynamics that follows which supports the hypothesis of a strong "hysterisis" effect with a high degree of labor market duality.

Figure 3.12: STU and LTU Cycles, 1998-2004 ST & LT unemployment rate,

LTU is stubborn, STU is cyclical



Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

E. AND EMPLOYMENT MOBILITY REMAINS LIMITED

3.21 In addition, the Slovak labor market has traditionally been characterized by very low mobility in terms of job turnover, spatial migration and/or changes in the labor market statuses. Figure 3.13 shows the persistence of geographical disparities over the period 1998-2004 by plotting the district level unemployment rates in 1998 versus those in 2004. At 66 percent, the correlation between these rates is very high and suggests the difference between regions to be long-lasting and of a structural nature.¹⁷

¹⁷ There was also little change in the coefficient of variation of district level unemployment rates during that period.

Chapter 3 29

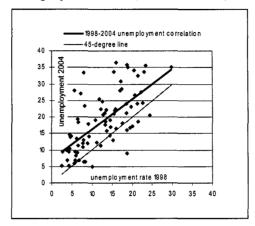


Figure 3.13: Unemployment Rates, District Level, 2004 versus 1998

Source: EUROSTAT and Slovak Labor Force Survey, authors' calculations.

3.22 Mobility between jobs and between employment statuses also remains very limited. The transition matrices presented in Policy Note 1 of Volume II suggest, for example, that on average only 2.7 percent of workers lose their jobs and only 21 percent of the unemployed find a new job within a year. It is perhaps more worrying that nearly one-fifth of the exits from unemployment are out of the labor force (20 percent), and only 3.2 percent of the inactive find a job within a year (with the majority being school-leavers). The size of these flows is nearly half of that experienced in the EU, suggesting that employment dynamics are very limited.

Flows Into and Out of Employment: The Tale of Education

- 3.23 It is worth noting that the single most important correlate of the direction and extent of the flows into and out of employment over the last few years is the individual's level of education. A typical worker with a university education is unlikely to ever leave employment. The worker has less than a 2 percent probability of becoming jobless within a year, and should this worker become unemployed, he/she finds work relatively rapidly: over one-third of the high-skilled unemployed find a new job within a year.
- 3.24 By way of contrast, the typical low-skilled worker has a much higher probability of falling into unemployment and has only a 9.6 percent chance of finding a job within a year. The worker is then likely to become discouraged and to move into inactivity, rarely returning to the labor market. This is in sharp contrast with the experience of the rest of the EU where the association between skill levels and flow rates tends to be weak.

F. But Job Dynamics Are Relatively High

- 3.25 Data from the enterprise survey "Information System on Average Earnings" (ISAE) show that a substantial job restructuring has occurred in recent years. 18 Job flows are significantly higher than the average in the euro zone and more on the order of magnitude experienced in other Central European transition countries. This is the case despite the fact that the sample design makes it impossible to calculate the total job flows in the economy. It gives an indication of job creation and destruction only in firms that remain in the sample for the full period of the analysis, and is not able to assess the full extension of net job creation because new firms entering the market (and the sample) cannot be adequately analyzed. This is an important limitation that is likely to result in a considerable underestimation of the net job creation in countries like the SR which have experienced considerable growth and positive inflows of foreign companies over recent years. However, this is a common problem with this type of studies and one that cannot be easily overcome.
- 3.26 The average job creation rate in the sample of firms covering the 2000-04 period is 7.2 percent and the average rate of destruction is 10.9 percent, which leads to an 18.1 percent average job turnover rate and an excess job reallocation rate of 14.4 percent. The net job creation is negative at an average of 3.7 percent, and individual yearly rates vary from -3.3 percent in 2001 to -4.1 percent in 2003. This overall negative trend seems somewhat at odds with the positive trends in employment as evident from Table 3.1. Two main justifications can be advocated for what appears to be a contradiction:
 - The fact that the enterprise-level analysis focuses on "continuing firms" and ignores the effects of enterprise creation, which, in the context of the SR in recent years, could be substantial and is probably in excess of enterprise destruction. By comparing the average net job creation (-3.7 percent) with the average change in the number of

ISAE is a part of the Information System on Labor Costs that is collected by a private firm for the Ministry of Labor, Social Affairs and Family of the SR. The database contains detailed information on enterprises and their workers. The data are collected on the worker level on a quarterly basis by software integrated into a respondent enterprise information system. However, it is not possible to track a particular employee over time, which prevents us from building a panel. The sampling methodology used is in no way perfect (for more information, see Policy Note 1, Volume II). To correct for the sampling biases, we have restricted the data to enterprises with at least 20 employees. The data were cleaned from outliers, and records with missing observations were excluded. The samples contain two sets of variables, one describing the enterprise and the other describing the employee. For the enterprise, the number of employees, legal form, branch of economic activity (coded according to NACE), geographical location and ownership type are reported. Ownership types are divided into private, cooperative, foreign, international private and public, state owned, and municipal. For the employee, average hourly wage, gender, age, education, occupational classification (in the national extended version of the International Standard Classification of Occupations) and some other characteristics are reported. In principle, the data cover all industrial sectors and occupational categories except for the self-employed.

¹⁹ See Policy Note No. 1, Volume II, for more details.

- employed persons (-0.4), we can quantify the underestimation of job creation in our analysis to be approximately 10 percent.
- The recent marked change in the employment structure over the period which has seen a reduction in the number of employees but a sharp rise in the number of self-employed persons (22 percent in 2004). As the self-employed and the small enterprises are excluded from the analysis, the positive trends in this dynamic sector are not picked up in the job flows described here, while the reduction in the number of employees is.

Table 3.1: Number of Employed Persons in the Slovak Republic, 2000-04 (in thousands of persons)

	Employed persons					% Self-	Employment	
	Total	% Change	Employees	% Change	Self-employed	% Change	employed	rates, 15-64 (%)
2000	2,101.7		1,931.0		167.4		8.0	55.9
2001	2,123.7	1.0	1,943.4	0.6	177.9	6.3	8.4	56.3
2002	2,127.0	0.2	1,940.9	-0.1	183.1	2.9	8.6	56.0
2003	2,164.6	1.8	1,947.6	0.3	210.9	15.2	9.7	56.5
2004	2,170.4	0.3	1,904.2	-2.2	256.8	21.8	11.8	
2000-04	2,137.5	0.8	1,933.4	-0.4	199.2	11.6	9.3	

Source: Labor Force Survey, Statistical Office of the SR

JOB FLOWS BY REGIONS

3.27 According to Table 3.2, large regional disparities in job flows have existed. The most dynamic regions over the period 2000-04 were Zilina and Bratislava with a job turnover rate that was 19 percent higher than the sample average, and the most stagnant was Nitra, with a job turnover rate that was 14 percent below the sample average and a job creation rate (5 percent) that was only half of the job destruction rate. The driving force behind regional differences in job flows is the job creation rate. The job creation rate in Bratislava, the most successful region, was twice as many new jobs (11 percent versus 5 percent) as in Nitra, the least successful region. However, once the three most successful regions (Bratislava, Zilina and Trencin) are excluded, the differences across the other regions becomes minimal.

²⁰ See Policy Note No. 1, Volume II, for more details.

Region	Job creation	Job destruction	Net job creation	Job turnover	Excess job reallocation	
Average SR 2000-04	7.2	10.9	-3.7	18.1	14.4	
	100	100	100	100	100	
Bratislava	147.6	100.4	192.5	119.2	131.1	
Trencin	111.2	97.2	130.3	102.8	96.5	
Banska Bystrica	94.1	86.8	127.7	89.7	77.6	
Zilina	119.4	120.0	78.9	119.8	111.9	
Trnava	75.8	92.0	76.2	85.6	67.7	
Nitra	63.5	91.6	53.0	80.4	63.5	
Presov	77.8	102.2	49.6	92.5	77.8	

Table 3.2: Job Flow Rates by Regions, average over 2000-04 (%)

Note: The average over 2000-04 is computed for each region and the average over 2000-04 in the sample considered is taken as a base (100 percent). Results are presented as a percentage change, relative to the defined base.

45.3

103.1

Source: Authors' calculations.

Job Flows by Industries

3.28 Job turnover also varies substantially by industry (59 percent of the sample average in utilities versus 47 percent above the sample average in wholesale and retail trade), but the net employment change emerging from the sample is negative in the majority of sectors (Table 3.3). Sectors with the highest rates of restructuring, – measured in terms of the excess job reallocation rate above the sample average – include construction (45 percent) and retail (33 percent). The highest job creation rates were found in retail (106 percent above the average) followed by banking and insurance, and construction. Conversely, major job destruction took place in mining (76 percent above the average) and the agriculture sectors (50 percent above the average), the two sectors with the highest amount of job closures.

Industry	Job creation	Job destruction	Net job creation	Job turnover	Excess job reallocation	
Average SR 2000-04	7.2	10.9	-3.7	18.1	14.4	
	100.0	100.0	100.0	100.0	100.0	
Agriculture, Forestry, Fishing	107.2	149.7	-33.4	132.7	87.9	
Mining, Metallurgy	25.6	176.1	-272.4	116.1	25.6	
Manufacturing	88.0	89.6	107.1	89.0	87.0	
Utilities	68.1	52.9	177.0	59.0	30.6	
Construction	158.1	127.9	131.6	139.9	145.3	
Wholesale, Retail Trade	205.9	107.4	286.2	146.7	132.6	
Hotels and Restaurants	149.4	121.8	132.5	132.8	63.5	
Transport, Communications	106.9	124.4	41.2	117.4	86.5	
Banking and Insurance	158.1	75.8	286.0	108.6	84.7	
Business Services*	143.8	95.3	200.2	114.6	79.0	
Public Administration	112.8	85.9	167.1	96.5	51.6	
Education	80.4	76.5	131.2	78.1	79.2	
Health and Social Work	70.5	57.1	169.4	62.4	38.8	
Other, Personal Services	140.4	98.2	185.0	115.0	130.8	

Note: The average over 2000-04 is computed for each region and the average over 2000-04 in the sample considered is taken as a base (100 percent). Results are presented as percentages, relative to the defined base.

Source: Authors' calculations.

- 3.29 In addition, two growing sectors emerge from this analysis²¹:
 - The construction industry, with a fast growing job creation rate (from 5 percent in 2001 to 15 percent in 2004)
 - The banking sector, with (i) an average job creation rate of 13 percent over the period 2000-04, despite a decline of 6 percent in 2004, and (ii) the lowest job destruction rate of all sectors (an average of 4 percent if 2001 is excluded).²²

Job Flows by Enterprise Size

3.30 It may be somewhat surprising that over the period 2000-04 the enterprises with 20-49 employees (small enterprises) seem to be the most dynamic enterprises, with a 26 percent job turnover compared to a job turnover of 15 percent for the largest establishments. However, this high job turnover is induced by high job destruction rates in the sample considered, which decline with the increasing number of workers: from 22 percent in small enterprises to 7 percent in extra large companies. Job creation rates vary less, with 4 percent in small enterprises compared to 8.5 percent in larger establishments. Thus, only in the largest enterprises is net employment change positive and approaching 1 percent. For the other

See Policy Note No. 1, Volume II, for more details.

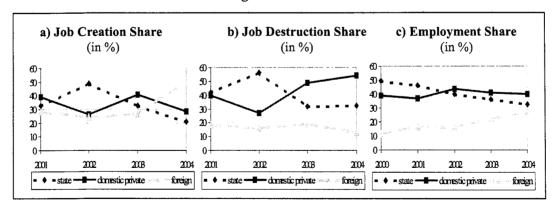
The year 2001 is not representative because in the period 2000-01 four of the Slovak banks went into bankruptcy.

categories, net employment change is always negative and rises uniformly, peaking at -18 percent for the smallest enterprises.²³

Job Flows by Ownership Categories

- 3.31 A significant difference in trends emerges between state-owned and domestic private enterprises on one side and foreign enterprises on the other. The former experienced a substantial gap between job creation (on average at 6 percent) and job destruction (at 11 percent and 12 percent, respectively), which led in both cases to negative net job creation growth. Consequently, their job turnover and excess job reallocation rates are similar in magnitude. However, the dynamics were significantly higher among foreign owned enterprises where the average job turnover rate reached 27 percent. At 15 percent the job creation rate was more than twice that in domestic enterprises (both state and private), leading to a positive net job creation growth of 2 percent.
- 3.32 The dynamics of the contribution of different ownership categories to job creation and destruction are presented in Figure 3.14. In particular, the following can be observed:
 - The developments in foreign enterprises are different from the other two categories: job creation and destruction shares were almost constant during the first three periods, with the job creation share always well above the job destruction share. In the last period, the job creation share rose significantly, while the job destruction share experienced a decline.
 - The employment share in foreign enterprises is rising constantly, and is accompanied by a uniform decrease in the employment share for state-owned enterprises. The share of private enterprises in the sample stays almost constant over the period analyzed.

Figure 3.14: Job Creation, Job Destruction and Employment Shares by Ownership Categories in 2000-04



Source: Authors' calculations.

²³ For detailed results, see Policy Note No.1 in Volume II.

Job Flows by Educational Level of the Labor Force

3.33 Finally, job turnover is highest in enterprises with more than 60 percent of educated workers (5 percent above the sample average). As Table 3.4 shows, this difference is driven predominantly by the relatively high rate of job creation (32 percent above the average) in this category which more than compensates for the relatively low job destruction. Indeed, this is the only category of enterprises where the net job creation is zero as opposed to negative.

Table 3.4: Differences in Job Flows by Share of Skilled Workers, Average over 2000-04 (in %)

Skilled Workers (in %)	Job Creation	Job Destruction	Net Job Creation	Job Turnover	Excess Job Reallocation
Average SR 2000-04	7.2	10.9	-3.7	18.1	14.4
	100.0	100.0	100.0	100.0	100.0
Low [0,30]	98.6	102.0	91.2	100.6	98.6
Medium [30,60]	86.7	104.1	61.7	97.2	86.7
High [60,100]	131.6	87.2	200.2	104.9	109.9

Note: Skilled workers are those with completed secondary and tertiary education. The percentage share of the skilled labor force is computed in every enterprise and enterprises are then categorized into three groups.

The average over 2000-04 is computed for each group and the average over 2000-04 in the sample considered is taken as a base (100 percent). Results are presented as percentages, relative to the defined base.

Source: Authors' calculations.

Job Flows by Gender Decomposition of the Labor Force

3.34 Job turnover rates are significantly higher in enterprises with a higher fraction of employed females (20 percent compared to 16 percent); this is due to the much higher job creation in these enterprises (10 percent as compared to less than 5 percent).

What Are the Main Sources of Differences in Job Reallocation?

3.35 Over the last years, clear differences in the patterns of job reallocation are found across different groups of enterprises. These differences can be summarized in employment shifts that occur within and between groups. Empirical evidence suggests that a misallocation of resources in the economy implies that employment shifts occur mainly between groups – from the declining groups to the growing groups. However, job reallocation in the SR seems to be accounted for predominantly by within group reallocation according to a pattern similar to that found in other Central European transition countries (Table 3.5). 25

According to Bilsen and Konings (1998), at the beginning of the transition process in CEE countries, the job reallocation was identified mainly between groups; later on it was identified primarily within groups. For more details on the methodology used, see Policy Note No. 1, Volume II.

54.1

81.1

Groups (iii /0)				
	Region	Industry	Enterprise Size	Ownership Category
2000/2001	69.7	69.4	47.8	87.7
2001/2002	50.9	71.5	72.6	84.8

73.5

56.9

Table 3.5: The Share of Excess Job Reallocation Due to Employment Shifts within Groups (in %)

Source: Authors' calculations.

2002/2003

3.36 It is interesting to note that, while for regions, industries and enterprise sizes no significant pattern of evolution over time in the decomposition of excess job reallocation can be detected, an increase in the cross-group excess job reallocation has occurred, in accordance with the findings of the analysis of job flows, where a shift in the job creation and employment shares between the state-owned and foreign enterprises has been reported.

G. AND WAGE INEQUALITIES REMAIN LOW BUT ARE GROWING

3.37 Unfortunately, the Slovak Labor Force Survey does not provide information on earnings, which prevents accurate monitoring of wage dynamics and inequalities. In addition to being somewhat outdated (2002), the Microcensus contains information on individual monthly earnings but not the number of hours worked and, as discussed extensively in Chapter 5, it is not statistically representative of the Slovak population. Thus, the only source of information on earnings is the Slovak employer survey known as the "Information System on Average Earnings" (ISAE) which, although not fully free of sampling biases, has the advantage of being carried out on a quarterly basis. ²⁶ It is important to note, however, that the levels of wages reported in this survey are likely to be overestimations of the average wages in the economy, because (i) the survey covers only registered enterprises and does not include any informal activities, and (ii) owing to the potential sample bias the smaller enterprises are excluded from the analysis.

What Happened to Wage Levels after 1998?

