

# Experience of the 2003-2004 Labour Market Reform in Slovakia

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## Abstract

This paper presents the experience of the labour market reforms in Slovakia. It gives an overview of the major reforms adopted after 2003 and how they influenced the labour market. In 2002, Slovakia had almost 20% unemployment rate and the public perceived it to be the most serious problem. In 2007, the unemployment rate fell to 11% and took a 3<sup>rd</sup> place in the ranking of the most serious problems. Improved business environment, more flexible labour market, and “it pays off to work” principle did work. Recently, several big investors signal the shortage of the labour force and begin to employ foreign workers. Lack of flexible immigration policy and lack of qualified labour force are becoming new challenges for the future reforms.

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## Part 1: Introduction

On October 24<sup>th</sup> 2007, the Slovak government cancelled quotas for Ukrainian employees working in Slovakia. Before, maximum 200 Ukrainians per year could get long-term employment licence. Cancelling quota came after “the Slovak industry got increasingly nervous about the shortage of the labour force” (SME daily, 2007). This was considerable improvement, although several administrative barriers remain: Ukrainians still need visa and employment licence, and, since December 21<sup>st</sup>, 2007 when Slovakia enters Schengen area, they also must comply with new restrictions for people coming from outside the Schengen.

Earlier this year, local newspapers informed that several big investors in Slovakia such as PSA Peugeot Citroën and Samsung started to employ foreign workers particularly from Romania, and Bulgaria (Pravda daily, 2007). The reason is that they feel the shortage of the local labour force especially with technical qualification. Perhaps the best example gives the producer of electrical devices Samsung, which builds a new EUR320 million factory in south-western Slovakia. The company plans to employ 500 workers before the end of 2007, half of them from Bulgaria and Romania. Operation director Anton Ondrej explains (Pravda, 2007):

“The Slovak labour market is depleted and we together with our suppliers and new factory have to employ 15 thousand people. So we solve it this way. Although it means higher costs to bring them here, administrative and language barriers, we have no other choice.”

He notices that Slovakia should change its education system “so that the secondary schools did not produce only cooks and waiters, who leave for work abroad, but also electricians.” “There is a lack of qualified people,” he insists.

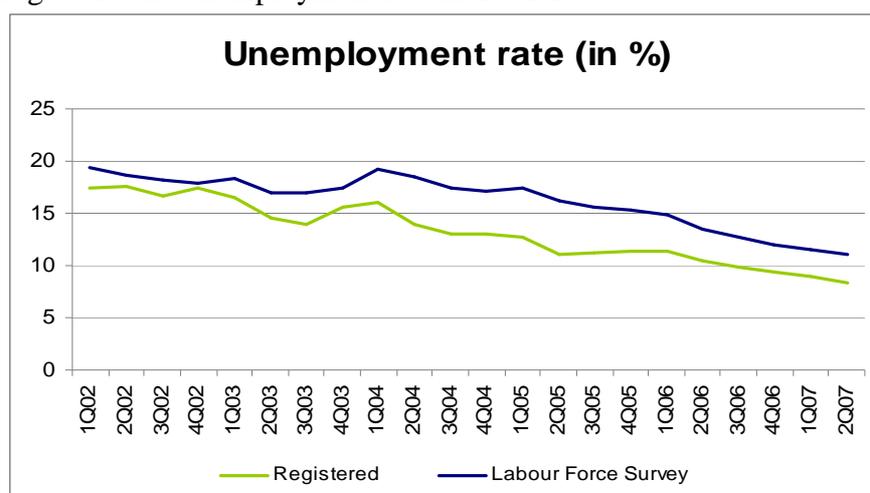
Back in 2002<sup>1</sup>, Slovakia confronted quite different problems. Foreign investors were present mainly thanks to the large scale privatization of the financial, telecommunication, and energy sectors during 1998-2002. Just a few of them started on a “green field”. The unemployment rate was almost 20%, and people considered it to be the most serious problem of the Slovak society. By 2007, the unemployment rate fell to 11% (Figure 1) and people felt it to be the 3<sup>rd</sup> most serious problem (Table 1). During 2002-2007, 230 thousand of jobs have been created (Figure 2). However, this number does not show how many jobs created the Slovak economy itself. The reason is that it includes jobs taken by the Slovak citizens abroad. Before 2005, there are no statistics about Slovaks working abroad. We only know that their number increased from 125 thousand in 2005 to 158 thousand in 2006 (Ministry of Labour, 2006). This increase represented almost 40% of the total increase in new jobs created between 2005 and 2006. The share of Slovaks working abroad on total working population increased from 5.6% in 2005 to 6.9% in 2006.

Table 1: The most serious problems of the Slovak society

2002	2007
1. Unemployment	1. Living costs
2. Living costs	2. Differences among people
3. Differences among people	3. Unemployment
4. Criminality	4. Criminality
5. Health care	5. Health care

Source: MVK agency, public opinion polls

Figure 1: The unemployment rate in 2002-2007

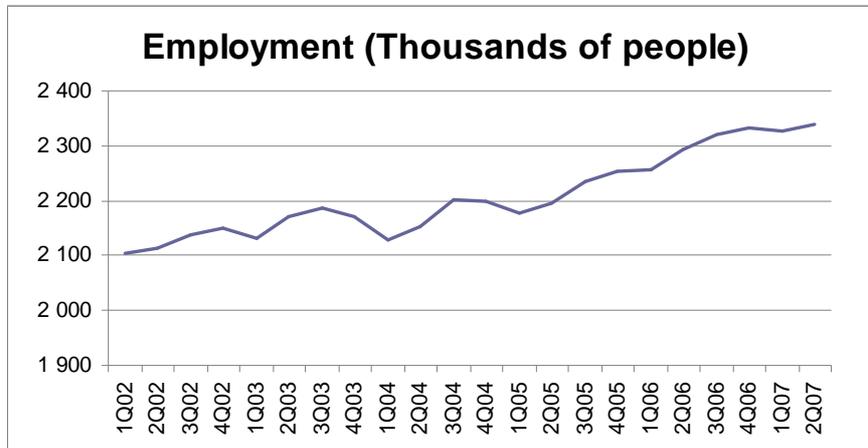


<sup>1</sup> We have chosen 2002 as a base year for comparisons, because this was the last year preceding the sweeping reforms influencing the labour market. However, the reform process was continuous and included large scale privatization of financial, telecommunication, and energy sectors as well as reforms in the welfare system launched after 1998. In 2002, the situation in the labour market was already slightly improving.