- 3.38 Overall, mean hourly wages in 2003 were 5.3 percent higher in real terms than in 1999, with the increase for male workers being 7.2 percent compared to 4.8 percent for females. The average wage level varied according to enterprise characteristics, employee characteristics and occupation. Average wages were higher in the following:
 - Foreign enterprises, followed by state-owned enterprises and private domestic enterprises
 - Enterprises with more than 1,000 employees
 - Bratislava, where average wages reached 16.5 percent above the national average.
- 3.39 Moreover, the average wage differential between foreign companies and others and between the Bratislava region and the rest of country increased rapidly over the last five years.

²⁵ See Faggio and Konings (2001).

²⁶ For more details, see footnote 18, above.

Average wages in Bratislava increased by 17.8 percent in nominal terms versus an average increase for the country as a whole of 5.3 percent. This can be at least in part attributed to the higher job creation experienced in foreign companies and in the Bratislava region,

- 3.40 At the individual level, unsurprisingly, wages increase with age, education and occupational ranking. Managers rank first and are followed by professionals. While skilled agricultural workers receive wages that are comparable to those of unskilled workers in other sectors, the share of skilled workers in total employment has increased over time. In 2003, 54 percent of workers in the sample had at least completed secondary education (3 percent more than in 1999). This pattern applies in particular to the middle occupation classes (technicians, clerks and service workers).
- 3.41 Female earnings are significantly lower than male earnings across all age and educational categories. Unskilled female workers earn the lowest wages and males with only basic education in 2003 continue to receive, on average, wages comparable to those of women with a secondary education. However, because of the generalized increase in returns to education, by 2003 women with university degrees were paid more than men with a secondary education.

And to Their Distribution?

3.42 Table 3.6 highlights a considerable increase in wage inequality over the period considered, with the overall Gini coefficient rising from a very low 0.236 to 0.279, an 18 percent increase and a value much more in line with international comparisons. The increase is particularly high for men (24 percent as compared to 13 percent for women), following a pattern common to all advanced economies. Over three-quarters of this increase is attributable to an increase in wage dispersion within foreign companies, with the dispersion within the domestic private sector declining slightly and that within the state sector increasing slightly. This is particularly true of inequalities among women which in foreign companies reached a Gini coefficient of 0.311.

Table 3.6: Gini Coefficients by Ownership Type and Gender, 1999 and 2003

Ownership Type	All		Male		Female	
	1999	2003	1999	2003	1999	2003
All	0.236	0.279	0.229	0.283	0.218	0.247
State	0.213	0.223	0.202	0.231	0.210	0.205
Private	0.263	0.254	0.263	0.251	0.218	0.225
Foreign	0.277	0.316	0.267	0.290	0.252	0.311

Source: Authors' calculations based on Information System on Average Earnings (ISAE).

What Accounts for Wage Inequalities?

3.43 Table 3.7 represents the results of an OLS regression of hourly wages over a set of variables capturing characteristics of the worker, the company and the occupation. The findings of this exercise are not surprising.

Table 3.7: OLS Estimation Results - All Types of Ownership as a Dummy, 1999 and 2003

(Dependent Variable: Log of Hourly Wage) 1999 2003 Coef t-Stat t-Stat 3.138 Constant 141.600 3.114 167.258 Worker's characteristics Female -0.190-140,906 -0.205-197.175Education (Elementary omitted) 0.066 31.295 Apprenticeship 0.058 32.352 0.17274.830 69.994 Secondary 0.136 0.346 102,812 0.314 109.606 University Age 0.036 21,138 0.064 43,497 Age^2 -4.2E-04 -10.040-1.1E-03 -31.007*7.5E-07 Age^3 2.221 6.6E-06 21.795 0.002 44.316 0.218 113.880 Union Occupation (Unskilled workers omitted) Managers 0.780 180.399 0.065 60.444 Professionals 0.435 125.073 0.855 255.457 Technicians 0.378 142.195 0.547 176.439 71.661 Clerks 0.236 0.413 190.778 Service workers 0.175 51.846 0.200 82.158 Skilled agricul, workers 0.195 32.255 0.044 18.742 Craft and trade workers 0.203 81.240 0.145 31.404 Operators and assemblers 0.254 105.884 0.164 82.804 **Enterprise characteristics** Regions (Bratislava omitted) Banska Bystrica -0.097-42.095 -0.182-105.124 Kosice -0.043-19.353-0.151-83.827 -39.950 Nitra -0.089-0.137-74.618 Presov -44.100 -0.187-102.340 -0.113 Trencin -0.065 -27.251 -0.142 -80.499 -22.500 Trnava -0.066-0.060 -31.605 Zilina -0.089-38.210-0.133 -74.803 4.1E-06 Nr employees 75.876 4.4E-05 226.989 Industries (Industries (C-F) omitted) Agriculture (A-B) -0.162-48.018 -57.407 -0.163Business Services (G-K) -0.071 -34.036 **0.001 0.557 Public Services (L-O) -0.406 -166.207 -0.187-104.126Ownership type (State omitted) Domestic private -0.032 -18.979 -0.018-13.8730.146 Foreign 0.044 15.257 87.200 R-squared 0.495 0.591 Adj R-squared 0.495 0.591 8489.2 F-statistic 21728.7 Prob(F-statistic) 0 0 Observations 251,446 436,274

Note: Estimated coefficients are statistically significant at the 1 percent level.

Source: Authors' calculations based ISAE.

3.44 They show the following:

- There are high returns to education (15 percent for secondary and 39 percent for tertiary education in 2003) and some returns to age and to being a member of a union.
- Higher wages prevail for professionals and for employees of large firms.
- Working outside Bratislava and in public services or agriculture has a negative effect

^(*) Stands for significance at the 5 percent level (**) indicates that the estimated coefficient is \underline{not} significantly different from zero at the 10 percent level.

on an individual's earning potential. This is particularly true in the eastern region of Presov and the central region of Banska Bystrica.

- The returns to education, age and unionization have not increased substantially over time.
- However, the differential between occupations and size of enterprise has increased.
- It pays increasingly more to work in Bratislava than in other parts of the country.²⁷

Is Gender an Important Correlate of Wages?

3.45 At around 24 percent, the gross gender gap is comparable to that of other EU8 countries. Figure 3.15 shows that on average the percentage of the gender wage gap that can be explained by the differences in the observed characteristics is rather low (around one-third) and it has remained unchanged over time. However, the explained component has increased considerably in foreign enterprises and declined in the state sector and among domestic private companies. This suggests that the female labor force in foreign companies is becoming, on average, comparatively less skilled.

☐ % explained ■ % unexplained □ % explained ■ % unexplained 100% 80% 80% 60% 60% 40% 40% 20% 20% 0% All State Private Foreign A11 State Private Foreign

Figure 3.15: Decomposition of Gender Wage Gap in 1999 and 2003

Source: Authors' calculations.

To What Extent Does Ownership Count?

3.46 The descriptive section above concluded that ownership of enterprises was an important determinant of wage levels, with foreign enterprises paying much higher wages than others. However, it is also evident that they employ different types of workers, on average more qualified but younger. Table 3.8 decomposes the wage differentials between different enterprises with different ownership into two components: one that is explained by differences in the workers' characteristics – i.e., the "explained" component – and one that is due to differences in rewards to these characteristics.

3.47 The results are extremely interesting. They show that in 1999 the foreign firms in the sample were paying higher wages for workers who on average had lower productivity-related characteristics than those working in other enterprises. However, this had changed considerably by 2003, with over 61 percent of the wage differential between foreign enterprises

It is, however, important to note that part of the wage differential between Bratislava and the rest of the country may be due to differences in living costs.

and private domestic enterprises (and nearly 45 percent of that between the foreign and the state sector) being accounted for by the higher characteristics of the workers. It also shows that the domestic private sector may have lost ground in terms of workers' productivity-related characteristics when compared to the state. This is a somewhat worrying scenario suggesting two possible explanations: (i) the foreign companies have "cream-skimmed" the Slovak private sector by buying out the most productive enterprises – i.e., those with the most productive workers – or (ii) the domestic private sector is losing the most productive workers and with them competitiveness relative to the foreign sector.

Table 3.8: Decomposition of the Wage Differential According to Ownership Type, 1999 and 2003

	1999	2003
State and Domestic Private		
Mean Log Wage Gap:	0.056	0.075
Differences in workers' characteristics	0.004	-0.042
Differences in rewards to characteristics	0.052	0.117
Foreign and State		
Mean Log Wage Gap:	0.004	0.419
Differences in workers' characteristics	-0.492	0.185
Differences in rewards to characteristics	0.496	0.219
Foreign and Domestic Private		
Mean Log Wage Gap:	0.059	0.494
Differences in workers' characteristics	-0.069	0.300
Differences in rewards to characteristics	0.129	0.180

Source: Authors' calculations based on ISAE.

H. IS THE REFORM BEGINNING TO BEAR FRUIT?

- 3.48 As pointed out above, the implementation of the most recent, and most far-reaching, round of reforms in January 2004 marked a watershed in the development of the Slovak Republic, which was followed shortly after by EU accession. A year and a half is clearly too short a period for a full evaluation of the impact of a structural far-reaching reform of the labor market and the social assistance system whose effects should be fully evident only after the economy has adjusted to a new higher-employment equilibrium. However, in view of the importance of an adequate evaluation for the sustainability of the reform process, Policy Note 1 in volume II provides some analysis of the short-term impact using seasonally adjusted quarterly data, predominantly from the LFS.
- 3.49 These data suggest that, after an initial negative effect, the full implementation of the reforms may have been associated with a positive trend in basic labor market indicators. It is clear from Figure 3.16, for example, that the beginning of the second phase of reforms that followed the 2002 election saw a relatively high increase in employment, with a year to year seasonally adjusted growth of 1 to 2 percent, driven primarily (but not only) by growth in self-employment. Indeed, self-employment continued to increase even after the implementation

Chapter 3 41

of the 2004 reforms and stabilized at around 2 percent per quarter from the second quarter of 2004. By way of contrast, the number of employees declined by as much as 4 percent in the second quarter of 2004.

3.50 Nevertheless, after a sharp drop in the first half of 2004, overall employment began to increase with the year-to-year growth reaching 2 percent by the first quarter of 2005. This positive trend is also confirmed by the quarter-to-quarter data, which show an increase in overall employment beginning from the second quarter of 2004 and suggest that the reduction in the first quarter of 2004 were the result of events in the last months of 2003 rather than the direct effect of the reform. To what extent this is the beginning of a positive trend and whether it is attributable to the 2004 reforms is too early to determine, but the signs are encouraging. The fact that this growth is driven predominantly by growth in self-employment and in smaller enterprises is also worth noting, as it points to economic liberalization as the main driver of growth and has important implications for policymaking.

Figure 3.16: Seasonally Adjusted Trends in Employment by Type

Source: EUROSTAT.

3.51 At the same time, the active population grew steadily by around 1 percent in 2004 as a result of the growth in the working age population, as shown in Figure 3.17. Unsurprisingly, given the trends in employment and active population, the unemployment rate spiked in 2004q1 to 19.5 percent (15-64 age bracket), the second highest figure in the records (after 2001q1). However, it fell rapidly after that and throughout 2004. The key drivers of unemployment dynamics in 2003 had been employment creation. In 2004, as job creation came to a halt, the increase in the active population translated into higher unemployment. Employment creation resumed in the third quarter of 2004, and, together with a slightly lower activity rate, it offset the population pressures.

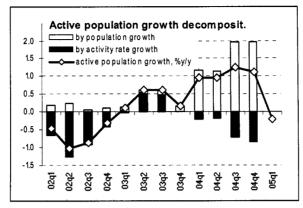


Figure 3.17: Sources of Growth in the Active Population

Source: EUROSTAT.

I. EMERGING ISSUES

3.52 In a nutshell, the most striking result of this detailed analysis of the Slovak labor market is the degree of segmentation that has historically characterized the SR and the fact that this duality has deepened over time. Traditionally, labor economists talk about a "dual" labor market with reference to a single labor market where two distinct groups of workers face very different conditions both pre- and post-entry in different segments of the labor market. In the SR the selection criterion for entry into the two segments of the labor market is the skill level. The reforms of recent years have helped skilled workers to take full advantage of the increased competitiveness of the economy and the rapid growth that it has generated. Although positive, the progress for the unskilled has been slower and this has resulted in increased inequalities.

Bleak Prospects for the Unskilled

3.53 According to the evidence reported in this chapter, the prospects for the unskilled population in the SR are not promising, as they face a significant disadvantage compared to the rest of the population in all indicators used and that disadvantage is increasing rapidly. An alarming—by international standards—proportion of unskilled working age individuals, especially males, leaves the labor force never to go back. Of those who remain economically active, over half are unemployed and most have been unemployed for more than 12 months (LTU). This is particularly worrying, since the re-employment probabilities for the unemployed in general, and the LTU in particular, are very low by European comparisons and are particularly low for the low skilled. This is partly due to the relatively low job creation of the types of enterprises that tend to employ a higher share of unskilled labor, which is clearly a major concern not only for the low-skilled unemployed but also for school-leavers without adequate qualifications. Finally, those who succeed in finding and maintaining a job despite their low skills face an increasing wage gap compared to other workers, given the growing inequality in earning distribution.

3.54 This suggests a crucial, and growing, role for education in determining labor market opportunities and curbing social exclusion. The "new" SR is increasingly becoming a "knowledge-based economy" where the returns of education are seen not only in terms of higher wages (although these clearly exist) but especially in terms of better access to jobs and economic opportunities. This also signals the risk of considerable inefficiencies emerging from the existing skill mismatches and the threat that they may pose to economic growth. If, for example, the economy and employment were to grow by roughly 20 percent (that is, to the point at which there were enough job places to eliminate unemployment completely), and the skill composition of employment and the labor force were to remain unchanged, some 80 percent of the low-skilled (namely, one-fifth of the unemployed) would not find employment. At the same time, there would be a shortage of high-skilled persons to fill the opening high-skill vacancies.

Ample Evidence of the Geographical Segmentation of the Labor Market

3.55 Another salient feature of the Slovak labor market is provided by the magnitudes of the existing regional disparities in labor market indicators in a relatively small country. At around 8 percent, the unemployment rate in Bratislava is less than one-third of that in the disadvantaged regions of Banska Bystrica, Kosice and Nitra, and at the NUTS3 level, the SR has the second largest variance in the regional unemployment rate in the EU25 after Italy. Other labor market characteristics such as the employment rate or long-term unemployment also vary substantially by region.

To What Extent Are Skills and Regional Mismatches Related?

3.56 Using two major indicators of labor market performance, Figure 3.18 suggests the existence of a strong correlation between the skill composition of different regions and the prevailing labor market conditions, so that regions with a relatively high share of unskilled population also have worse labor market opportunities. An important issue from a policy point of view, then, is the extent to which the poor educational indicator can be considered a cause of the poor labor market outcomes in those regions.

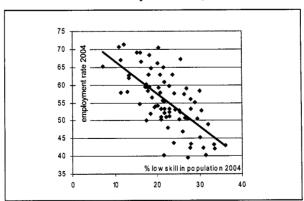


Figure 3.18: Negative Correlation between Employment Rates and Skills by Districts, 2004

Source: Slovak Labor Force Survey, authors' calculations.

- 3.57 The simplest reason why skill composition can produce spatial differences in unemployment rates is that high-skilled workers tend to have a lower natural rate of unemployment (since job matching that is, hiring, training and firing is much more costly for them).²⁸ If one of the factors was not mobile and was unequally distributed, then high-skilled workers would cluster in high capital regions (or vice versa) and a difference in natural unemployment rates would emerge. However, cross-regional variations in the unemployment rate in the SR are too large to be explained in this way.
- 3.58 This situation points to other factors being at play, factors that are strong enough to prevent the equalization of unemployment rates. These effects include: agglomeration (firms tend to cluster to exploit network externalities), the transportation advantages of some regions, the marginal tax imposed under the old system by the combined welfare-tax system, sorting effects (where high-skilled workers are reluctant to move to low-skill regions), rigidity in relative wages between high and low skills, imperfection in the housing market, especially for rented accommodations. Also, it is plausible to assume that, because of technology, various externalities and network effects, modern economies require skills in certain proportions. The proportion is weighted increasingly towards high skill. As more mobile high-skilled workers migrate to more dynamic regions, the stock of human capital in the lagging regions deteriorates and the skill mix becomes sub-optional.
- 3.59 For a more precise answer to the question of how much of a regional variation in labor market outcomes (if any) can be explained by regional skill mismatches, two models are estimated in which the probability of being jobless is defined as depending on both individual and regional characteristics, including variables related to the skill mismatch (see Box 3.1). The findings point to the individual's level of education as the most important single determinant of employment status (apart from age) with the second most important determinant being the region in which the person lives. Regional skill mismatches also matter, with the regions with the lowest skill mismatches having the highest employment rates. However, given the plausible range of values for these skill mismatches and coefficients, these effects are relatively smaller. These results suggest the importance of tackling inequalities in labor market opportunities via a combination of individual specific policies and a regional development strategy. At the individual level, improving the skills of the unemployed is paramount for better market outcomes. At the regional level, geographically targeted interventions may be required. These interventions should be designed to address the current barriers to a more effective strategy for regional "cohesion."