Source: Statistical Office of the Slovak Republic (Labour Force Survey), Headquarters of Labour, Social Affairs, and Family (Registered)

Note: Difference between “Labour Force Survey” and “Registered” unemployment is caused by fact that some people considered by the Statistical Office as unemployed are not officially registered.

Figure 2: The employment in 2002-2007



Source: Statistical Office of the Slovak Republic

## Part 2: The Labour Code Amendment

In July 2003, sweeping amendment to the Labour Code came into the force. It brought up over 200 amended provisions and thus represented a large change to the original Code. In general, the amendment strengthened the flexibility in employment relations, and weakened power of trade unions. It also restricted the coercive character of the Labour Code – it only set basic frameworks and assumed that respective employment relations would further be specified at the corporate level, depending on specific circumstances of employers, regions and industries.

### Proponents and opponents

The 2003 Labour Code Amendment was evaluated positively by a committee of more than 40 local experts, mainly economic analysts, journalists, business and academic people (INEKO, 2004). Positive rating of 157 points on a scale (-300; 300) put it on the 4th place in a ranking of 114 measures proposed or adopted in Slovakia during January 2003 – March 2004. In the opinion of many experts, the original Labour Code, as a result of many bans, was a major hindrance to people’s opportunities to get employed and increase their life standard. It was also often avoided which resulted in the lower protection of employees. Thus, the amended Labour Code was expected to encourage the creation of new jobs.

The new Labour Code had also been welcome by the business community as it gave wider freedom in hiring and firing procedures. The business community expressed their satisfaction with decreased powers of trade unions in companies. As they proposed, the amendment would bring new drivers for competition, encourage investment and allow launching production with higher added value, the fruit of which would be secure jobs. As revealed in January 2004 polls conducted by the Business Alliance of Slovakia with selected businesses operating in Slovakia, the amended Labour Code was clearly beneficial to Slovakia’s business environment and slightly stimulated the creation of new jobs.

The main opponents to the new Labour Code were the trade unions represented by the Confederation of Trade Unions of the Slovak Republic. Trade unions called for an alert and threatened with a general strike. They argued that the new Labour Code was unconstitutional, providing employers with a big chance to use the new changes to the detriment of employees. Disputes led to January 2003 protests of the trade unions outside the Ministry of Labour premises. As Jurajda and Maternová depict it (Jurajda and Mathernová, 2004):

“A factor that helped in withstanding the pressure was the popular demand for changes in the labor legislation. Fueled by the media, it was based on the widely perceived feeling that the 2001 Code “went too far” in setting too rigid rules and gave too much power to the trade unions that are otherwise playing an ever-decreasing role in the society. Once the unions saw the government was determined to push through the new Code and had the public support for it, they agreed to the language and the Parliament adopted it very rapidly thereafter.”

However, before parliamentary elections in 2006, the trade unions agreed with the leftist party SMER led by Mr. Robert Fico about reversing some of the changes adopted by the 2003 amendment. Eventually, SMER won the elections and became a leading party in the new government coalition with Mr. Fico as the prime minister. In September 2007, a new Labour Code Amendment came into the force. It reversed some of the changes of the 2003 reform. However, most of reform changes remained untouched. Both the experts and the businesses criticised the changes brought by the 2007 amendment. They argued that it increases the labour costs, weakens flexibility of employment relations, and thus hinders the job creation.

Major changes

### A. Lowering firing costs

Before 2003 reform, the Code ordered 3-month notice period in the case of the employment termination for organisational reasons (in other cases, it was 2 months) plus a compensation (severance payment) in the amount of a 2-month wage. Thus, a termination of contract cost 5-month wages (or 4-month wages in case of other than organizational reasons for contract termination).

Costs of contract termination for organizational reasons  
(Before 2003 reform, in monthly wages)

Notice period ...			... plus Compensation/Severance	
1 <sup>st</sup> month	2 <sup>nd</sup> month	3 <sup>rd</sup> month	4 <sup>th</sup> month	5 <sup>th</sup> month

After 2003 reform, the Code ordered to option between taking a notice period and taking compensation after termination of contract. It was not possible to take both the notice period and the compensation. The Code ordered 2-month notice period and 2-month compensation for employees who have been working with their employer for less than 5 years; and 3-month notice period and 3-month compensation for employees who have been working with their employer for over 5 years. These were the minimum limits valid if not agreed otherwise in a collective agreement. Thus, a termination of contract cost 2-month wages in case of employment lasting under 5 years and 3-month wages in case of employment over 5 years.

Costs of contract termination  
(After 2003 reform, employment under 5 years, in monthly wages)

Notice period ...	
1 <sup>st</sup> month	2 <sup>nd</sup> month
... or Compensation	
1 <sup>st</sup> month	2 <sup>nd</sup> month

#### Costs of contract termination

(After 2003 reform, employment over 5 years, in monthly wages)

Notice period ...		
1 <sup>st</sup> month	2 <sup>nd</sup> month	3 <sup>rd</sup> month
... or Compensation		
1 <sup>st</sup> month	2 <sup>nd</sup> month	3 <sup>rd</sup> month

After 2007 reversal, the Code cancels optioning between a notice period and compensation. It orders 2-month notice period plus 2-month compensation for employees who have been working with their employer for less than 5 years; and 3-month notice period plus 3-month compensation for employees who have been working with their employer for over 5 years. Thus, a termination of contract costs 4-month wages in case of employment lasting under 5 years and 6-month wages in case of employment lasting over 5 years.