Assuming the ideal world of classical production function, competitive markets and full employment (subject to turnover), but constraining the mobility of one production factor: if capital and labor were perfectly mobile, factor movement would make the spatial distribution of skill uniform and, hence, would produce no unemployment differences.

Box 3.1: Are Regional Inequalities in the Employment Situation a Matter of Skill Composition?

One way of assessing the extent to which regional skill composition affects regional employment levels through channels other than individual characteristics is to model the probability of being employed as a function of other regional and individual characteristics. To this end we estimate two models, both including some measures of regional skill mismatches and/or composition. In the first model we use two "skill-mismatch" variables: deficit of high skills and oversupply of low skills. Other region-specific variables include: share of industry and services and dummies for regions. Individual characteristics include an age and sex profile meant to account for age-related nonlinearities. The reference education category is basic education (low skills). In the second model, share of high skill and share of medium skill in the region have been included to control for the regional skill structure. The models are estimated as a binary choice model (probit) and are intended to describe the probability of being jobless, given individual and regional characteristics, for individuals not in education. Results are presented in the table.

Estimation of Regional Mismatches versus Skill Mismatches

Estimation of Regional Mismatches versus Skill Mismatches						
Model 1: Joblessness & a ski	<u>ll mismat</u>	ch	Model 2: Joblessness & a skill composition			
Dep. variable: not-employed	Coeff.	z-stat	Dep. variable: not-employed	Coeff.	z-stat	
Sex and age profile			Sex and age profile			
Woman? [dummy]	0.097	6.9	Woman? [dummy]	0.099	7.0	
age if 15 <age<30< td=""><td>-0.026</td><td>-30.5</td><td>age if 15<age<30< td=""><td>-0.026</td><td>-30.3</td></age<30<></td></age<30<>	-0.026	-30.5	age if 15 <age<30< td=""><td>-0.026</td><td>-30.3</td></age<30<>	-0.026	-30.3	
& woman	dropped		& woman	dropped		
age if 30 <age<55< td=""><td>0.018</td><td>11.1</td><td>age if 30<age<55< td=""><td>0.018</td><td>11.1</td></age<55<></td></age<55<>	0.018	11.1	age if 30 <age<55< td=""><td>0.018</td><td>11.1</td></age<55<>	0.018	11.1	
& woman	-0.018	-8.7	& woman	-0.018	-8.5	
age if 55 <age<65< td=""><td>0.158</td><td>14.6</td><td>age if 55<age<65< td=""><td>0.159</td><td>14.6</td></age<65<></td></age<65<>	0.158	14.6	age if 55 <age<65< td=""><td>0.159</td><td>14.6</td></age<65<>	0.159	14.6	
& woman	0.069	30.1	& woman	0.069	30.2	
age 55-60? [dummy]	-2.099	-11.4	age 55-60? [dummy]	-2.101	-11.4	
& woman	dropped		& woman	dropped		
age 60-65? [dummy]	-1.104	-4.7	age 60-65? [dummy]	-1.103	-4.7	
& woman	-1.224	-16.2	& woman	-1.227	-16.2	
Individual characteristics			Individual characteristics			
Head of household? [dummy]	-0.179	-11.4	Head of household? [dummy]	-0.177	-11.2	
medium education? [dummy]	-0.997	-59.0	medium education? [dummy]	-0.978	-57.4	
higher education? [dummy]	-1.671	-62.7	higher education? [dummy]	-1.639	-60.8	
Regional characteristics			Regional characteristics			
Trnava? [dummy]	0.223	7.8	Trnava? [dummy]	0.159	5.2	
Trencin? [dummy]	0.203	6.1	Trencin? [dummy]	0.178	5.1	
Nitra? [dummy]	0.631	21.3	Nitra? [dummy]	0.538	16.8	
Zilina? [dummy]	0.465	15.8	Zilina? [dummy]	0.427	13.9	
Bystrica? [dummy]	0.579	21.2	Bystrica? [dummy]	0.475	15.6	
Presov? [dummy]	0.552	18.7	Presov? [dummy]	0.467	15.3	
Kosice? [dummy]	0.662	24.4	Kosice? [dummy]	0.569	19.2	
share of industry	-0.004	-4.6	share of industry	-0.005	-5.6	
share of services	-0.011	-5.9	share of services	-0.010	-5.6	
Skill mismatch			Regional skill composition			
deficit of high skills	-0.007	-0.3	share of high skill	-0.013	-8.3	
oversupply of low skills	-0.006	-3.8	share of medium skill	-0.010	-7.1	
N=70266, ps.R2=0.2694			N=70266, ps.R2=0.2647			

Results of Estimation 1 are presented in the table. All coefficients are signed as expected and most are significant at the 5 percent and 1 percent levels. Results indicate that the skill composition of the region in which a person lives plays a role in determining this person's labor market status, on top of the individual's skill level and pure regional effects. However, given the plausible range of values for skill mismatches and the respective coefficients, these effects seem too small to account for and explain a significant part of the differences in regional employment rates.

CHAPTER 4-

HAVE RECENT REFORMS WORSENED THE ODDS FOR THE MOST VULNERABLE?

- 4.1 Any policy change is likely to worsen the welfare of some while improving that of others. The "potential Pareto" criterion advocates in favor of implementing those policies that increase the overall welfare of the population i.e., to the point where the sum of the benefits to the winners exceeds the sum of the costs to the losers. The policy will then become an "actual Pareto improvement" if the losers can in some way be compensated for the loss of welfare they face so that their final welfare is unchanged.
- 4.2 There is little doubt that, overall, the Slovak reform represented a "potential Pareto improvement". The rationale for the reforms was clearly and fully consistent with the overall objective of increasing employment opportunities and strengthening the incentives to take up a job for the overall population. As such, it addressed many of the criticisms of the old system as they had been pointed out by both Slovak and international observers.²⁹ Thus the reform package was necessary and long overdue, since the old system was outdated and economically unsustainable. This was clearly a widely shared view, as according to an opinion poll conducted in June 2004 by the Markant Agency 82 percent of respondents were in favor, to varying degrees, of the changes to the tax code, while 57 percent were in favor of the changes in social benefits.³⁰ This conclusion is also supported by the results of the qualitative analysis conducted as background to this report, which was based on detailed interviews with main stakeholders in 11 sites.
- 4.3 Nevertheless, when the reforms were introduced in January 2004, the SR experienced considerable social unrest due to the concern that the reforms had shifted resources away from the most vulnerable and towards groups of individuals that, while poor, were not as socially excluded as those that lost out. Evaluating the full impact of the changes is, therefore, critical to the sustainability of the reform process, which could potentially be

²⁹ See also World Bank (2004), *Doing Business in 2005*, for a more detailed description and an international context.

Miroslav Beblavy, "Reform of the Social System: Motivation, Targeting and Consolidation," presented September 2004.

jeopardized by the concerns about its effect on the living standards of the most vulnerable groups.

- 4.4 This chapter attempts to master this task, which is made difficult by a number of factors.³¹ The first is the very broad scope of the reform which, as described below, was extremely comprehensive and far-reaching. This makes it extremely difficult to evaluate its full impact in view of the potential interaction of its many components. This report takes a "partial equilibrium" approach that is, it focuses on two prominent aspect of the reform and attempts to evaluate their impact on the level of and inequality in the living standards of the population under different assumptions about what happens to the rest of the economy. The aspects analyzed are the following:
 - The introduction of the flat-rate tax
 - The changes in the structure and the average value of the social benefits.
- 4.5 Data limitation is the other reason why a satisfactory impact evaluation cannot be carried out. Detailed information on income is only available for 2002—in the 2003 Microcensus. Thus, the data predate the reforms and cannot be used to evaluate their impact. However, despite the limitations on the accuracy of the income reporting, the data could provide a useful basis for comparing the income levels and distribution before and after the reform.

A. WHY REFORM THE INCOME TAX AND THE BENEFITS SYSTEM, AND How?

- 4.6 There was broad agreement among both Slovak and international observers that the social benefits system in operation in the SR over the 1990s acted as a reasonably effective safety net mechanism, but also that (i) it was fiscally unsustainable; (ii) it provided a financial disincentive for individuals with low earning potential to actively seek employment; and (iii) the high tax wedge that it generated resulted in barriers to job creation.
- 4.7 The need for far-reaching reforms had been argued convincingly in the previous World Bank Living Standards Assessment (World Bank, 2002), which had reached the following conclusions:
 - The pre-2002 social benefits system was an effective safety-net mechanism.
 - However, its generosity generated both a "poverty trap" and an "unemployment trap" which removed the financial incentive for some groups of workers to actively seek employment. This was because the value of the benefits received by workers with low earning potential when out of work (and in poverty) was higher than the amount that they could have received in employment i.e., the replacement ratio was close

For more details on the analysis, see Policy Note 2 in Volume II.

- to one.³² This is clear from Figure 4.1, which plots total income (including benefits) against gross wage for selected groups of households under the two different social benefit regimes that were in operation before the reform.³³ The last two graphs in particular show the lack of incentive generated by the old benefit system for the second adult to work in a low-income two-adult household with children.
- The high rates of unemployment and inactivity were associated with low job creation (especially in some regions) and with the existence of severe mismatches between the labor supplied and that demanded. Among the main reasons for low job creation was the comparatively high tax wedge on wages required to finance the generous benefits system. This was particularly biting for the lower level of wages and in low-productivity/low-employment regions.
- 4.8 In response to the weaknesses of the system, the "New Social Policy" of the government elected in the autumn of 2002 focused on employment creation, poverty reduction, and the improvement of the fiscal sustainability of the benefits system. The reform addressed three interrelated sectors: (i) social assistance and family policy; (ii) the labor market and active labor market policy; and (iii) the pension and social insurance system. It had three guiding principles: (i) clear and simple rules, (i) active individuals, and (iii) making work pay.³⁴

The "replacement ratio" is the ratio of income out of work to potential work income.

Under the old system *individuals in material need* were divided into two distinct groups (for objective reasons and for subjective reasons) depending on their recent job search history. Those who were in material need for *subjective reasons* – i.e., who were able to work but were not looking for a job, had been deleted from the unemployment registry, or were not paying alimony – received lower benefits than the rest (generally, the elderly and the sick). It is worth noting that the total number of beneficiaries under the two regimes was approximately equal. For details, see Policy Note 2 in Volume 2.

See Concept of Pension Insurance, approved by the government on April 2, 2003; Strategy of Labor Market Reform to Generate Growth in Employment, approved on April 30, 2003; and Strategy of Public Sector Employment, approved on June 11, 2003.

Single household, with job 1 child 3 children 225,000 205,000 205.000 18 5.0 0 0 185,000 165,000 165,000 145.000 125,000 12 5.000 105,000 - - - Net Income 2002 obj 105.000 = = = Net income 2002 obi 85.000 85,000 -Net Income 2002 subj -Net income 2002 subj 65,000 65,000 45.000 72,000 96,000 120,000 144,000 168,000 192,000 216,000 240,000 72,000 96,000 120,000 144,000 168,000 192,000 216,000 240,000 Annual Gross Wage Annual Gross Wage A couple, both with job 1 child 3 children 285,000 265,000 265,000 245,000 245,000 225,000 225,000 205,000 205,000 18 5,0 0 0 185,000 165,000 16 5,0 0 0 14 5,0 0 0 145,000 125,000 - - - Net Income 2002 obi 125,000 -Net income 2002 obj 105.000 105,000 85,000 85,000 65,000 65,000 144,000 168,000 192,000 216,000 240,000264,000 288,000 312,000 144,000 168,000 192,000 216,000 240,000264,000 288,000 312,000 A couple, one with job, other long-term unemployed 1 child 3 children 225,000 225,000 205,000 205,000 18.5.000 18 5.0 0 0 165,000 165.000 14 5.000 145,000 125.000 125,000 - Net income 2002 obj - Net Income 2002 obi 10 5,0 0 0 105,000 Net income 2002 subj 85,000 85,000 65,000 72,000 96,000 120,000 144,000 168,000 192,000 216,000 240,000 72,000 96,000 120,000 144,000 168,000 192,000 216,000 240,000 Annual Gross Wage Annual Gross Wade

Figure 4.1: The "Poverty Trap" for Different Family Typologies under the 2002 Benefits System

Note: When there is zero gross wage, net income of the unemployed person (couple) is considered with the same number of children. A gross wage of 72,000 roughly reflects the minimum wage in 2002 (in 2004 prices). Total gross wage of the working couple assumes that one of the partners receives only the minimum wage.

Source: Authors.

B. THE MILESTONES OF THE REFORM AND ITS MAIN FEATURES

4.9 The reform was implemented in two stages. The first was primarily a fiscal maneuver designed to address the concerns of external observers about the sustainability of the budget deficit and to reduce fiscal pressure by cutting child benefits and other social transfers.³⁵ Meanwhile, the New Social Policy was developed in two concept papers on (i) pension reform and (ii) a "Strategy of Growth in Employment Based on the Labor Market Reform". The main elements and milestones of the New Social Policy are highlighted in Box 4.1.

Box 4.1: The Milestones of the Reform: Action Plans and New Legislation

The concept papers were elaborated in two National Action Plans and a Joint Inclusion Memorandum (JIM):

- The National Action Plan on Social Inclusion 2004-2006 was adopted by the Government of the Slovak Republic on July 14, 2004.
- The National Action Plan for Employment 2004-2006 was adopted by Governor of the Slovak Republic on September 22, 2004.
- The Joint Inclusion Memorandum was prepared with support from the European Commission, Directorate-General for Employment and Social Affair. Memorandum. It outlines the principal challenges in tackling poverty and social exclusion, presents the major policy measures taken by the Slovak Republic and identifies the key policy issues for future monitoring and policy review.

The Action Plans served as background materials for designing ten new legislative pieces, which reformed the social system and labor market from January 2004. These are:

- Flat personal income tax (PIT) at 19 percent, and corporate income tax at 19 percent.
- Single value added tax at 19 percent.
- Introduction of a single basic social benefit for the poor, allowances for health care and housing, and activation and protection benefits.
- Introduction of a single child benefit for all parents paid in cash and as a tax credit.
- Simplified calculation of the base for and payment of social benefits and increases in the benefits for families with children.
- New active labor market policies requiring the registered unemployed to visit the Labor Office every two weeks, long-term unemployed every seven days, and activation workers once a month. The new instruments include training, services for families with children, the "activation allowance," the mobility allowance and allowances for disabled workers.
- The merging of social and labor agencies into Offices of Labor, Social Affairs and Family (Labor Offices).
- More transparent social insurance. The act on social insurance made social insurance more transparent reduced certain contributions, re-defined sickness and unemployment benefits and prepared the conditions for pension reform.

During 2004, several amendments to existing legislation increased the amounts of the social benefits, housing allowance, child benefit, child birth grant and multiple birth benefit, foster care benefits and funeral allowance (government decrees nos.790-795 from August 18, 2004).

The cut in child benefits was from Sk 480-Sk 1,290 per month to Sk 270-Sk 890 per month. Social benefits were reduced in size but most important was the introduction of a monthly ceiling per household set at Sk 10,500.

- 4.10 The focus of this report is on the second component of the reform the reform of benefits and taxes which was approved by the government on April 30, 2003 and developed into new legislation (see Box 4.1 for a list and description) which substantially reshaped the tax and benefits systems in the following ways:
 - The tax system by introducing (i) what is increasingly known as the flat tax on personal income, and (ii) a single bracket value added tax (VAT)
 - The **social benefits system** by (i) lowering the base benefit; (ii) supplementing it with an additional benefit conditional on employment; (iii) changing the child benefit from a means-tested benefit to a flat benefit tax credit; and (iv) introducing more proactive labor market policies.

Introducing the Flat Tax

4.11 Table 4.1 summarizes the changes introduced by the reform of the personal income tax. The initial five brackets and the corresponding rates between 10 and 38 percent were replaced by a 19 percent flat tax with a sharp increase in deductibles (more than double) and the introduction of a tax credit on dependent children. The flat tax is a relatively new concept in public finance that has been gaining increasing support and prominence after its seemingly successful implementation in Central European and some CIS countries (see Table 4.2). Its main advantages are seen to be (i) its ease of implementation, (ii) its higher transparency, and (iii) the increased compliance rate that it appears to generate. Although – as is evident from Table 4.2 – countries vary substantially in the rate they adopted, the overall evidence is of a very successful alternative to a more complex tax system in countries with a relatively young system of collection and enforcement and generalized issues of governance and compliance.

Table 4.1: Personal Income Tax in 2004 and 2002

	2004	2002		
		Income range, rate on the rate + fixed amount		
		Sk 0-Sk 90,000	10% + Sk 0	
T	19% flat	Sk 90-Sk 180,000	20% + Sk 9,000	
Tax rate	19% 11at	Sk 180,000-Sk 396,000	28% + Sk 27,000	
		Sk 396,000-Sk 564,000	35% + Sk 87,480	
		Sk 564,000 and more	38% + Sk 146,280	
Deductible items				
Taxpayer	Sk 80,832 *	Sk 38,760 (Sk 48,000 if hand	licapped)	
Spouse	MAX (Sk 80,832 minus spouse's income, 0) Sk 12,000 if had no income		
Old-age	01- 0	Sk 0 (Sk 8,400 if partially dis	sabled; Sk 16,800	
pensioners	Sk 0	if disabled)		
Dependent child	Sk 0	Sk 16,800 (Sk 22,800 if hand	licapped)	
Tax credit			•• /	
	Sk 4,800 only if parent's annual gross			
Dependent child	income exceeds 6 x minimum wage, i.e. Sk	Sk 0		
	36,480			

^{*} The amount is set to 19.2 times the minimum subsistence level as of January every year (see Act No. 601/2003).

Source: Act on Income Tax No. 595.

Chapter 4 53

Table 4.2: The Flat Tax in Central Europe

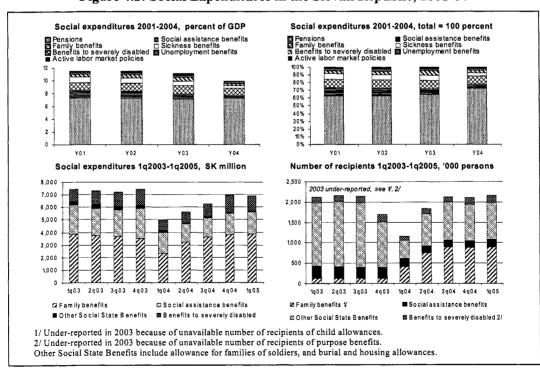
Country	Rate	Year	
Estonia	26	1994	
Lithuania	33	1994	
Latvia	25	1995	
Russia	13	2001	
Serbia	14	2003	
Ukraine	13	2004	
Slovak Republic	19	2004	
Georgia	12	2005	
Romania	16	2005	

Source: The Economist (2005).

Changing the Social Benefits System

4.12 Recent reforms have maintained the traditional categories of benefits and introduced new types of interventions, conditional on the individual's taking a more active role in the labor market and the economy, the so-called "activation program". Nevertheless, the overall expenditure on social benefits has declined from about 11.5 percent of GDP in 2002 to 9.9 percent of GDP in 2004. As shown in Figure 4.2, the main reason for the decline is the sharp reduction in social assistance and in sickness benefits (more than 50 percent) but spending on active labor market policies has also declined by two-thirds, and benefits to the severely disabled were reduced by more than one-third.

Figure 4.2: Social Expenditures in the Slovak Republic, 2001-04



Sources: Statistical Office of SR, Ministry of Labor and Social Insurance Agency, Authors' calculations.

	Description /Income related	2004	2002 (in 2004 prices)
Family-related			
Child birth grant 1/	one-off payment / Not	Sk4,320 or less	Sk3,370 or less
Multiple birth benefit	annual / Not	Sk2,340-Sk3,070	Sk2,340-Sk3,080
Child benefit	monthly / 2004 Not, 2002 Yes	Sk540	Sk520-Sk970
Parental allowance	monthly / 2004 Not, 2002 Yes	Sk4,110 or less	Sk2,970
Foster care allowances	three allowances / Not	**	••
Poverty-related			
			depends on past
Social benefit	monthly / Yes	Sk4,850 or less	behavior and family
Housing allowance	monthly / Yes	Sk1,670 or less	size, no cap N/A
<u> </u>	•	Sk13,740 or less	
Lump-sum benefit	annual, no entitlement / Yes	•	 NT/A
Health-care allowance	monthly / Yes	Sk50	N/A
Activation allowance	monthly during activation works / Yes	Sk1,500	N/A
Back-to-work allowance	monthly / Yes	special formula	N/A
Protection allowance	monthly, exceptional / Yes	Sk1,500	N/A
Subsidy for catering and	daily and annual, respectively,	Sk25 catering,	N/A
school needs	paid to school / Yes	Sk1,000 school needs	
Scholarships for pupils	monthly, depends on grades / Yes	Sk500 or less	N/A
Scholarships for students	monthly, depends on grades / Yes	Sk1,200 or less	N/A
Housing benefit	monthly / Yes	special formula	special formula

Table 4.3: Social Assistance Benefits Before and After the Reform, 2004 and 2002

1/ Lower amount paid for second and subsequent children. Payments per child.

Sources: Law No 235/1998 and authors' calculations.

4.13 Family-related benefits consist of the child birth grant, multiple birth benefit, child benefit, parental allowance, and foster care allowances. The most important is the child benefit³⁶ which in 2002 was income-related but is now a fixed amount per child independent of the household income (see Table 4.3).³⁷ Poverty-related benefits³⁸ are provided to all in material need – i.e., those under a minimum subsistence level which is defined by the structure and composition of the household.³⁹ The reform increased the minimum subsistence level for adults, but left it almost unchanged for dependent children. However, the amount of social benefits paid to households below this level was substantially reduced (see Box 4.2 for minimum, maximum and mean benefits paid in 2001-04). Between 2002 and 2004 the minimum social assistance benefit per recipient⁴⁰ declined by 59 percent, the mean benefit declined by 56 percent and the maximum benefit declined by 34 percent. The special housing benefit in 2002 was intended for low income families and was phased out in 2004 and replaced by a more systemic housing allowance.

Act No. 600/2003 on the child benefit.

For details of the payments see Policy Note 2 in Volume II.

Acts on Social Assistance no. 599/2003 and no. 195/1998. Note that social assistance is in the competency of municipalities and the Labor Office.

³⁹ The details of the benefits paid before and after 2002 are given in Policy Note 2 in Volume II.

⁴⁰ Recipient defines a household dependent on social assistance.

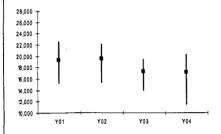
Box 4.2: Average Social Assistance Benefits and Number of Recipients

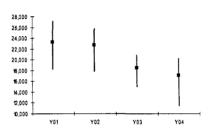
The minimum subsistence level increased in real terms for adults, and remained almost unchanged for dependent children. However, the amounts of the social benefits were cut so much that between 2002 and 2004 the minimum social assistance benefit per recipient declined by 59 percent, the mean benefit declined by 56 percent, and the maximum benefit by 34 percent (see below).

Figure (i). Annual Social Benefits Paid, per Recipient, 2001-2004 (minimum, maximum and mean values)

Nominal amounts, Sk

In 2004 prices, Sk





(annual payment per recipient in Sk)

(annual payment per recipient in Sk)

Maximum	22,505	22,066	19,479	20,247	
Minimum	15,205	15,313	13,998	11,520	
Mean	19,289	19,504	17,255	17,145	
(in percent of annual payment per recipient in 2004)					

Maximum	27,116	25,738	20,940	20,247
Minimum	18,320	17,861	15,048	11,520
Mean	23,240	22,749	18,550	17,145

(in percent of annual payment per recipient in 2004)

(iii percent c	or armidar po	lyment per re	corprome in 20	,0-1)
Maximum	111.2	109.0	96.2	100.0
Minimum	132.0	132.9	121.5	100.0
	112.5	112 0	100.6	100.0

Maximum	133.9	127.1	103.4	100.0
Minimum	159.0	155.0	130.6	100.0
Manu	125 6	122.7	100 1	100.0

Note: Maximum, minimum and mean payments were calculated from an average annual benefit per recipient (dependent household).

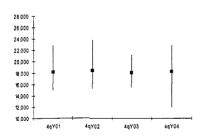
However, one may argue that for analytical purposes it makes sense to compare data for the fourth quarter of each year to allow for the phasing in period of changes in social assistance in 2004 (including the introduction and implementation of the changes). Therefore, below we present a comparison of fourth quarters for 2001-2004. It is clear that in nominal terms average benefits did not change. In real terms, however, benefits in 4q2004 were lower by 20 percent than in 4q2001, by 18 percent than in 4q2002, and by 6 percent than in 4q2003.

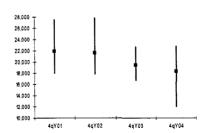
Mean

Figure (ii). Annual Social Benefits Paid, per Recipient, 4q2001-4q2004 (minimum, maximum and mean values)

Nominal amounts, Sk

In 2004 prices, Sk





Source: Ministry of Labor and authors' calculations.

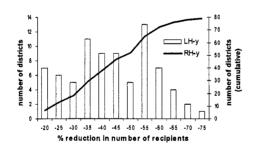
4.14 Because of tighter entitlement rules, the number of recipients declined also, by as much as 38 percent, between January 2001 and December 2004 (see Box 4.3). This was in line with a 34 percent decline in the registered unemployment rate. However, large disparities existed across districts in the extent of the reduction in number of recipients. While the median change between January 2001 and December 2004 was large (a 41 percent reduction), there were districts that remained well below that rate (such as Medzilaborce and Poltar) owing to a persistent lack of jobs in those districts and limited labor mobility.

Box 4.3:Reduction in the Number of Recipients of the Social Assistance Benefits between January 2001 and December 2004

Because of the lower social benefits, the number of recipients also declined: by 38 percent between January 2001 and December 2004. 1/ This seems to be very much in line with a 34 percent decline in the registered unemployment rate (although the correlation between the two variables calculated on 79 districts was 0.49 only) and in line with a 15 percent decline in the LFS unemployment rate. However, the registry of dependents contains data only on those households that were receiving social assistance benefits (i.e., those whose income was lower than the sum of the benefits for which they were eligible), and not on those that were below the MSL poverty line. Because the benefits were cut significantly, previously eligible persons would drop from the registry independently whether or not they found a new source of income (job).

Below we present the distribution of districts by percentage reduction in the number of recipients between January 2001 and December 2004, and five districts with the greatest and least reduction. While the median change between January 2001 and December 2004 was large (41 percent reduction), there are districts that stayed well below that rate, such as Medzilaborce and Poltar.

Number of Districts by percent Reduction of Recipients



Notes:

Least change: 10 percent reduction in a number of recipients

Median change: 41 percent reduction in a number of dependents

Maximum change: 75 percent reduction in a number of dependents

Tables below: districts ranked by percent change in number of recipients. Registered unemployment rate (LFS not available by district).

Source: Ministry of Labor and authors' calculations.

	Districts with most change				ש	istricts wit	n least ch	lange	
	percent of dependents		1			percent of dependents		Unemployment rate	
	Dec04	Jan01	Dec04	Jan01		Dec04	Jan01	Dec04	Jan01
Namestovo	3.4	13.8	10.4	23.1	Medzilaborce	11.4	12.6	20.6	26.1
Myjava	2.8	9.4	7.7	15.6	Poltar	11.5	12.8	24.4	27.7
Tvrdosin	3.3	10.0	11.7	22.6	R. Sobota	21.8	24.4	28.7	37.6
Puchov	2.1	5.8	6.9	13.4	Revuca	21.1	23.7	28.4	34.4
Cadca	3.6	9.8	10.8	20.4	B. Stiavnica	7.7	8.8	17.3	22.8

¹ The fact that unemployed youth are no longer counted individually if they are still living with their parents is a factor in this reduction as well.

4.15 An important part of the new social policy is the introduction of a number of *active labor market policies*, ⁴¹ designed to help match jobs and job-seekers⁴² and to support the income of the poor while in work. These policies, which are summarized in Table 4.4, vary in their character and in the group that they are designed to target. The broadest are open to all of the unemployed while others are targeted to the long-term unemployed, and to youth, parents and the disabled.

Table 4.4: Focus of Active Labor Market Policies in 2004 and 2002

Contribution	2004	2002	Beneficiary
For commuting expanses related to job interview	All unemployed	N/A	Unemployed
For labor market preparation and training of job seekers	Re-training of previously unemployed person	Allowance for re-training	Employer
For self-employment	All unemployed for more than 4 months, who start and maintain their own business	All unemployed	Unemployed
For job mobility Activation (subsidy)	All unemployed for more than 6 months All unemployed in poverty	N/A N/A	Unemployed Employer
For graduate practice	Youth bellow 25	Similar scheme existed	Both
For employment of disadvantaged job seeker	Long-term unemployed, youth or elderly, single person taking care of child, disabled person	Long-term unemployed, elderly and graduate	Employer
For child-care costs of job seeker attending labor market preparation and training	Unemployed parent undertaking a training	N/A	Unemployed
For establishing and maintaining of a sheltered workplace and workshop	Disabled	Disabled	Employer
For self-employment of disabled job seeker	Disabled unemployed for more than 4 months	N/A	Unemployed
For production costs of sheltered workplace and workshop and for transport-related costs of disabled job seekers	Disabled	N/A	Employer
For an assistant at work for disabled employee(s)	Disabled	N/A	Employer

Note: For active labor market policies in 2002 see also Act No. 387/1996 on Employment. N/A stands for not available in 2002.

4.16 In total, Sk 1.9 billion was spent on active labor market policies in 2004 (as opposed to Sk 3.5 billion in 2002), and 270,000 people took advantage of them (figure not available for 2002).⁴³ The main part of the expenditure was used for activation contributions: 82 percent of

⁴¹ Act No. 5/2004 on Employment Services and Act No. 387/1996 on Employment Services.

⁴² A job-seeker is a person obliged to visit the labor office at the following frequencies: once a week if long-term unemployed, once a month if participating in activation programs, or once every two weeks otherwise (Act No. 5/2004, Art. 8).

The comparatively low spending on ALMPs in 2004 could be explained by a gradual phasing in of the new policies: the activation subsidy was implemented from February, while other policies were implemented from March to May. Thus, while in the first half of the year only Sk 0.4 billion was spent, in the second half Sk 1.5 billion was spent. Using the latter figure, we estimate a potential cost of Sk 3.0 billion in 2004, which is a somewhat higher than the Sk 2.8 billion spent in 2003.

all beneficiaries of the active labor market policies participated (almost 220,000 people, or 46 percent of all unemployed in 2004) and 53 percent of total expenditure went to this benefit (see Figure 4.3). Contributions for the child-care costs of job-seekers attending labor market preparation and training were paid to 10 percent of the beneficiaries and accounted for 11 percent of total expenditure. Contributions for graduate practice were paid to 5 percent of the beneficiaries and cost 11 percent. The main disproportion seems to be between the percentage of beneficiaries of the contribution for self-employment (2 percent) and its high cost (17 percent). All other active labor market policies benefited only 1 percent of the beneficiaries and cost 7 percent of total funds (for more details see Policy Note 2 in Volume II).

Number of beneficiaries and costs (SK million) Beneficiaries and costs in percent of respective total 250 000 ☑ %ALM P participants No.of participants (LH-y) 80 -Cost (Skm , RH-y) □ %AIM P Total cost 70 800 60 150.000 50 600 40 100,000 400 30 20 50,000 200 10 Contribution Contribution Contribution Other Contribution Contribution Contribution Activation for child-care for graduate for selffor child-care for graduate sub sid y for selfemployment costs of job seeker practice emp to yment costs of job Number of beneficiaries, cumulative monthly (persons) Cost of the programs, cumulative monthly (SK million) — ■ § 46 Contribution for child-care costs of job seeker → § 51C antribution for graduate practice → § 51C ontribution for graduate practice — § 49 Contribution for self-employment A-S 49 Contribution for self-employment 2.000 35.000 400.000 700 Other -O Other 1,800 350,000 -§ 52 Activation subsidy (RHS) 600 1.600 500 25.000 250 000 1,200 400 20 000 1,000 200.000 15.000 800 150,000 600 200 10 0 .0 0 0 400 10 0 50.000 200 Apr29 Oct29 Dec31 Feb25 Apr25 Apr29 Jun25 Aug27 Oct29 Dec31 Feb25 Apr25 Average cost per beneficiary (SK) - § 52 A ctivation subsidy -- § 46 Contribution for child-care costs of job seeker - § 51C o ntribution for graduate practice 90,000 - § 49 Contribution for self-employment 80.000 70.000 Average cost per beneficiary, note: 60,000 50,000 because different programs imply different 40,000 duration of contributions, the average cost per 30,000 beneficiary provides biased picture. Unfortunately, 20,000 10,000 information on the duration of each program was not available. Feb23 Apr29 Jun25 Aug 27 Oct29 Dec31 Feb25

Figure 4.3: Active Labor Market Policies in 2004: Beneficiaries and Costs

Source: Labor Office, Ministry of Labor and authors' calculations.

Chapter 4 59

C. HAVE THE REFORMS REDUCED THE INCOME OF THE POOR?

4.17 Earlier parts of this chapter outlined clearly the need for the reform and its rationale. However, as mentioned earlier, when the reforms of the tax and benefits systems were introduced in January 2004, the SR saw considerable social unrest which received wide media coverage both nationally and internationally. The source of the unrest was the concern by some groups that the reforms had shifted resources away from the most vulnerable and towards groups of individuals that, while poor, were not as socially excluded as those that lost out. This concern was particularly vivid among the long-term unemployed and in the most vulnerable communities but was also shared by other parts of the society (see Policy Note 2, Volume II).