#### Costs of contract termination

(After 2007 reversal, employment under 5 years, in monthly wages)

Notice period ...		... plus Compensation	
1 <sup>st</sup> month	2 <sup>nd</sup> month	3 <sup>rd</sup> month	4 <sup>th</sup> month

#### Costs of contract termination

(After 2007 reversal, employment over 5 years, in monthly wages)

Notice period ...			... plus Compensation		
1 <sup>st</sup> month	2 <sup>nd</sup> month	3 <sup>rd</sup> month	4 <sup>th</sup> month	5 <sup>th</sup> month	6 <sup>th</sup> month

## B. More flexible overtime and working hours

Before 2003 reform, the Code ordered maximum limits for required overtime 150 hours a year plus 150 hours a year based on an agreement with a respective trade union and after having received permission from the National Labour Office.

After 2003 reform, the Code ordered maximum limits for required overtime 150 hours a year plus additional 250 hours a year overtime agreed upon with employees. The agreement about overtime was in the sole discretion of employers and employees, i.e. the former did not have to ask for permission from trade unions nor the National Labour Office.

The 2003 amendment also deregulated working time: depending on the nature of a job and the type of work, the new Labour Code allowed employers to design the working time accordingly, which means either evenly or unevenly across weeks.

Before 2003 reform, the Code ordered maximum working time hours with all employers of 58 hours per week including overtime.

After 2003 reform, the Code ordered maximum working time hours with one employer of 48 hours per week including overtime. However, the employee was allowed to work longer for

other employers. Moreover, exceptions were possible in the case of agricultural seasonal works.

The new Labour Code also made it possible that a pregnant woman, a woman or a man permanently looking after a child under three years of age, a lone woman or a man permanently looking after a child under 15 may only work overtime if they agree to it (it was not possible before at all). They could also agree with their employers that they would be on standby duty if necessary.

The 2007 amendment left the above mentioned provisions almost unchanged. However, it included standby duty into overtime hours causing a labour shortage of some employees, especially nurses and physicians in hospitals. Most of them started to avoid new provisions.

### **C. More flexible fixed-term and part-time contracts**

Before 2003 reform, the Code ordered maximum duration of the fixed-term contracts to 3 years. No extension was allowed.

After 2003 reform, the Code did not change the maximum duration of the single fixed-term contract (3 years), but the employers were allowed to prolong and renew them. Practically, the maximum duration was indefinite. The Code also expanded the applicability of the fixed-term contract to allow firms dependent on the cycle to hire a necessary number of employees in the time of recovery and then to lay them off in the time of recession. Further, the Code defined anew the fixed-term employment and part-time work such that an employer could ensure the fulfilment of all his tasks, depending on whether they are long-term or interim tasks.

After 2007 reversal, the Code restricted possibilities to prolong and renew fixed-term contracts to once upon three years (no limits before). The provision aimed to ban so called chaining of the fixed-term contracts (for example consecutive renewal of a 1-year fixed-term contract, which allowed for practically indefinite duration of the fixed-term contracts).

### **D. Easing the firing procedures**

Weaker protection of a fixed-term employee:

After 2003 reform, an employer could terminate a fixed-term employment contract without giving any reason immediately. In that case, an employee was entitled to a compensation totalling to the amount of a 1-month salary he or she would receive under the contract.

After 2007 reversal, it is not possible to terminate a fixed-term employment contract immediately, the employer has to follow regular firing procedures.

Weaker protection of an employee with shorter working time:

After 2003 reform, both employers and employees could terminate the employment concluded for a shorter working time than 20 hours a week for any reason or without giving any reason. This type of a contract termination required a fifteen-day notice.

After 2007 reversal, the restriction of protection reduced to a working time shorter than 15 hours a week. The statutory notice period was prolonged to 30 days.

Weaker protection of unduly employees:

Before 2003 reform, the Code allowed employers to terminate an employment contract (among other reasons) in the case of serious breach. In the case of less serious violation, this violation would have to be recurring on a permanent basis.

After 2003 reform, the Code allowed employers to terminate an employment contract in a simpler manner if the employee was not able to duly perform his or her duties. If an employee violated the terms and conditions in a less serious manner, the employer was allowed to terminate the contract as soon as this repeated and the employee had been notified of his or her misdemeanour within the previous six months.

The 2007 amendment did not change this provision.

### **E. Weakening power of trade unions**

After 2003 reform, the Code abolished compensation for wages for trade unions representatives in the time of performing their trade union duties.

Further, as Jurajda and Maternová explain (Jurajda and Mathernová, 2004):

“The new (2003) Code also significantly constraints the powers of the trade unions. While under the 2001 regime they had an effective veto power over the organizational changes or firing of workers, under the 2003 Code they only need to get notified. The law puts the workers councils and trade unions on an equal footing (with the exception that the trade unions do collective bargaining and workers councils do not). Workers councils are found in an increasing number of businesses, especially with foreign investment, where trade unions do not exist. Essentially, under the new Code, trade unions need to bargain for all their powers and rights with the employers; very little is granted as a matter of law.”

After 2007 reversal, the trade unions received back some of the compensations for wages for their representatives. The Code also allowed them to co-decide about flexible working time.

### **The World Bank Doing Business in 2005 report**

Slovakia was the leading reformer in the World Bank Doing Business in 2005 report. The annual report investigated “the scope and manner of regulations that enhance business activity and those that constrain it” (The World Bank, 2005). It compared 145 countries based on several indicators of the business environment. Slovakia was number 1 reformer thanks to the following measures (most of them adopted in 2003):

- Introducing flexible working hours
- Easing the hiring of first-time workers
- Opening a private credit registry
- Cutting the time to start a business in half
- New collateral law, reducing the time to recover debt by three-quarters

The report praised especially measures introduced by the 2003 Labour Code Amendment. As in concludes, reforming its employment regulation, “Slovakia introduced the most far-reaching changes“. The report summarizes them in the following table:

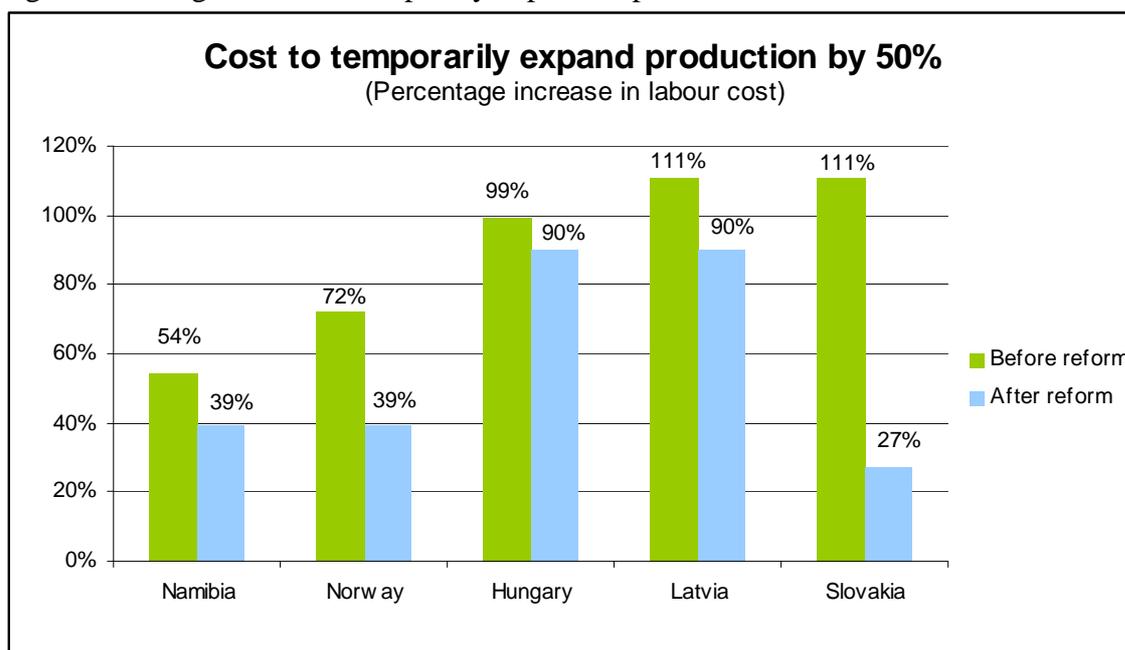
Table 2: Employment regulation - Sweeping reforms in Slovakia in 2003

Before	After
No part-time contract	Part-time contracts for students, women and retirees
Term contracts could not be extended	Extensions of term contracts possible
Limit of 150 hours of overtime a year	Limit of 400 hours of overtime, with worker consent
Approval by union for firing a worker	No requirement
Retraining before dismissal	No requirement
Union approval for flexible work time	No approval for shifting hours in a 4-month period
Approval by union for group dismissals	Notification for group dismissals

Source: The World Bank Doing Business in 2005

The report considered also how the labour costs would change if a firm increased its production in a reaction to a temporary increase in demand. It counted the change in labour costs in case of the 50% output increase. “Countries that move to more flexible work hours can bring those labour costs down considerably”, explained the report. As shown in the following figure, Slovakia brought those costs down from 111% to 27%.

Figure 3: Change in cost to temporary expand of production

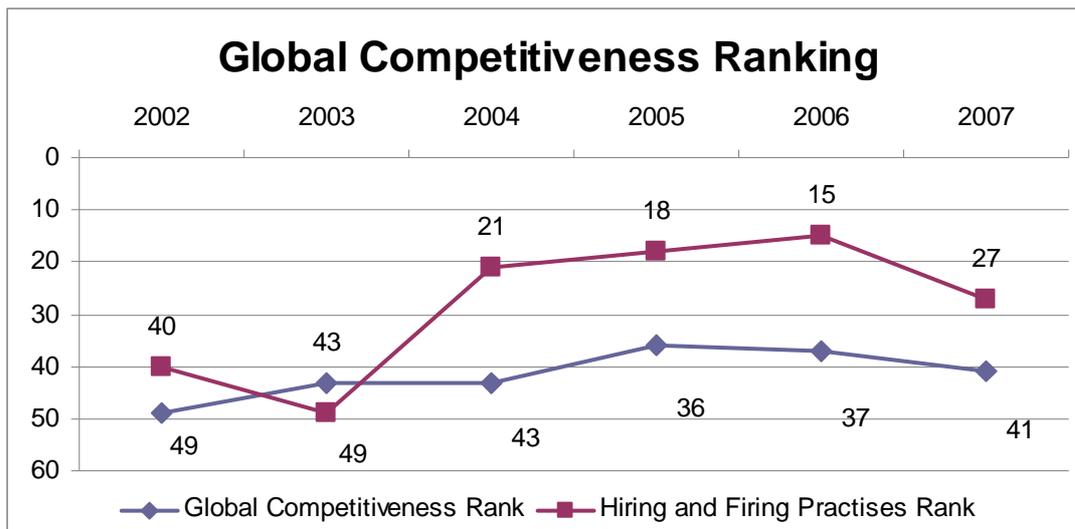


Source: The World Bank Doing Business in 2005

### Global Competitiveness Report

The introduction of new hiring and firing practices has been positively evaluated also by the World Economic Forum. The following figure shows ranking of Slovakia according to the Global Competitiveness Report which evaluates competitiveness of more than 130 countries.

Figure 4: Global Competitiveness Ranking



Source: World Economic Forum, Global Competitiveness Report

### Part 3: Social welfare reform

“It pays off to work” was the principle of the social welfare reform adopted in 2004. The goal was to improve work incentives and pro-active approach of the unemployed when searching for a job. The previous system was blamed for creating too high dependency on social benefits and discouraging people with lower income to work. One of reasons was that the benefits had been high relative to wages. For example, for a family with two children, welfare payments could exceed the net average wage (OECD, 2002). Such a system was expensive. In 2001 and 2002, spending on state benefits and social assistance ran over budget by about 0.3-0.4 percent of GDP annually, reflecting benefit abuse as well as underbudgeting (IMF, 2005).

Generosity of the social system has been abused particularly by some Roma communities. The Roma minority constitutes about 8 percent of the total Slovak population (though exact census data do not exist) but accounted for half of all long-term unemployed (Jurajda and Mathernová, 2004), and up to a fifth of overall unemployment in Slovakia (OECD, 2002). Data from 1997 showed as many as 80% of Roma were dependent on social assistance benefits (Ministry of Labour, 2003), and 70% of Roma were unemployed (UNDP, 2003).

On the other hand, the pre-reform social assistance system had been rather effective at mitigating poverty. IMF (2005) explains:

“The World Bank (2001) Living Standards study found that the social transfer system alleviated poverty significantly. The study estimated on the basis of the 1996 Microcensus that cancelling social transfers except for pensions would imply a poverty rate of 19 percent of all individuals, compared to an actual rate of 10 percent. For households whose main income earner is unemployed, cancelling non-pension social transfers would imply nearly a poverty rate of 80 percent, compared to an actual poverty rate of 45 percent.”

As IMF (2005) concludes, the reform had to face a difficult trade-off between addressing benefit dependency, and risking deteriorating poverty.

New structure of social benefits

Effective from 2004, a new structure of social benefits has been introduced. It consisted of the basic social assistance benefit depending on the number of people in the household (1,450 SKK – 4,210 SKK monthly<sup>2</sup>), plus following benefits:

Activation benefit (1,000 SKK monthly): Recipients are required to demonstrate effort to improve their situation, for example by active seeking a job, studying, participation in retraining programs or engaging in short-term public works organized by municipality, schools, non governmental organisations, etc. In case of public works, the benefit is paid, if these last a minimum of 10 hours a week. The activation benefit accounts for a significant share of the basic benefit, creating an obvious incentive for the effort to qualify. Its main aim was to decrease long-term unemployment. Long-term unemployed, who find a job, are allowed to take this benefit for 6 months into the job's duration, regardless of their income.

Protection benefit (1,000 SKK monthly): Designed for people who are unable to qualify for the activation benefit, such as pensioners, disabled, people on a sickness leave longer than 30 days, people caring for handicapped persons, people caring for new-born children, etc.

Accommodation benefit (780 SKK for single person or 1,330 SKK for families, monthly): Covering costs of accommodation (rent, electricity, heating, etc.).

Health care benefit (50 SKK monthly): Covers direct payments in hospitals and ambulances.

Lump sum benefit (up to 3-times subsistence minimum, i.e. 12,620 SKK for a single person): Payable only on special need, covering costs of clothes, furniture, school accessories, etc.

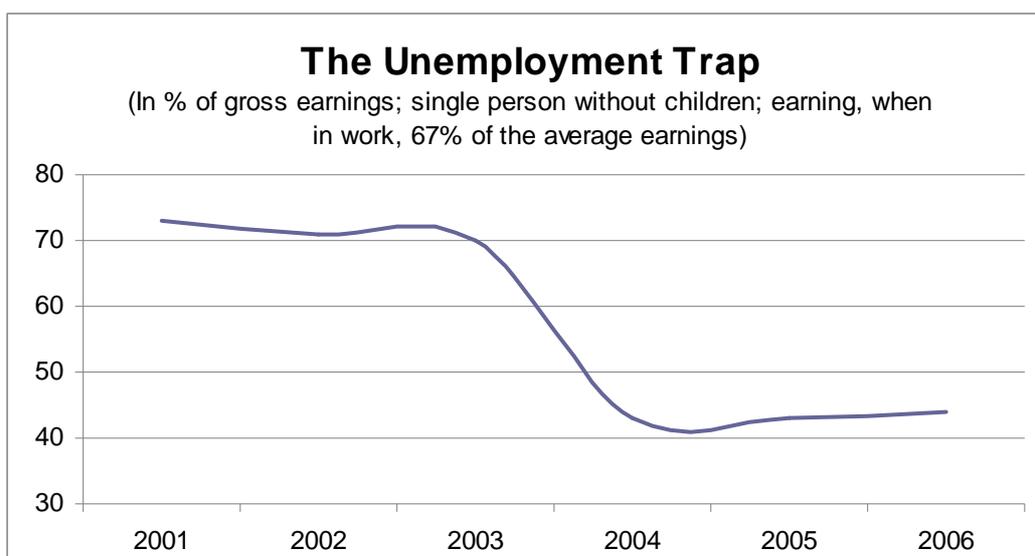
“It pays off to work” principle was strengthened also by less abrupt reduction of social assistance benefits in case the recipient earns a labour income. In general, social assistance benefits are paid to individuals and families with incomes below the national poverty line, the “subsistence minimum” (in 2003 it was 4,210 SKK monthly for a single person). The previous social assistance scheme was a simple top-up of income to the benefit level; any additional earnings resulted in a correspondingly lower benefit (IMF, 2005). In the new scheme, as much as 25% of a worker's salary can be deducted for the purpose of determining whether a household is below the subsistence minimum. Besides, there are other types of income that can be deducted: 25% of pension, child bonuses, scholarship, part of student's wage, etc.

These measures together with increased tax-free income (see Part 4: Tax reform) were the main reasons for a sharp reduction of the unemployment trap, i.e. the barrier faced by unemployed when they enter labour market (Figure 5). By Eurostat definition, “the unemployment trap measures the percentage of gross earnings which is “taxed away” through higher tax and social security contributions and the withdrawal of unemployment and other benefits when an unemployed person returns to employment.”

Figure 5: The unemployment trap

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<sup>2</sup> Here and in the following text, we mention the amounts of benefits valid at the time of reform (2004). Today, they are different due to later valorization.



Source: Eurostat

In summary, the new system increased the span between the minimum and the maximum levels of social assistance. Minimum level was significantly lower than in the previous system (Table 3). To achieve higher assistance, people had to be active in searching for a new job, educate themselves, participate in training activities, or in public work programs. To illustrate the reduction in the level of benefits, consider a family with two jobless parents and 10 children. Under the old scheme it received in total 28,640 SKK, under a new scheme it received 13,420 SKK without the “activation” bonuses (Jurajda and Matheronová, 2004).