- 4.18 On the surface this appears to be a somewhat justified concern, as the basic benefits available to those families that traditionally had been most dependent on the benefits had declined substantially. However, this is an excessively simplified conclusion that ignores the complexity of the reform and may fail to quantify its full impact. Thus, evaluating the full impact of the changes is clearly of critical importance to the sustainability of the reform process, which could potentially be jeopardized by the risk of social unrest. Unfortunately, the limitations of the data as highlighted extensively in Chapter 5 make this a rather difficult task. Indeed, detailed information on individual and household income after the reform is not available and the information that is available for the pre-reform period (i.e., the 2003 Microcensus) suffers from serious limitations in sample design and response rates (see Chapter 5 for more details).
- 4.19 This chapter attempts to fill this gap using two different quantitative methodologies. The first uses purposely built software to compute the total net income corresponding to different levels of gross earnings for a number of household typologies before and after the reform. By comparing the net income which corresponds to a given level of earning pre-reform with its post-reform counterpart, the model quantifies the net effect of the reform for a selected number of household typologies. The final part of the chapter uses a standard tax-benefit model to quantify the effect of this impact on poverty and income inequality.

Household Typologies

- 4.20 A number of different household typologies are analyzed. These can be summarized as follows:
 - Single headed household
 - o with or without employment if without, then long-term unemployed
 - o with different numbers of children of different ages.
 - Couple
 - o where both are in employment/only one is in employment/none are in employment (then long-term unemployed)
 - o with different numbers of children of different ages

Definition of Income and Model Specification

4.21 For the purpose of this model, net income is defined as original income (without pensions) minus personal income tax (PIT) and social contributions plus social benefits. The model does not include pensions, sickness and maternity allowances, and unemployment benefits (as it does not consider the short-term unemployed).⁴⁴ It is, however, designed to capture differences between the two schemes of social benefits that existed in 2002: that for individuals who were poor for subjective reasons and that for those who were poor for objective reasons.⁴⁵ The main structure of the model is defined in Table 4.5. The focus is on households whose annual gross wage is in a range of Sk 72,000⁴⁶ to Sk 240,000, which – according to Microcensus 2003 – covers 61 percent of all Slovak households (see Policy Note 2 in Volume II).

Table 4.5: Assumptions of the Benefit Impact Model

Contribution	Assumptions
	2004: includes child benefits and parental allowance (two amounts considered, depending on job status of the parent)
Family benefits	2002: includes child benefits and parental allowance
•	Parental allowance is received when child aged 0-3 years is not in kindergarten
	2004: includes social assistance benefit, activation, health care and housing allowances
	2002: includes social assistance benefit
Social assistance benefit	Household eligible when in material need, eligible for activation allowance when without job, eligible for housing and health-care allowances when in material need Note that while housing allowance in 2004 was a part of the social assistance benefits, in 2002 the housing benefit was considered independently of the social assistance benefits. However, during the transition period of 2004, those eligible for the housing benefit in December 2003 continued receiving the same amount in 2004, provided their net income was below the MSL and the total sum of social assistance
	benefits equaled zero.
School assistance	2004: includes food subsidy, school needs subsidy and average scholarship (which is based on grades, otherwise) 2002: N/A
School assistance	Household eligible when in material need and only if total social assistance benefits paid are greater than zero
Tax + Tax credit	Tax credit applicable only for 2004
Pensions	No pensions assumed, no pensioners in the household modeled
Sickness and maternity	No sickness and maternity allowances modeled
Unemployment benefits	No short-term unemployment modeled, thus no unemployment benefits considered

The model has been shared with the Ministry of Labor and the Ministry of Finance for comments, but also to serve as a simple tool for simulating certain changes in the social policy.

⁴⁵ See Footnote 33, above, and Policy Note 2 in Volume II for definitions and more details on these categories.

That is, the annual minimum wage in September 2004 was Sk 72,960 and the average wage in 2004 was Sk 189,900.

Chapter 4

Who Are the Winners and Who Are the Losers?

4.22 The findings of the analysis of the net impact of the reforms on selected household typologies (see Figures 4.4 (a) and 4.4 (b)) conclude that:

• The combined effect of the reform on the tax and benefit regime has increased the disposable income of the majority of households that are entitled to benefits

61

- The only households that may have lost out as an effect of the reform are those with three or more children where all adults are unemployed and those that before the reform were entitled to the higher benefit schedule
- Whether the households have lost out depends predominantly on their entitlement to school assistance
- Even for the most affected households the maximum potential loss in disposable income is limited.
- 4.23 These conclusions are confirmed by the findings of the tax-benefit model, which concludes that the reform has only a small potential effect on the incidence of poverty, with the poverty headcount declining by 2 to 3 percent according to the simulations based on the 2003 Microcensus. This is the case despite an overall reduction of around 16 percent in transfers paid. What this implies is that the change in the tax-benefit regime in itself (i.e., in isolation from the reduction in transfers) would have significantly reduced poverty by as much as 17 percent had it not been accompanied by a simultaneous reduction in the average transfer.

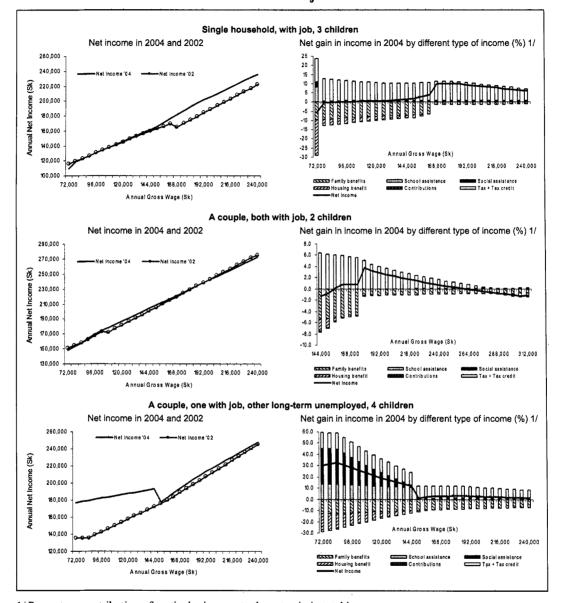


Figure 4.4(a): Examples of Results of Simulations, 2004 versus 2002: In Material Need for Subjective Reasons

1/ Percentage contribution of particular income to the net gain in total income.

Source: Authors' simulations.

Chapter 4 63

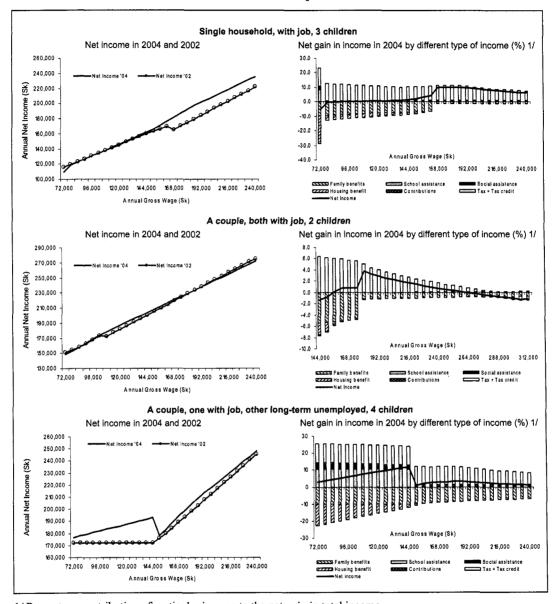


Figure 4.4(b): Examples of Results of Simulations, 2004 versus 2002: In Material Need for Objective Reasons

1/ Percentage contribution of particular income to the net gain in total income.

Source: Authors' simulations.

D. WHAT HAS HAPPENED TO POVERTY AND INCOME DISTRIBUTION?

4.24 A different approach to evaluating the impact of the reform is to use a "Tax-Benefit Model", which compares the household income levels before the reform with the simulated

post-reform levels. Then it becomes possible to identify the gainers and losers as well as all of the distributional and poverty changes (Orcutt, 1957). The use of a static microsimulation model makes it possible to focus on the effect of specific policy changes on poverty and income distribution while maintaining all of the other aspects of the reality constant.

Model Description

4.25 The framework used consists of two stages. The first involves computing the PIT due by each individual and his/her benefit entitlement on the basis of pre-reform tax benefit schedules. In the second stage, reforms are simulated by changing the parameters of the model and its specification as required and recomputing the entitlement /payment. The model assumes no tax evasion, full take-up of benefits and in the first instance no behavioral responses (for more details on these assumptions and other technical issues, see Policy Note 2 in Volume II).

4.26 Formally, the model structure for individual i is given by:

$$y^{D} = y^{G} [1 - t(y^{G})] + \sum_{i=1}^{m} B_{i}(y, a)$$
(1)

where y $^{\rm D}$ is the disposable income, y $^{\rm G}$ is the gross income, t $(y^{\rm G})$ is the tax rate (depending on gross income) and $B_{_J}$ (y,a) are income from different kinds of benefits that can be universal (B_0) or means-tested. The latter type of benefit varies by income type (y) and socio-demographic characteristics (a) relevant for eligibility (for further details, see Policy Note 2, Volume II).

4.27 Owing to data limitations it was impossible to simulate every fiscal and benefit instrument of the Slovak taxes and benefits system. For example, the unemployment benefits, maternity benefit and sickness benefit, as well as specific deductions such as those for disabled pensioners, handicapped tax payers and disabled dependent children, were not modeled because of the lack of information on relevant variables. The policies simulated in the model are:

- Child Benefits
- Scholarships
- Parental Allowance
- Social Assistance Benefits (for Households in Material Need)
- Personal Income Tax.

Data and Empirical Specifications

4.28 The simulation relies on micro-data collected at the individual level. The data set used is Microcensus 2003. It is a sample extracted from Census 2001 and representative at the national level. The sample size is 19,000 households (approximately 1 percent of all Slovak households) and 61,611 individuals. The data set contains individual and household characteristics as well as gross wage, and income from capital, pensions and benefits. All incomes are yearly (they refer to fiscal year 2002) and in Slovak koruna.

Chapter 4 65

4.29 In calculating the poverty and inequality indicators, the unit of observation is the individual, and, when not otherwise specified, the Standard OECD Equivalence Scale is used to assign household income to each member.⁴⁷ Relative as well as absolute poverty lines are used: a commonly used relative line equal to 60 percent of the median per equivalent adult income (43,422 SKK/year); and three absolute poverty lines (US\$2.15 PPP per day [10,776 SKK/year], US\$4.30 PPP per day [21,552 SKK/year], and the nationally set Minimum Subsistence Level [MSL]).⁴⁸

4.30 The poverty indicators used include: (i) the poverty rate (or Head-Count ratio); (ii) the income gap ratio; and (iii) the Foster-Greer-Thorbecke (FGT) index of the severity of poverty. The income quintile ratio (S80/S20) and the Gini coefficient are used as indicators of income inequality and the Kakwani and Reynolds-Smolensky indices are used to evaluate the redistributive effect of taxes and benefits pre- and post-reform.⁴⁹

Evaluating the Redistributional Impact of Implementing the Flat Tax

- 4.31 While the potential benefit of implementing a flat tax on the efficiency of the tax system is well known and widely recognized, many are concerned about the redistributional effect of moving from a traditional PIT system to one based on what is basically a proportional tax. The assumption here is that the reduction in tax brackets and the abolition of higher tax rates will reduce the progressivity of the system -i.e., the well-accepted principle that "equity" requires the better-off to pay a higher proportion of their income in taxes than the poor.
- 4.32 However, simulation of the distributional impact of the move to the flat tax in the SR show that it is possible to actually increase the progressivity of the tax system while replacing five tax brackets (and a fairly steep tax structure) by a single one. This is clear from Figure 4.5 which shows that (i) in 2004 the PIT burden was reduced for everybody except a very small range of income but (ii) particularly for the households on lower incomes. This is due to the combined effect of an increase in the value and a change in the structure of deductible items and tax credits.

This scale assigns a value of 1.0 to the first adult, 0.5 to children below 18, and 0.7 to other household members. To investigate the sensitiveness of the results to the equivalence scale used some results are also presented using the Modified Equivalence Scale or per capita values. The Modified OECD Equivalence Scale assigns a value of 1.0 to the first adult, of 0.3 to children below 14 and of 0.5 to other household members.

⁴⁸ The MSL differs by family structure with the lowest level equal to 47,160 SKK/year per single adult

⁴⁹ See Policy Note 2 in Volume II for more details.

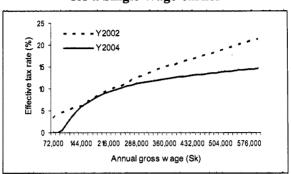


Figure 4.5: Effective Personal Income Tax Rates in 2004 and 2002 for a Single Wage-earner

Effective tax calculated as ratio of tax to gross income.

Source: Authors' calculations.

4.33 An alternative way of analyzing the change is presented in Table 4.6 which shows the impact of personal income tax reform on the tax burden and net income for different income decciles. On average, the change in the tax structure, ceteris paribus, has reduced the tax burden on households by 37 percent but the reduction was as high as 80 percent for the households in the first decile of original income, by around 60 percent for those in the second and third deciles and by only 20 percent for the upper deciles. This confirms the conclusion of Figure 4.5 that the poorest households benefited most from the tax reform.

Table 4.6: Simulated Personal Income Tax by Income Deciles (yearly SKK), 2002 and 2004

Income deciles*	· · · · · · · · · · · · · · · · · · ·	Tax	
	2002	2004	% Change
I	16	3	82.00
II	299	117	60.86
III	820	393	52.01
IV	1,204	726	39.64
V	1,421	1,042	26.67
VI	1,420	1,108	21.96
VII	1,603	1,270	20.76
VIII	2,296	1,858	19.08
IX	4,324	3,538	18.17
X	13,816	10,006	27.58
Average	2,722	2,006	36.87

Note: Taxes are per capita.

Source: Microcensus 2003.

4.34 According to the findings in Table 4.7, the Slovak tax system was slightly progressive before the reform and has become more progressive after 2004. This is reflected in the increase in the Kakwani index from 0.154 to 0.192 percent. Similarly, the Reynolds-Smolensky index shows that the mild redistributive impact of 2002 has grown stronger in 2004 after the reforms. This was due to the effect of the increase in deductions and credits which has more than

^{*} Income deciles are built using equivalized gross income.

compensated for the reduction in progressivity associated with the move to a single tax rate. The Kakwani index is halved or doubled if we consider separately the effect on progressivity of reducing five tax rates to only one rate of 19 percent or of introducing the new deductions combined with the tax schedule of 2002. In the first case, the progressivity index falls from 0.114 to 0.060, while in the second case the index increases up to 0.225.

Table 4.7: Progressivity and Redistributive Impact of the Tax System, 2002 and 2004

	2002	2004
Gini coefficient of original income	0.574	0.574
Concentration coefficient for taxes	0.688	0.766
Concentration coefficient for net income	0.557	0.556
Kakwani index	0.114	0.192
Reynolds-Smolensky index	0.017	0.018

Note: Households.

Source: Microcensus 2003.

4.35 However, before deriving strong conclusions on the distributional impact of the tax reform, it is important to remember that this analysis focuses exclusively on the new PIT and thus does not evaluate the full impact of the reforms on the overall tax system. The concern is that the overall reduction in the tax revenue generated by the new PIT overall may have led to a shift of the tax burden away from the PIT and into taxes on consumption (VAT and excise taxes), which tend to be more regressive.

Have Benefits Become Less Pro-poor?

4.36 As emphasized above, the 2004 reforms brought a generalized reduction in value of the average transfer. According to these simulations the reduction was around 35 percent for the child benefits and 51 percent for social assistance benefits and scholarships (see Table 4.8). In addition, in the case of social assistance benefits (and scholarships) the greatest reduction is found at the top of the income distribution (more than 50 percent), while in the case of the child benefit the greatest fall is for the bottom of the income distribution. However, this effect is compensated by the introduction of a tax credit for parents (as described above).

Income Deciles*	Child		('hild Kenefit		Parental Allowance			Social Assistance Benefit + Scholarship		
	2002	2004	percent Change	2002	2004	percent Change	2002	2004	percent Change	
I	12,982	7,531	-42	5,319	2,915	-0.45	58,025	36,829	-37	
II	15,956	9,398	-41	5,012	4,785	-0.05	27,436	14,577	-47	
III	11,698	6,924	-41	1,171	1,892	0.62	9,062	4,366	-52	
IV	8,997	5,428	-40	947	1,400	0.48	5,502	2,750	-50	
V	6,594	4,098	-38	499	1,089	1.18	2,606	1,217	-53	
VI	5,777	3,620	-37	705	700	-0.01	1,092	563	-48	
VII	6,013	3,925	-35	741	822	0.11	1,259	666	-47	
VIII	5,955	4,110	-31	327	710	1.17	561	198	-65	
IX	5,340	3,981	-25	396	660	0.67	410	158	-61	
X	4,355	3,370	-23	276	549	0.99	468	221	-53	
Average	8,367	5,238	-35	1,539	1,552	0.47	10,642	6,154	-51	

Table 4.8: Benefits by Income Deciles (yearly SKK), 2002 and 2004

Note: The Standard OECD Equivalence Scale assigns a value of 1.0 to the first adult, of 0.5 to children below 18 and of 0.7 to other household members.

Source: Microcensus 2003.

4.37 The overall benefit system, as well as its components, has become slightly less propoor. This conclusion is confirmed when comparing indices of redistributions from the benefit system before and after the reform (Table 4.9). The redistributive impact of benefits, already low in 2002, is likely to have been further reduced by the 2004 reforms (the Reynolds-Smolensky index was 0.121 in 2002 and 0.089 in 2004).

Table 4.9: Impact of Benefits on Income Inequality, 2002 and 2004 (percent)

		ne + Child vance	Net Income + Parental Allowance		Net Income + Social Assistance Benefit and Scholarship	
Measures	2002	2004	2002	2004	2002	2004
Gini index	36.6	37.4	37.4	37.8	33.1	33.9
Standard deviation of logs	80.8	89.9	69.3	71.8	60.7	63.9
Theil entropy measure	23.4	24.8	25.3	25.9	18.6	19.6

Note: Households disposable income.

Source: Microcensus 2003.

Evaluating the Overall Impact of the Reform on Poverty

4.38 If the impact of the overall reform is evaluated—rather than evaluating the tax and benefit system separately—the implementation of the new regime may have increased poverty independently of the indicators and the poverty line used. In the absence of behavioral changes, the results of the simulations reported in Table 4.10 conclude that the regime introduced in 2004 has probably resulted in a little change in the occurrence of poverty, with the headcount declining by 2 to 3 percent for households and increasing by 3 percent for individuals when relative poverty is considered and when the absolute poverty line is the MSL. However, the

^{*} Income deciles are built using equivalized gross income.

Chapter 4 69

percentage change is larger when extreme poverty is considered (US\$2.15 PPP), partly as a reflection of the small headcount for this type of poverty.

Table 4.10: Impact of Reforms on Poverty Indicators (% increase)

	Change in Headcount		
Poverty Line	НН	Indiv.	
60 percent median equivalent income	-2	3	
MSL	-3	3	
US\$2.15 PPP per person per day	25	20	

Source: Microcensus 2003.

4.39 Evaluating the simultaneous effects of tax and benefit reforms on income distribution, we can conclude that the reforms undertaken in 2004 may have increased inequality but only slightly (the Gini coefficient calculated on disposable income rose from 0.317 to 0.329). The decrease in the pro-poor impact of benefits and the loss of progressivity due to the tax rate partially compensated for the introduction of the tax bonus and higher deductible amounts from taxable income.

How Much of the Increase in Poverty Is Due to Changes in the Structure of the System?

4.40 According to the simulations, the average transfer paid to individuals dropped by 16 percent between 2002 and 2004. However, as noted earlier, this resulted in a small decline in the poverty headcount (3 percent). This suggests that the change in regime in itself has increased the targeting of the system and has protected the living standards of the poor from the potential effects of the decrease in transfers which was dictated by the need to increase the fiscal sustainability of the system.

But the Objective of the Reform is to Alter Labor Market Outcomes

- 4.41 Moreover, the models on which these results are based are static and assume no dynamic behavioral change (in other words, they assume that the employment status of the poor did not change after the reform). This is clearly a strong assumption, especially in the context of a reform that was designed to remove disincentives to work and to make work pay. In the absence of longitudinal data that can provide information on behavioral changes of the type the reform is trying to encourage, a speculative assumption can be made to try to incorporate the potential behavioral responses in the simulation of the impact of the reform.
- 4.42 One of these assumptions is the possibility that the new policies succeeded in having one extra person per each poor household (with more than one adult) in employment. The results of this exercise are presented in Table 4.12. The good news is that, if this should be the case, the poverty incidence would be reduced drastically—with the headcount ratio dropping from 16.8 to 3.1—and the poverty gap and FGT index would become close to zero. Unfortunately, this would require the creation of over 75,000 new jobs that would require the skill levels of the household members who are currently unemployed.

	2004 Regime (No Behavioral Changes)	2004 Regime (Allowing for Behavioral Changes	
Poverty rate	16.8	3.1	
Poverty gap	5.5	0.7	
Foster-Greer-Thorbecke (FGT) index (α=2)	2.9	0.3	
Number of additional jobs required		74,878	

Table 4.11: Poverty Estimates with Behavioral Changes, 2004

Notes: Poverty measures are based on household disposable income. The unit of observation is the household.

Source: Microcensus 2003.

4.43 This is a challenging but not impossible task. According to data from the Labor Force Survey (LFS), in the second and third quarters of 2004 the net increase in employment was 72,000 jobs. However, given the current patterns of job creation—as evident from the enterprise survey—only a small proportion of the newly created employment opportunities were for the types of workers who are most likely to be in poverty (i.e., the low-skilled in lagging regions). Thus, reducing labor market mismatches is of great importance to making the current growth and employment strategy an effective poverty reduction strategy as well.

4.44 A more optimistic way of looking at this result is to compute the minimum increase in employment required to maintain the poverty headcount at the simulated level for 2002, given the new benefit level (i.e., for the reform to be poverty neutral). If we assume no structural unemployment and no regional or skill bottlenecks, the economy would need to generate around 15,700 new jobs for the reform to be poverty neutral. This is less than one-third of the net increase in employment experienced in the third quarter of 2004 and just over half of that in the second quarter. Thus, even allowing for structural unemployment, this should not be an impossible target, especially if the targeted ALMPs implemented as part of the reform were to prove successful in reducing labor market mismatches and promoting employment opportunities for the most vulnerable groups.⁵⁰

⁵⁰ Early empirical evidence is encouraging: according to the Labor Office, subsidies for the employment of disadvantaged job seekers (which includes the long-term unemployed) made it possible to generate 1,800 jobs in 2004 and 1,900 jobs in 1H2005. Contribution for self-employment (for the unemployed for more than 4 months) made it possible to generate 5,618 jobs in 2004 and 5,323 jobs in 1H2005. Furthermore, according to the Ministry of Labor, Social Affairs and Family records, since February 2004, 20,000 previously long-term unemployed persons have become eligible for activation (job-start) allowance by finding a job or becoming self-employed (see law no.599/2003, art.12(8-9)).

CHAPTER 5-

WHY IT REMAINS IMPOSSIBLE TO ADEQUATELY MONITOR POVERTY AND INEQUALITY IN THE SLOVAK REPUBLIC

- 5.1 In evaluating the impact of the reforms, it is important to keep in mind that the quantitative information on poverty and living standards in the SR is limited and unreliable.
- 5.2 In the past there has been some reluctance to acknowledge the existence of poverty in the SR. The Slovak legislation never uses the term "poverty" and official statistics do not record basic poverty indicators. Synonyms for poverty such as "socially underprivileged population," "low-income households" and "material distress" have typically been used. However, recent years have seen a sharp change in attitude, with the government explicitly committing itself to fight poverty and social exclusion in a number of strategic documents linked to entry into the EU, such as the Joint Inclusion Memorandum (JIM) (2003) and the National Action Plan on Social Inclusion (NAP) (2004). Consequently, research on poverty in the SR is relatively new, although there are now a number of studies on this topic.

A. Data Limitations Prevent an Accurate Profile of Poverty

5.3 Until the release of the Microcensus data last summer, the last quantitative indicators referred to 1996. Then, according to World Bank figures--with a headcount at 8.6 percent and a US\$4.30 ppp/day poverty line – the SR had a comparatively low poverty rate, but it had a comparatively high incidence (2.6 percent) when the poverty line was lowered to that of extreme poverty (US\$2.15 ppp/day).⁵¹ This suggests the existence of relatively small but very deep pockets of poverty compared to other EU8 countries. With a Gini coefficient of 0.250 in 1996, the SR also had a very low level of income inequality, slightly higher than, for example, Denmark (Gini=0.227) but lower than Spain (0.340), Greece (0.351), or Portugal (0.368).

⁵¹ World Bank (2000), Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia.

However, inequalities increased in the first half of the 1990s with a rise of over 35 percent since 1992, when the Luxembourg Income Study calculated an extremely low Gini of 0.187.

- 5.4 As emphasized in the previous chapter, the concern of the critics of the reform is that the process of economic liberalization and widespread reforms, while fostering GDP growth and average household consumption, may have further increased both poverty and inequality over recent years. The initial rationale for this study was to verify the empirical relevance of this claim by quantifying and analyzing the changes in the levels of poverty and inequality since the last study. Unfortunately, the lack of reliable, nationally representative data with which to calculate the basic indicators made it impossible to derive a profile of poverty which was multidimensional in nature, representative of the Slovak population and in anyway comparable with that emerging from the 1996 Microcensus.
- 5.5 The limitations of the data are neither a new development nor a new discovery. The World Bank (2002) report pointed out at some length and made extremely clear the fact that the figures obtained for the basic indicators were unlikely to be totally reliable and should be treated with caution. Nevertheless, these figures are still widely used for lack of better options. The risk was that any further numbers generated by this report would also be used widely as a quantitative description of the current living standards in the SR. In addition and perhaps more worrying the comparison between the values of the indicators in 1996 and 2002 would be used to make comparisons over time. This would clearly be highly undesirable since (i) neither the 1996 nor the 2002 data are representative of the Slovak population and their living standards; (ii) the lack of representation does not arise from the same limitations of the sample design and is unlikely to affect the result in the same directions; and (iii) thus, it is not only the absolute level of the indicators that is likely to be biased but also the magnitude and direction of any change that occurred between the two periods.
- 5.6 In order to avoid this type of misunderstanding, this report does not attempt to provide a profile of poverty and living standards in the post-accession Slovak Republic and it definitely does not intend to fully assess how welfare distribution has changed in the "new" SR. Rather, it focuses on building the capacity to appropriately monitor poverty and living standards in the future so that:
 - The impact of the continuing process of transformation can be properly evaluated
 - The findings can feed into the policymaking of a government that is extremely conscious of the importance of monitoring its performance in a number of directions
 - The requirements of monitoring employment and social exclusion under the Lisbon agenda can be adequately satisfied.

B. Assessing the Current Capacity to Monitor Trends in Living Standards

5.7 The SR has the basic framework of surveys needed to monitor poverty and social exclusion, to evaluate the impact of economic reforms and to deliver evidence-based

policymaking. However, the execution of the surveys within this framework shows varying degrees of success, and potential problems with sample design and the actualization of sample designs may limit the usefulness of the data collected. In addition, at this time the data for some of the core variables are not being collected. This includes information on the non-monetary aspects of living standards and representative data on household income. The forthcoming Survey of Income and Living Conditions (SILC) may resolve this problem.

73

5.8 The existing data framework is described in Box 5.1. In addition to this basic framework, there are a few other surveys that could be useful for poverty monitoring (among other uses) but that are not currently included in the work of the Statistical Office. These include specialized health surveys such as the Demographic and Health Survey or the Reproductive Age Mortality Surveys, and the Multiple Indicator Cluster Survey (MICS) which is designed to look at women's and children's issues. In addition, surveys of facilities—such as schools and health posts—would be useful to assess infrastructure availability and needs, and could be carried out by the line ministries involved.

Box 5.1: Existing Data Capacity for Monitoring Poverty in the SR

The data currently available in the SR to monitor poverty include:

- The Census, which was carried out in 2001
- The Labor Force Surveys (LFS) undertaken quarterly since 1993
- A Microcensus carried out in 2003 which collected information about 2002
- The Household Budget Survey (HBS) which was re-designed in 2004

A Survey of Income and Living Conditions (SILC) planned for 2005.

C. Areas of Potential Improvement

5.9 There are several common concerns with the surveys currently implemented, which can be grouped broadly into five categories: (i) questionnaire design; (ii) sample design; (iii) field work; (iv) response rates; and (v) comparability over time.

Questionnaire Design

5.10 There is no systematic attempt to field-test alternative specifications of surveys before their implementation and this often leads to excessively complex surveys which may not give the answers they were designed to address. This is particularly obvious in the case of the HBS. Thus, the coverage and quality of the data could be greatly improved by putting in place a system to pilot test any and all changes to survey questionnaires. The pilot testing system would determine whether the information provided was accurate and could show where interview techniques needed to be modified or improved.

The Household Budget Survey (HBS)

5.11 The questionnaire for the HBS, which was re-designed in 2004 from earlier versions, consists of three schedules: (i) a short questionnaire on household demographics; (ii) a summary diary for income and expenditure for the first month of participation; and (iii) a family diary to record daily expenditures for the second month of participation. The questionnaires are

delivered to the participating households along with detailed instructions for completion, but they are complicated and difficult to fill out and there are no mechanisms to ensure the completeness of the data. This is of particular concern in the recording of income.

- 5.12 In addition, in its current format the information contained in the HBS is not sufficient to measure consumption, as opposed to expenditures, as the HBS does not:
 - Collect information on the consumption of home production and of goods received in exchange for goods and services
 - Limit the recording of expenditures to those that will be consumed in the same period in which they were purchased
 - Collect price information to permit regional adjustments.

5.13 In addition:

- There is no way to estimate the amount of consumption from subsidized government services such as education or health. Only those education and health items purchased by the household are included in the survey.
- No attempt is made to estimate the consumption value of durable goods and housing, items of particular importance in middle income countries.
- Most important, the diary is completed by one household member on behalf of the whole family i.e., a Family Diary (FD). Although this is fairly typical of expenditure surveys in Eastern Europe and CIS countries, it is unlike the expenditure surveys in most Western countries, including the EU15 and the other EU8, where each family member keeps his/her own diary i.e., a Personal Diary (PD).⁵²
- Finally, a major limitation for the monitoring of poverty is the fact that the HBS does not cover non-monetary poverty indicators, such as access to education and health care services, availability of clean water supplies, indicators of social exclusion, etc.

The Labor Force Survey (LFS)

5.14 The questionnaire for the Labor Force Survey (LFS) has been in place since 1993 and will be re-designed in 2006 to include the new EUROSTAT codification. The survey collects most of the information needed for analyses of the employment situation of all individuals aged 15 years or older, except for information on wages or salaries. This is a major limitation since the only information available on wages in the SR is derived from an enterprise survey whose sample design appears to be questionable. Moreover, enterprise surveys tend to overestimate earnings since they do not have information for the self-employed, small businesses and the informal sector generally. The exclusion of the wage question from the LFS survey is based on the a priori and never tested belief that accurate information will not be provided. However,

PDs are generally considered better for obtaining complete household expenditure data because it is unusual, in most societies, for any one household member to know the expenditure of every other member, especially expenditures on items such as alcohol, tobacco, daily travel, personal toiletries, daily newspapers/magazines, meals (especially snacks and lunches) eaten outside the home, etc. Recent research in Georgia and Russia has confirmed that FDs do in fact result in under-recording of expenditure – around 7 percent overall in the Russian HBS and about 15 percent in Georgia.

proper testing of this hypothesis should be carried out, as wage information is included in the LFS of all other EU countries.

The Microcensus

5.15 The 2003 Microcensus questionnaire was administered in April 2003 and collects information on income and other indicators for the calendar year 2002, with a recall period for information up to 16 months long. Recall periods of this length lead either to underestimation of household income because it is difficult to remember one's income over this lengthy period, or to educated guesses in which respondents estimate their income over the whole year using their current rate of income. In addition, serious errors with respect to items for which there are no written records, such as casual work, income from self-employment, or own consumption of self-produced food, are likely to occur.

Sample Design

5.16 The surveys have all taken advantage of the 2001 Census to re-design their samples, but information on sample designs is somewhat difficult to assess.⁵³ The most serious issue – at least in the case of the HBS – is that the sample seems to be drawn so as to include the areas that are closest to the sites in which the 8 regional and 42 sub-regional offices are located. This could result in a strong geographical bias in the implemented samples. Households distant from regional and sub-regional offices may be underrepresented along with any characteristics associated with living in remote areas. In addition, the different surveys allegedly use different sampling techniques and different sample frames, which makes it impossible to integrate their results.

Field Work

- 5.17 Interviewers, who are permanent SOSR employees, receive minimal training and little or no supervision in the field. The interviewers are responsible not only for the data collection but also for the key entry of the data, and the verification of the key entry is minimal. Supervisors check approximately half of the questionnaires, but the procedures used for these checks are not known.
- 5.18 The central office in Bratislava has few if any oversight functions. Decisions on how to implement the field work are left to the regional offices. There is no information on whether there are commonly enforced rules for decision making among the regional offices. If regional offices use different rules, the resulting data could differ from region to region.