IMF includes:

“Assuming participation in activation programs, smaller families can maintain benefit levels near the pre-reform levels, even increasing their household income if they earn the minimum wage. However, for families with 4 or more children, benefit reductions are greater. (...) For families with 5 children, Ministry of Labor staff estimate typical benefit reductions of around 10-20 percent if parents participate in activation programs; if the parents do not participate, the benefit reductions—and the gap with the subsistence minimum—can exceed 50 percent.”

Table 3: Minimum and maximum levels of social benefits

(In SKK)	Number of children	Average amount in old system	Minimum in new system	Maximum in new system
Single unemployed	0	1 974	1 500	3 280
	1	3 171	2 260	4 590
	2	4 218	2 310	4 640
Couple, both unemployed	0	3 281	2 630	5 960
	1	4 382	3 360	6 690
	2	5 782	3 410	6 740

Source: INEKO (2004), Reforms in Slovakia 2003 – 2004, HESO project

Note: Since April 2004, higher activation benefit increased maximum levels by 500 SKK.

Sharp decrease in social benefits for large families had very strong impact particularly on Roma population. Their reaction came almost immediately, in late February 2004. Jurajda and Matheronová (2004) describe it:

“The socially excluded, predominantly jobless Roma minority, which relies heavily on social transfers, staged a number of protests against the new low level of social assistance benefits. In many instances, the protests turned into riots and resulted in looting of stores. The army and extended police forces were called to suppress the lootings. As a reaction to these events, the government amended some of the recently adopted legislation. For example, the “activation” bonus was raised from 1,000 to 1,500 SKK.”

The raising of activation benefit came into effect on April 1<sup>st</sup> 2004. The protection benefit went up to 1,500 SKK as well.

Beside activation benefit, the social welfare reform introduced several other active labour market policy instruments (the list does not include all of them):

**Activation benefit for employers** (up to 900 SKK monthly) – this benefit should cover part of costs of municipalities, schools, NGOs, etc., which engage unemployed in short-term public works or other activation programs.

**More frequent registration at the unemployment office** – the registration is a precondition for collecting many types of social benefits including the unemployment benefit. Basically, at least one personal visit every two weeks is required; one visit per week for inactive long-term unemployed (not participating in activation programs); and one visit per month for active long-term unemployed. The measure should activate unemployed and curb the abuse of the social system by people taking benefits and, at the same time, working abroad or in a shadow economy.

**Private employment and personal agencies** – these agencies were designed to offer a complete service to the unemployed searching for a job (consulting, training, identifying and contacting potential employers, etc.). Personal agencies can conclude an employment contract with the unemployed and consequently place them on a labour market. These are usually temporary placements and serve for higher flexibility in meeting seasonal demand for labour.

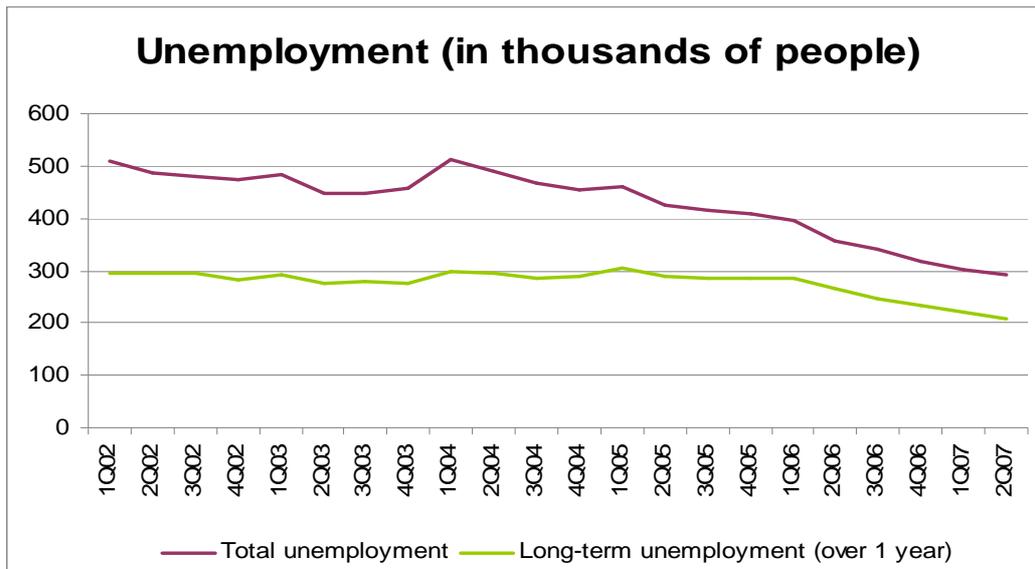
**Relocation benefit** (up to 10 thousand SKK) – lump sum benefit available for people changing their place of living due to moving at least 30 kilometres in order to acquire a job.

**Benefit for self-employment** (up to 197 thousand SKK) – lump sum benefit available for unemployed people who become self-employees. They should work at least 2-years.

**Individual action plan** – every unemployed should have an assessment of personal abilities, capacities, skills, etc. and determining the approach necessary for his or her employment.

Despite wide variety of active labour market policy instruments, the long-term unemployment in Slovakia remained unchanged during 2004 and 2005 and started to decline in 2006 (Figure 6). On the other hand, total unemployment has been falling since 2004. This is probably a consequence of the fact, that the labour market absorbs better qualified short-term unemployed at first, and, consequently, less qualified long-term unemployed people.

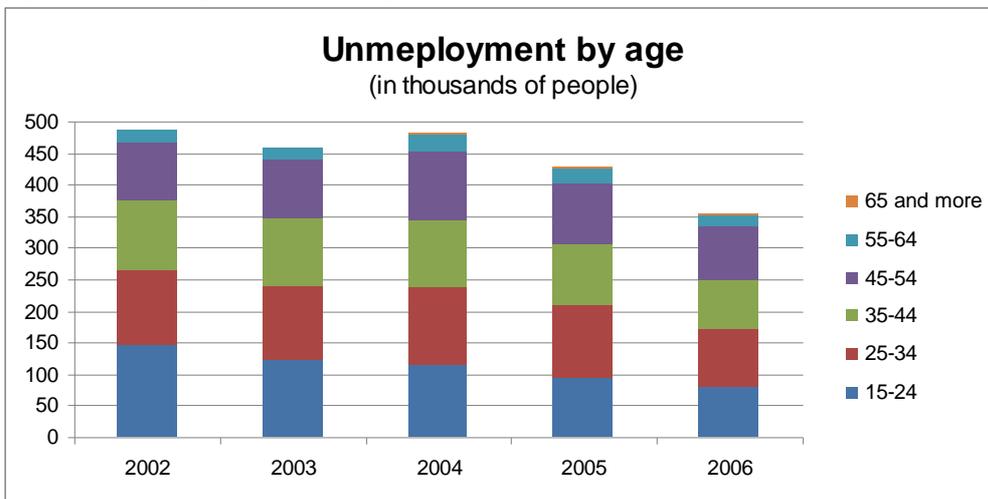
Figure 6: Long-term unemployment



Source: Statistical Office of the Slovak Republic

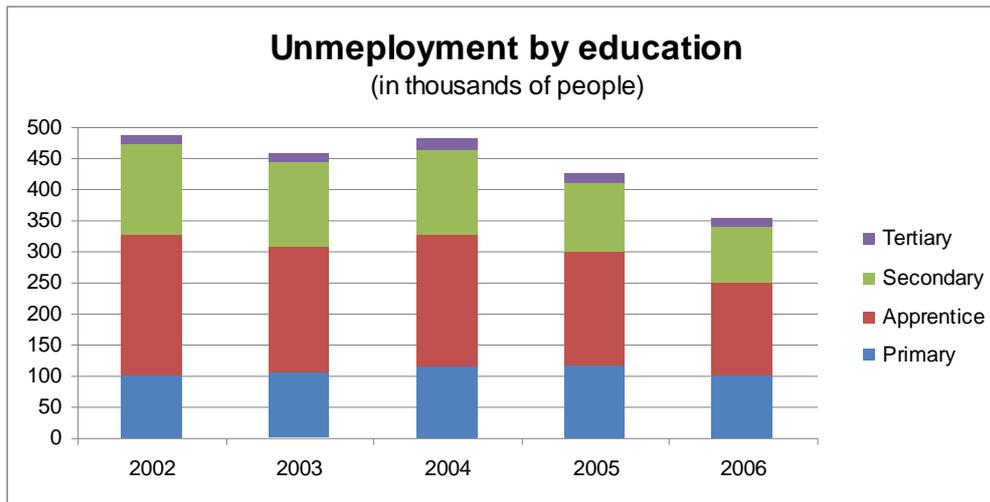
As shown in the following figure, the number of unemployed at the age of 15 – 44 decreased by more than 100 thousand between 2002 and 2006. The number of unemployed older than 45 years remained almost unchanged. Regarding the education, the number of unemployed with the primary education remained almost unchanged between 2002 and 2006 (Figure 8). The most of jobs have been taken by people with apprentice and secondary education. This proves the assumption, that the older and low qualified people have the biggest problems to find jobs.

Figure 7: Unemployment by age



Source: Statistical Office of the Slovak Republic

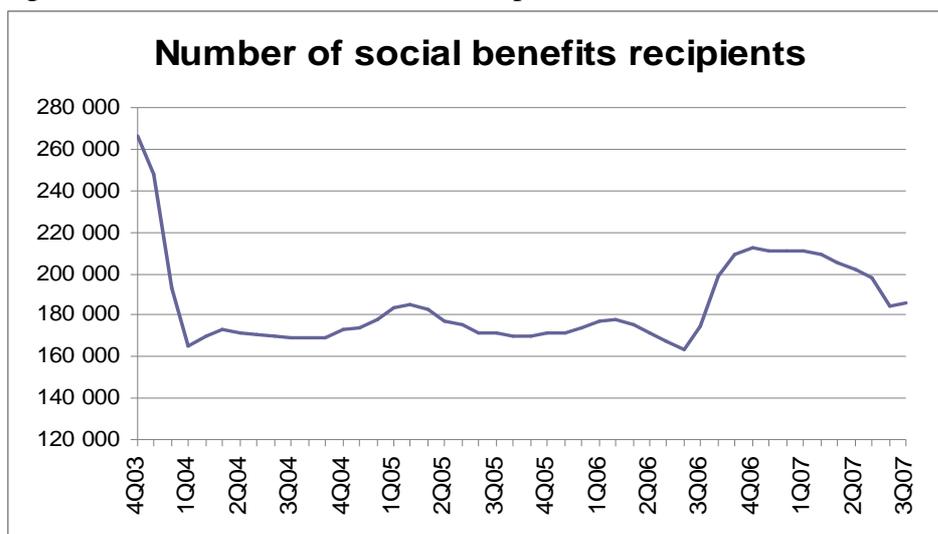
Figure 8: Unemployment by education



Source: Statistical Office of the Slovak Republic

The new structure of social benefits together with pro-active labour market instruments led to a sharp decrease in the number of people taking social benefits. In the first quarter of 2004, more than 100 thousand people (or 38%) left the system (Figure 9). This was probably a result of new motivations brought by the reform, when particularly people abusing the social scheme and unwilling to adapt to new pro-active policies were discouraged.

Figure 9: Number of social benefits recipients



Source: Headquarters of Labour, Social Affairs and Family

Note: Older data is not available.