Response Rates

5.19 The very low response rate is probably the most worrying aspect of current data collection. The survey with the lowest response rate is the HBS. Despite an incentive payment of 1300Sk (about US\$43) paid to each cooperating household, response to the HBS is very low, at about 25 percent. Response is even lower in Bratislava and among the very rich and very poor. Of particular concern is the fact that the effect of the incentive payment is negated for those households that receive social benefits because the benefit is offset against the

⁵³ For more details, see Volume II of this report.

payment (although recipients of unemployment benefits are not affected).⁵⁵ This suggests a non-response bias which would considerably reduce the number of poor households in the sample. Attempts have been made to have the regulations changed, but they have so far failed. However, although these factors will undoubtedly contribute to the response problem, the extent of non-response is too great to be explained by these factors alone.⁵⁶

5.20 The LFS has a response rate close to 93 percent. The Microcensus had an overall response rate of approximately 73 percent, which is quite a low rate considering that response is meant to be compulsory and that this figure also includes partial responses.

Comparability over Time

5.21 Another important limitation of the data for policymaking is the fact that the surveys currently in place – and their findings – cannot be compared to similar surveys carried out in previous years. This is the result, primarily, of the fact that the previous sample frame was based on the 1991 Census, which was undertaken prior to the dissolution of the federation of the Slovak and Czech Republics. However, the 2001 Census did not completely solve the problem. Until 2003, the HBS used a quota sample made up of the following social groups (as defined by the household head): manual workers; employees, the self-employed, farmers; and pensioners. Households headed by unemployed individuals were not included. Quota samples do not permit the calculation of selection probabilities, which precludes the weighting of the results to make them representative of population totals. This is not the case with the LFS, which is therefore more easily compared over time.

5.22 In addition to changes in the sample frame, comparability across different waves of the Microcensus surveys is limited by changes in the questionnaire design, as the categories used to collect information are more detailed in 2003 than in the 1997 questionnaire.⁵⁷ In addition, the period of time between the Microcensus surveys is too long to make this a useful tool for monitoring the income in the country.

The Issues of the Roma Population

5.23 The Roma are among the most vulnerable groups in the Slovak Republic. However, measuring the living standards of the Roma and the characteristics of the communities in which they live is difficult using the existing surveys. The SOSR is not permitted by law to ask ethnicity in surveys. Nationality can be included in a questionnaire, but not all Roma identify their nationality as Roma. The 2001 Census identifies approximately 80,000 Roma living in approximately 700 communities using the nationality question. Roma groups estimate the number of Roma as closer to 350,000. A social mapping exercise identified more than 1,000 communities in which Roma are living, but there is no reason to believe that the discrepancy

Although the official line is that non-responding households are not substituted, the fact that the SO selects a sample of about 19,000 addresses in order to achieve a cooperating sample of 4,700 seems to amount to a substitution strategy.

This at least seems to be the view of the Statistical Office and the public despite existing legislation that allows for the possibility of social benefits being unaffected by one-off income items such as the mentioned incentive payment (Article 5, paragraph 4e of the Act 599/2003.)

⁵⁶ Unemployment benefits are not reduced by the amount of the incentive payment.

Chapter 5 77

arises from more than 300 communities being excluded from the census rather than from the inhabitants not having been identified as Roma.

5.24 Nevertheless, because of problems with the implementation of the sample designs and because of the difficulty of identification in the Census, the Roma are probably underrepresented in every survey. It is possible to use other information as proof of the extent of the problem. For example, in the 1997 Microcensus, few households reported having more than 3 children while the average number of children for Roma families was 4.2. However, these discrepancies have been rectified in the 2003 Microcensus.

Lack of Information on the Non-income Dimension of Living Standards

- 5.25 Currently no information on some of the core indicators of welfare is being collected in the SR. Periodic specialized surveys, such as a Demographic and Health Survey, should be undertaken on a regular basis to provide more detailed information on such topics as women's and children's health. Administrative data as collected by line ministries and specialized research institutes should also be used. Examples of the type of indicators for which information can be obtained from administrative data and the potential sources of that information are provided in the Technical Note in Volume II.
- 5.26 However, it is widely accepted that the best tools for collecting information on living standards are surveys that collect information on more than one subject, in order to capture the multiple dimensions of living standards and their recognized connections--for example, between health and housing conditions or between education and fertility. While single topic surveys are important and provide much useful information, for the purposes of measuring living standards their focus is too narrow to address broader issues of social and economic development.⁵⁸
- 5.27 Unfortunately, none of the surveys currently implemented in the SR is multi-topical in nature. The Survey of Income and Living Conditions (SILC), which is shortly to be carried out by the SOSR, will represent the first multi-topic integrated household survey in the SR and, as such, it provides the first opportunity to obtain a complete multidimensional profile of poverty and living standards in the SR. Thus, it is extremely important that special attention is given to the sample design and the implementation of this survey, so that it will generate the high quality integrated information that is required to (i) adequately evaluate the impact of the reform process on growth and living standards; (ii) inform policymaking at this challenging but promising time; (iii) prepare a meaningful and realistic strategy for reducing poverty and social exclusion along the lines of the NAP required by the EU; and (iv) monitor progress towards the implementation of the strategy.

With the long recall period, it is better to use more detailed questions in order to obtain a more complete recollection. However, because of changes to the questions, the answers cannot be compared completely because the responses cover different units of measurement.

D. Conclusions

- 5.28 Essentially, if correctly carried out and expanded to cover the non-income dimensions of living standards, the surveys currently in place in the SR would provide much of the information needed for monitoring poverty, evaluating the impact of reforms, and formulating evidence-based strategies for social inclusion and poverty reduction. However, the execution of the surveys shows varying degrees of success. This chapter has highlighted a number of potential problems, of which of the following are of particular concern:
 - Questionnaire design This is an issue particularly for the HBS which (i) is based on a very complex self-completion questionnaire; (ii) uses Family Diaries rather than Personal Diaries for the recording of expenditure; and (iii) does not collect the information required to compute household consumption, as opposed to expenditure. Thus, the main concerns are that:
 - (a) The information on income may be highly unreliable
 - (b) The use of Family Diaries leads to under-recording of expenditure
 - (c) No information on a very important indicator of household welfare i.e., household consumption--is available for the SR.

More generally, the lack of systematic piloting of the questionnaires is cause for concern.

- Design and implementation of the sample The largest issue in the design of the sample, at least in the case of the HBS, is that the implemented samples seem to be drawn so as to include the areas that are closest to the sites in which the 8 regional and 42 sub-regional offices are located. This could result in a strong geographical bias.
- Very low response rates on some surveys The survey with the lowest response rate is the HBS for which only approximately one-quarter of the households that were asked to participate agreed to do so. The Microcensus had an overall response rate of approximately 73 percent, which is also quite low considering that response is meant to be compulsory and this figure also includes partial responses. By contrast, the LFS has a response rate close to 93 percent.
- Lack of training of interviewers and of supervision in the field Of concern also is the poor quality control exercised over the data collection process. For the HBS and the Microcensus there is very little proper training of, or field supervision over, the interviewers. Although the LFS interviewers do seem to receive systematic training and re-training, the concern about lack of field supervision remains.
- Lack of information on the non-income dimension of living standards At this

⁵⁸ Chander, Grootaert, and Pyatt, p. 5.

Chapter 5 79

time, information on some of the core indicators of welfare is not being collected. While other ways of collecting this information are possible, it is widely accepted that the best tools are multi-topic surveys that simultaneously collect information on more than one subject. These surveys have the capacity to capture the multiple dimensions of living standards and their recognized connections--for example, between income and education, health and housing conditions or education and fertility. The Survey of Income and Living Conditions (SILC) which is shortly to be implemented is one of these surveys and will represent the first opportunity to obtain a complete multidimensional profile of poverty and living standards in the SR. Thus, it is extremely important that special attention is given to the sample design and the implementation of this survey so that it will generate the high quality integrated information that is required.

CHAPTER 6-

CAN COMPETITIVENESS AND INCENTIVES BREAK THE CIRCLE OF POVERTY AND DEPENDENCE?

- 6.1 Perhaps the clearest mandate emanating from the 2002 election in the Slovak Republic was the reduction in unemployment that followed the economic restructuring and the structural changes in the enterprise sector. This mandate was reinforced in the preparation of the Joint Inclusion Memorandum (JIM) prior to EU accession and later in the National Action Plan for Employment (NAPE) where, according to the Lisbon Treaty, it was reformulated in terms of growth in employment and an increase in competitiveness. Therefore, it is not surprising that economic liberalization and improved labor market indicators became a priority for the government that emerged from the 2002 elections.
- 6.2 These objectives were pursued with determination and thoroughness. Over the period 2002-04 the government introduced a number of measures designed to increase the demand for and supply of labor. On the demand side, the emphasis has been on fostering job creation by improving the business environment through a package of measures that covered both the labor market and the economy more widely. These measures included the following:
 - Making the taxation and regulatory frameworks more supportive of new enterprise creation and business sector development
 - Reducing non-wage labor costs (by as much as 13 percent on average, from 38 percent to 33.2 percent of total labor cost
 - Increasing in flexibility in labor contracts and labor relations including easing many restrictive regulations in both the labor market and the product market.
- 6.3 On the supply side, on the other hand, the focus was on making work pay and reducing skill mismatches through the following measures:
 - Increasing the value of the minimum wage relative to the average wage
 - Reducing the disincentive to work generated by the pre-reform social assistance system

- Making the public education system more efficient, effective and responsive to the needs of the twenty-first century environment.
- 6.4 In the view of many Slovak and international observers, the comprehensive reform package was long overdue and was very much in line with recommendations from a number of sources.⁵⁹ It also represented the main element of first the JIM and then the National Action Plan prepared by the Slovak government in cooperation with the EU as part of the reporting requirements for the Lisbon agenda. Indeed, the spirit of the reform was very much in line with the principles underlying the EU Lisbon Treaty of 2000 and, in particular, with the objectives of "making work pay" and increasing employment opportunities for the overall population by increasing the competitiveness of the economy.
- 6.5 At the same time, the reform package met with vigorous opposition in some parts of the country and among some groups. The main concern of the critics was that, while promoting economic growth and increasing the returns from employment, the reform deepened the gap between those who could benefit fully from better economic opportunities and the rest of the population, who risked a considerable reduction in their income. This concern is of particular relevance in the context of a country such as the SR with deep-rooted historical inequalities and is reinforced by the findings that to date the growth in GDP has not been fully reflected in more favorable labor market outcomes for those groups with the strongest barriers to employment, such as the unskilled and those living in lagging regions.

A. HAS THE STRATEGY WORKED TO DATE AND FOR WHOM?

- 6.6 While it is too early to assess the full impact of the reform, the findings of this report suggest that overall the "Strategy of Growth in Employment" seems to have been reasonably effective in achieving the following targets:
 - Eliminating the disincentive to work provided by the high replacement ratio faced by individuals with low earning potential under the old system
 - Increasing the disposable income of the majority of households that are entitled to benefits
 - Providing better employment opportunities and access to ALMP programs for the average worker and for particularly vulnerable groups.
- 6.7 However, questions remain regarding the magnitude of these effects and their sustainability over time. In addition, it is important to note that, given the short time-frame of the analysis, it is difficult to establish whether the recent positive trends in some indicators are the result of the reforms or the effect of short-term trends.
- 6.8 In addition, owing to the lack of adequate post-reform data, the impact of the reform on income and poverty cannot be evaluated but can only be simulated. This report uses

⁵⁹ Among them were the World Bank reports (2002 a) and OECD (2004).

Chapter 6 83

two different approaches. First, it computes pre-reform and post-reform income levels for different household typologies and calculates the net impact of the reform by comparing these two levels. The second approach uses a "Tax-Benefit Model" to compare, for all sample households, the income levels of the household before the reform with the simulated post-reform levels so as to identify the gainers and losers as well as the distributional and poverty changes. The first approach draws the following conclusions:

- The combined effect of the reform on the tax and benefits regime has increased the disposable income of the majority of households that are entitled to benefits
- The only households that may have lost out through the reform are those with three or more children where all adults are unemployed and that were entitled before the reform to the higher benefits schedule
- Whether households have lost out depends predominantly on their entitlement to school assistance
- Even for the most affected households the maximum potential loss in disposable income is limited.
- 6.9 These conclusions are confirmed by the findings of the Tax-Benefit Model, which concludes that the reform has only a small potential effect on the incidence of poverty, with the poverty headcount decreasing by 2 to 3 percent according to the simulations based on the 2003 Microcensus. This is the case despite an overall reduction of around 16 percent in the average amount of the transfers. What this implies is that the change in the tax-benefit regime in itself (i.e., in isolation from the reduction in transfers) would have significantly reduced poverty, by as much as 17 percent, had it not been accompanied by a simultaneous reduction in the average transfer.
- 6.10 A primary factor behind this result is the reduction in the tax burden on the lower income groups which has been associated with the move to a flat-rate personal income tax (PIT) combined with a substantial increase in deductions and credits. This is an important result, since it shows that concerns about the potentially negative distributional effect of a flat-rate PIT may be misplaced. In the Slovak case the flat rate tax has not been merely an efficiency measure. The reform has increased the progressivity of the tax system while replacing five tax brackets (and a fairly steep scale of tax brackets) by a single one. Indeed, in 2004 the PIT burden was reduced for everyone but particularly for households with lower incomes. This was due to the increase in deductions and credits, which has more than compensated for the reduction in progressivity associated with the move to a single tax rate.
- 6.11 However, while the incidence of poverty has declined, its intensity and the related poverty gap have increased considerably—by 81 and 62 percent, respectively—suggesting that the income levels of those in poverty have declined as result of the change in tax-benefit regime. The simulations suggest that the inequality in household income has also increased as a result of the changes in the structure of taxes and benefits.
- 6.12 In terms of labor market indicators, the information presented in this report refers to 2004 as a whole. However, these values hide a clear difference between the first quarter of 2004 and the last part of that year. During the earlier period, the overall performance of the labor

market deteriorated sharply with 41,000 fewer people employed and a 3 percent reduction in the employment rate. However, the labor market's performance improved considerably in the next two quarters, with an overall increase in employment of 73,000 people and a 2.6 percent increase in the employment rate, and remained largely unchanged in the last quarter.

- 6.13 Thus, the use of quarterly data suggests that after an initial negative effect the post-2002 reform package may have led to a relatively high increase in employment with a year to year seasonally adjusted growth of 1-2 percent, driven primarily, but not only, by growth in self-employment. Self-employment continued to increase even after the implementation of the 2004 reform and stabilized at around 2 percent per quarter from the second quarter of 2004. By way of contrast, the number of employees declined substantially, by as much as 4 percent, in the second quarter of 2004. However, overall employment began to increase from the third quarter of 2004, reaching 2 percent by the first quarter of 2005. An inspection of quarter to quarter changes reinforces this finding. After a sharp drop in the second half of 2003 (-0.3 percent and -0.4 percent in the third and fourth quarters, respectively), overall employment began to increase in 2004 with a total increase of 46,200 jobs—and a 0.4 percent increase in the employment rate—in the period from the second quarter of 2004 to the first quarter of 2005 [all seasonally adjusted]).
- 6.14 It is too early to say to what extent this is the beginning of a trend and whether it is attributable to the success of the 2004 reforms, but the signs are encouraging. The fact that this growth is driven exclusively by growth in self-employment—in the context of a declining number of employees—is also worth noting, as it points to economic liberalization as the main driver of growth and has important implications for policymaking. This could be interpreted as sign that the labor market is moving in the right direction. However, it is too early to conclude with any degree of confidence that the 2004 reforms have increased employment opportunities. The confirmation that this is not simply a cyclical effect can be provided only by continuous monitoring over the next months.
- 6.15 Finally, it is also too early to fully asses the effect of the ALMPs that have been implemented. The available data show that the "activation contribution" is by far the most popular policy introduced to date in terms of number of beneficiaries and that it is a very successful measure, despite the lack of employment opportunities in some areas. However, the question of whether participation in this scheme will permanently increase a person's employment opportunities remains open. The international evidence on the success of these types of interventions is contradictory and country-contingent.
- 6.16 It is also important to realize that, in addition to their potential effect on future employment prospects, ALMPs can play a significant role as a strategy for reducing social exclusion. This is particularly important in a dual labor market such as that in the SR, where a small pocket of the labor force is at risk of becoming increasingly marginalized and "discouraged." Within this context, the programs can be seen as a way of keeping these workers engaged in the labor market and the economy rather than having them rely exclusively on social assistance. In this context these policies would act more as an alternative form of social assistance designed to break the cycle of dependence on social exclusion rather than as a route to permanent employment.

Chapter 6 85

B. PRIORITY ACTIONS ARE NEEDED TO CURB POVERTY

- 6.17 The overall conclusion of this report is that the government's strategy for increasing employment and tackling social exclusion is comprehensive and internally consistent. All of the right mechanisms are possibly in place to address poverty and social exclusion in the long term by breaking the vicious circle of lack of skills/poverty/state dependence that has prevented the poor from breaking out of poverty for generations. The findings to date, although limited, also suggest that this strategy is beginning to achieve the desired results and, based on recent trends, the expectations for the future are optimistic.
- 6.18 Nevertheless, it is important not to be complacent, as (i) the progress to date has been somewhat slower than anticipated, and (ii) the SR faces issues of deep-rooted socioeconomic inequalities which historically have always been of a much larger magnitude than those experienced by other EU countries—with the possible exception of regional disparities in Italy. Within this context, the following priorities emerge:
 - Maintaining the conditions for equitable growth
 - Increasing the skills of the poor and reducing the cost of employment
 - Strengthening the effectiveness of active labor market policies
 - Supporting the living standards of the most vulnerable.

Maintaining the Conditions for Equitable Growth

- 6.19 Although a rigorous analysis of the link between growth and poverty reduction is prevented by the lack of comparable data on poverty, the importance of growth for poverty reduction is clear. In the eyes of many, the comprehensive package of reforms implemented in recent years has (i) positioned the SR well not only in terms of other New Member States (NMS) of the EU but also in comparison with the Old Member States (OMS), and (ii) provided the SR with the chance to take full advantage of the new opportunities presented by its entry into the EU. Thus, the prospects for sustainable growth over the next years are very good.
- 6.20 But the evidence from recent years shows that growth alone will not be sufficient to move the SR closer to the Lisbon targets, where the responsiveness of employment to growth is substantially lower than that in the EU15 countries, although in line with that in the EU8. For growth to become an effective engine for poverty reduction, its link with employment creation needs to be significantly strengthened by making the growth environment more "labor friendly" and "equitable." In general, this would require interventions in both the demand side and the supply side of the labor market as well as in the area of labor market mismatch. The SR has already introduced many of the changes required to improve conditions on these different fronts. However, while the formula for the next few years is likely to be one of waiting for the benefits of these measures to bear fruit and for their full impact to be realized, some marginal changes may help in moving the country more rapidly to higher employment equilibrium.
- 6.21 This is particularly true on the demand side, where a positive business climate has been created over the last years by reducing the "tax wedge" (payroll taxes) and increasing

the flexibility and competitiveness of the labor market and the economy at large. However, a further reduction in labor costs may be required at the bottom end of the earning distribution in order to increase the employment opportunities for those low-skilled/low-productivity workers who are at the highest risk of unemployment. In this regard, it is recommended that the current policy of raising the minimum wage more rapidly than the average—as part of the objective of increasing the incentive to work—be progressively abandoned, since increasing the price of low-paid/low-skilled workers relative to other workers and to their productivity would reduce the demand for these workers. It is also recommended that the tax wedge be further reduced, particularly at the bottom end of the earning distribution, by raising the minimum level of earnings to which contributions are paid above the minimum wage and by introducing a uniform deductible level in line with the reform of the PIT.

- 6.22 On the other hand, on the supply side, the recent reforms of the tax and social benefits system have substantially increased the incentive to actively participate in the labor market by (i) eliminating the previously substantial poverty trap, (ii) considerably reducing the replacement ratio, and (iii) introducing financial incentives to take up employment even if on a part-time basis. In addition, the issue of labor market mismatch has been addressed via an imaginative package of active labor market policies designed to bring the long-term unemployment and discouraged workers back into employment and to increase geographical mobility via targeted policies combined with more general types of interventions.
- 6.23 Finally, the government has addressed the issue of regional inequalities within the context of the EU Regional Development Program. However, in order to continue to utilize the incoming funds effectively to reduce inequality, the SR needs to make an important decision on whether to put efficiency or equity first in its model of development. The diverse experiences of some EU countries clearly show that a trade-off may exist in this area, especially in the case of countries with large regional inequalities. The crucial question here is whether the available funds should be used to target low-income regions or to increase the potential of already more affluent "growth poles" that is, whether or not to choose the route of "balanced growth".⁶⁰

Increasing the Skills of the Poor

6.24 The low level of skills in the Slovak labor market, especially in the poorest regions, is a major cause of concern for the economic development of the country. Addressing this issue comprehensively requires a multi-pronged strategy designed to undertake the following:

- Improving school enrollment and the quality of education for young people currently in the education system
- Enhancing the skills (and employment prospects) of those who have already left the school system
- Implementing as soon as possible a radical reform of the higher education system in line with that recently prepared by the government.

⁶⁰ Funck and Pizzati (2003).

6.25 The government of the SR has taken active measures to address these issues. For example, among the main elements of the reform are (i) the introduction of scholarships for children in material need attending school; (ii) the school subsidies program; and (iii) extensive provisions for retraining the LTU and others. In addition, the MoLSAF and the MoE are working closely to improve the transition from school to work and to break the cycle of the intergenerational transmission of poverty that is so strong in the SR.

6.26 Generally speaking, a certain degree of skepticism exists regarding the effectiveness of retraining programs. However, recent evidence suggests that these programs are fairly successful, except for the retraining of workers in cases of mass layoffs. In addition, in the case of labor market duality, these programs can be considered as one way to effectively reduce social exclusion by providing otherwise excluded workers with an opportunity to go back into the labor market, at least temporarily. In this case, the programs would be seen more as an alternative form of social assistance than as a route to permanent employment.

Strengthening the Effectiveness of Active Labor Market Policies

6.27 The findings of this report indicate that the spread of long-term unemployment in the SR is associated with the deterioration of the relative position of specific vulnerable groups, such as the unskilled and individuals living in poor areas. When unemployment risk is concentrated and the receipt of benefits discourages regional labor mobility, there may be a strong case for active labor market policies (ALMPs) on the grounds that they can hardly involve deadweight costs, while substitution effects may even be desirable.

6.28 From the beginning of the transition to a market economy, the Slovak government has applied a wide range of such policies to combat LTU. In terms of expenditures, three programs have been of particular importance: training, "intervention works" and public works. Training programs are designed to solve skills mismatch in the Slovak labor market. Workers with redundant skills or no skills are trained in those occupations where there is a strong labor demand in the expanding sectors of the economy. "Intervention works" is a program that in essence gives employers wage or job subsidies in the amount of the level of unemployment benefits. These wage subsidies are given to firms in the private or public sector if they hire an unemployed person and are larger the longer this person is kept on in the firm. Public works jobs are jobs directly created by the government, in particular the municipalities, and targeted mainly (but not exclusively) at the long-term unemployed. Many of these jobs are in construction and in the cleaning of public buildings, parks, etc. In other words, they have low skills content, although in principle both intervention works and public works have been conceived as maintaining or enhancing the human capital of participants.

6.29 While evidence from the SR is limited, several studies have investigated the effectiveness of ALMPs in other Central European countries by drawing on micro data on labor market transitions⁶¹ and using a variety of techniques (e.g., estimates of augmented matching functions, simple duration models including program intakes, matching estimators

⁶¹ Puhani and Steiner (1996 and 1997); Boeri (1997); Puhani (2000).

substituting for randomization in labor market programs, etc.). The key question addressed by these studies is whether after participating in an ALMP a person finds himself or herself better positioned in the labor market than if he or she had not taken part in the program.

6.30 The results are not altogether encouraging with respect to the effectiveness of these programs in improving re-employment probabilities. However, there is increasing evidence at the macro level that ALMPs can help countries to grow and increase employment. For example, EC (2004) notes that while trade openness is a main determinant of employment growth, the intensity of spending on ALMPs also contributes significantly. In particular, training programs only mildly affect job finding rates. Better results are obtained from wage subsidies, but, typically, public works schemes involve stigma effects which may actually reduce the likelihood of finding a job after participation in such schemes. A type of public service that is usually fairly successful in increasing employment among those seeking work is job search assistance. This is also a relatively cheap type of initiative that often has a very favorable cost-benefit ratio. However, it is effective in labor markets with low structural unemployment and low long-term unemployment. Hence, in itself such assistance is likely to be limited in value in the SR. Labor mobility grants, on the other hand, can also be useful instruments for bringing labor force skills closer to the needs of employers and for reducing labor market mismatches via increased labor mobility, an issue that is clearly of importance in the case of the SR.

6.31 Nevertheless, policymakers should not attach excessive hopes to ALMPs and should be realistic about what they are capable of achieving. There is no standard ALMP that works consistently and none of these policies is a panacea. Some of them could work in some places, for reasons which are not always fully identified. Successful programs often involve a non-orthodox approach and may be difficult to replicate or to expand. A summary of the evidence on best practices to date is presented in Box 6.1.

Table 6.1: Which Active Market Policies Are Most Likely to Work?

A reasonable consensus exists among researchers regarding key success features of successful ALMPs. The main conclusions are as follows:

- (i) A comprehensive package of services (for example, a combination of individualized job counseling, retraining and temporary employment subsidies) usually works better than policies separately
- (ii) Orientation towards labor demand helps (linking actions to real workplaces, providing on-the-job training rather than formal classroom, etc.,) and ALMPs work best when the economy is growing
- (iii) Careful design, including precise targeting, and consideration of the environment in which a program operates, is an obvious sine qua non
- (iv) Careful assessment of incentives provided is necessary particularly when benefit disincentives play a role making sure that consistently working pays better than welfare
- (v) Finally, monitoring and evaluation are important to provide feedback on the effectiveness of a program.

The following broad ALMP categories are found to be most promising in putting people back to work:

- Interventions in the unemployment spells, forcing a sustained job search effort and a continuous contact with the labor market
- Job intermediation including an individualized approach when possible and necessary (support, counseling, placement assistance, individual action plan, labor supply/demand analysis, use of IT)
- Programs dealing with issues such as individual skill deficits, lack of work experience and information barriers in the labor market.

The pros and cons of the ALMPs currently used in the SR are summarized below:

- Employment services: (such as counseling, placement assistance, job matching, labor exchanges etc.) are generally found to have a positive impact, particularly in transition countries, where many people have never learned how to actively and effectively look for a job. A good thing is that they are relatively cheap, so benefits could be large. The biggest problem is that they are usually of limited use at times of weak labor demand or if the structural unemployment is high and entrenched. Separately, an open question in the area concerns the relative effectiveness of public versus private delivery of employment services.
- Training: Evidence shows that training of the unemployed has the potential to be successful in bringing people to jobs. In particular, an on-the-job training with an active involvement of an employer, or specialized training (possibly leading to formal qualifications), could have large positive impacts. The effects of training programs on employment for transition economies are consistently found to be positive. On the negative side, youth training programs are very often found to be unsuccessful, but this result concerns only developed countries. Some inconsistent but positive results, however, are found in other countries. In any case, this would make a case for putting the money in earlier in the process--i.e., in the education system and reduction of drop-outs.
- Employment subsidies: which used to be assessed as not likely to have a positive impact and were associated with substantial deadweight costs and substitution risks. However the evidence is more promising with "new" types of employment subsidies paid directly to individuals as a supplement to their earnings, as an incentive to encourage work and (in contrast to welfare payments) as a way to achieve greater economic self-sufficiency. Also, subsidies programs are more likely to work, to the extent that they are used to compensate employers for their screening, orientation, and initial training costs. Finally, design, precise targeting, monitoring and packaging (i.e., combining the subsidy with other components such as training or job search assistance) are important to the success of employment subsidies.

Source: G. Betcherman, K. Olivas, and A. Dar (2004), "Impacts of Active Labor Market Programs," World Bank,

OECD Employment Outlook 2002, The Ins and Outs of Long-term Unemployment

6.32 The Slovak government introduced a wide package of ALMPs as part of the 2004 reform. Among the policies introduced to date, the activation subsidy is the most popular in terms of both number of beneficiaries and total expenditure. The second most popular instrument, the contribution for child care costs for a job seeker, involves about 90 percent fewer beneficiaries and costs about 90 percent less than the activation subsidy. Monthly data indicate no major changes in the trends in numbers of beneficiaries, with the contribution for child care costs for job seekers and the contribution for graduate practice developing at the most rapid pace. The average cost per beneficiary seems to have stabilized. However, while the three most popular policies cost between Sk 5,000 and Sk 14,000, the contribution for self-employment costs almost Sk 60,000, and other contributions cost more than Sk 70,000 (however, information of duration of each program is missing by now).⁶²

6.33 Unfortunately, it is clearly too early to fully assess the impact of these policies on the employment prospects of those in the scheme. However, it is important to realize that, in addition to their potential effect on future employment prospects, ALMPs can play an important role as a strategy to reduce social exclusion. This is particularly important in a highly dual labor market such as the Slovak one where a small pocket of the labor force is becoming increasingly marginal to the labor market and is increasingly "discouraged." Within this context the programs can be seen as a way of keeping these workers engaged with the labor market and the economy rather than having them rely exclusively on social assistance. Thus, in this context these policies would act more as an alternative form of social assistance designed to break the cycle of dependence and social exclusion rather than as a route to permanent employment.

Supporting the Living Standards of the Most Vulnerable

6.34 It is also important to recognize that, even under the best possible scenario, in which the reform proves extremely successful in promoting employment opportunities and "making work pay," pockets of unemployment and social exclusion will remain, especially in a country with a highly segmented labor market like the SR. In order to improve the living standards of the most vulnerable, a comprehensive and adequate system of social assistance is needed. While the 2004 changes in the tax and benefits structure have potentially increased the disposable income slightly for most low-income households, they seem to have had a negative effect on the income level of poor households with unemployed adults and large numbers of children. These households are highly concentrated at the bottom end of the income distribution (both pre- and post- 2004) and thus it would not be surprising if the 2004 reforms had left the poverty headcount basically unchanged but had increased the intensity of poverty, as the disposable incomes of poorest households were the only ones negatively affected by the reform.

⁶² The comparatively low spending on ALMPs in 2004 could be explained by the introduction of new policies and their gradual phasing in: the activation subsidy was implemented from February, while other policies were implemented from March to May. Thus, while in the first half of the year only Sk 0.4 billion was spent, in the second half Sk 1.5 billion was spent. Using the latter figure, we estimate a potential cost of Sk 3.0 billion in 2004, which is a somewhat higher than the Sk 2.8 billion spent in 2003.

Chapter 6

- 6.35 To some extent this was the unavoidable consequence of the shift to work incentives and the reduction in the basic benefits which was required to reduce the fiscal pressures generated by the formerly overgenerous benefits system. However, in view of the barriers to employment that remain (at least in the short run) for unskilled workers and for those in the lagging areas, the government may wish to target these groups and communities with targeted short-term measures designed to help them overcome the loss of livelihood.
- 6.36 In the context of the emphasis on providing the right incentives, any individual/household level intervention of this type would need to be designed as a *conditional* transfer program (i.e., as one in which entitlement to the benefit is conditional on some form of positive behavior). As the focus of this intervention is likely to be households with large numbers of children, it may be advisable to make the condition related to children. Programs of this type that have proved to be successful in similar contexts have provided transfers conditional on child attendance and regular visits to health clinics.⁶³ Such programs may directly address the vicious circle of the intergenerational transmission of poverty that is so evident in the SR.
- 6.37 The 2004 reform has already introduced a number of conditional transfers such as the activation allowance and the secondary and higher education scholarships. It has also introduced similarly targeted interventions at the community level via the training and education grants and the other interventions. These were steps in the right direction that need to be reinforced for a more perceivable effect and to ensure their long-term sustainability.
- 6.38 In principle, funding for these additional types of interventions should not be difficult to obtain. The simulations in this report suggest that in its current format the new benefits system maintains a relatively high degree of inefficiency, with benefits being paid not only to the poor but also to households in the top income deciles. This is partly due to the shift away from income contingency of all family-related benefits. While child benefits tend not to be income-related across the EU countries, it is arguable whether this is a choice in a country with limited resources and very deep pockets of poverty. In addition, the removal of income conditionality for the parental allowance is more difficult to justify in the context of limited resources for social assistance. Reverting to a system of income-related family benefits may generate enough savings to finance the increased emphasis on conditional transfers.

⁶³ Programs of this type that have received particular attention are, for example, *Progressa* in Mexico and *Borsa Escolar* in Brazil.

C. Improving the Capacity for Monitoring the Impact of Recent and Future Changes Is Paramount

- 6.39 In the midst of such a comprehensive process of transformation, the government's desire (i) to evaluate the impact of the reforms already implemented and feed the results of this evaluation into the next phase of the reforms, and (ii), more generally, to build the capacity for an effective monitoring system and effective evidence-based policymaking is very welcome and is to be encouraged. Unfortunately, the next steps in this direction are prevented by the lack of reliable data produced at regular intervals.
- 6.40 In short, for the economic transformation of the SR to be complete, it is essential that (i) the country's statistical system is updated to the level of the other EU25 countries and to the minimum level required for adequate monitoring and reporting to the EU on priority indicators; (ii) adequate capacity is built within the government for evidence-based policymaking; and (iii) closer links are established between the SOSR and the Slovak government especially the MoLSAF. These objectives are clearly a priority and both the SOSR and the government of the SR are working in this direction.

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