### Child benefits

Before 2004, every family received child benefits consisting of three parts:

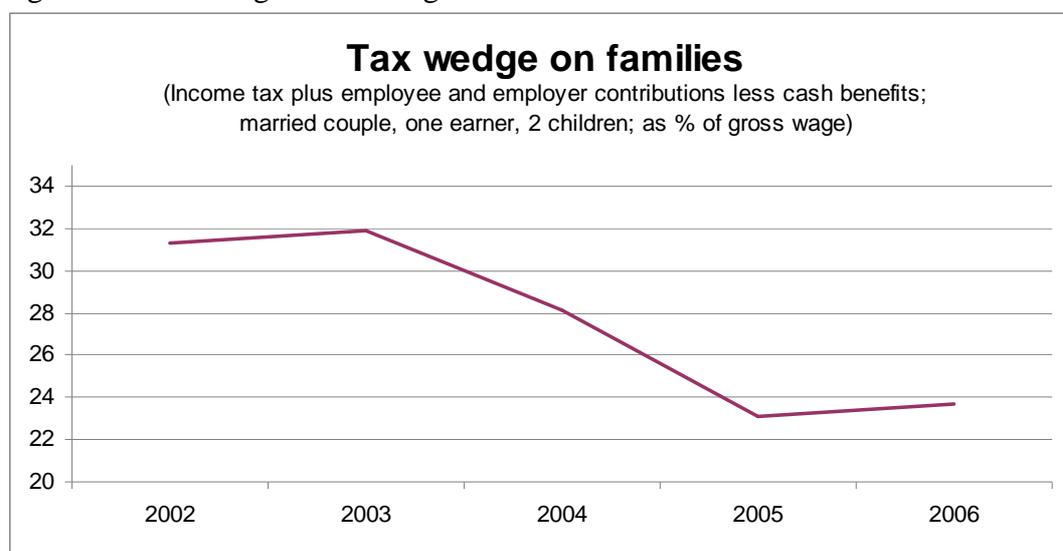
- (1) Flat benefit (270 SKK per child, monthly) – universal payment regardless the income
- (2) Means-tested benefit (210 SKK – 620 SKK per child, monthly) – benefit depending on family's income and child's age. The lower was the income; the higher was the benefit.
- (3) Tax base bonus (16,800 SKK per child, yearly) – bonus deductible from the income tax base

Since 2004, the child benefit has been split into two parts:

- (1) Flat benefit (SKK 500 per child, monthly) – universal payment regardless of the income
- (2) Tax bonus (SKK 400 per child, monthly) – bonus deductible from the income tax. It was designed as a negative tax, which means, that if the tax is lower than the tax bonus, the family receives the difference. The tax bonus is conditional on at least one parent being employed. This condition was aimed at increasing incentives to work.

The means-testing was cancelled mainly due to its complexity and administrative burden. In 2004, the total average child benefit was 900 SKK per child monthly, compared to 762 SKK before the reform (INEKO, 2004). The introduction of child tax bonus contributed to a decrease in the tax wedge on working families (Figure 10).

Figure 10: Tax wedge on working families



Source: OECD Taxing Wages

### Sickness benefits

In the old system, all sickness benefits have been paid by the state. After reform, the period has split into a short-term and long-term part. First ten days of a sickness leave is being paid by an employer – the benefit in the first three days is 25% of daily gross wages; in the other days (4 through 10), it is 55%. From the eleventh day onwards, sickness benefits are being paid, as before, by the state, at 55% of gross wages. The aim of such changes was to eliminate abuse of the sickness benefit – people often pretended to be ill as their loss of income was not so high, firms often recommended their employees to take a sickness leave when they had no work for them. In a new system, the employers lost motivation to send people on sickness leave and started to watch their employees and control the reasons of their sickness. As a result the average length of a sickness leave measured as a percentage of the working-time shortened substantially from 5.1% in 2003 to 3.7% in 2004. On the other hand, even sick people tend to stay at work now or take a holiday instead of a sickness leave.

### Unemployment benefits

Eligibility period for benefits has been cut from 9 to 6 months. IMF (2005) notes, the benefits are paid on condition that the unemployed has contributed for at least 24 of the previous 36

months (later changed to 36 of the previous 48 months). The replacement rate is 50% of past gross income; previously, this has been 55% for the first six months, falling to 45% for the last three months. Benefits remain subject to a ceiling raised from about 50% to 60% of the economy-wide average wage.

## Poverty

It is difficult to assess the impact of reforms on poverty, because there is no reliable data measuring poverty in Slovakia before 2004. However, later data shows, that the poverty risk rate (percentage of people living in poverty) decreased from 13.3% in 2004 to 11.6% in 2005 (Table 4). Thus it seems that the reforms had rather positive impact on the poverty.

Table 4: Poverty risk rate

2004	2005
13.3%	11.6%

Source: Ministry of Labour (2006)

Note: Older data is not available or reliable.

## Minimum wage

Generally, the economists agree, that the high minimum wage leads to higher unemployment, weakens chances to find employment especially for the poor, unskilled, and young people. As shown in the Table 5, the Slovak governments keep the minimum wage on a stable level of 40% - 42% of the average wage in the economy.

Table 5: Minimum wage

	2002	2003	2004	2005	2006	2007
Average wage	13 511	14 365	15 825	17 274	18 761	20 074
Minimum wage	5 570	6 080	6 500	6 900	7 600	8 100
<b>Share of minimum wage on average wage</b>	<b>41%</b>	<b>42%</b>	<b>41%</b>	<b>40%</b>	<b>41%</b>	<b>40%</b>

Source: Statistical Office of the SR (Average wage), Ministry of Finance of the SR (forecast for average wage in 2007), INEKO (minimum wage)

## Part 4: Tax reform, pension reform

**Tax reform:** The new tax system became effective as of January 2004. The goal was to create a simple, pro-active, and business friendly system which would also boost employment. This has been achieved through (Golias̄ and Kičina, 2005):

1. **Shifting the tax burden from direct to indirect taxes;** i.e. taxing consumption rather than production. This should support incentive to work. Moreover, in the era of globalization and increasing labour mobility the collection of direct taxes becomes more difficult to control and it is easier to avoid paying them compared to the indirect taxes. As a result, the relatively high direct taxes are harming country's fiscal position and competitiveness - people "escape" to a shadow economy or to countries with lower direct taxation. The shift towards the indirect taxes should reduce tax evasion.

Adopted measures:

**The corporate income tax rate down from 25% to 19%**

**The dividend tax down to zero:** The tax on dividends (15% in the old system) has been cancelled. As a result, Slovakia had the lowest effective taxation on investment income (combined corporate tax and dividend tax) in the OECD.

**Flat tax - The personal income tax rates unified at 19%:** The old system was strongly progressive with five tax rates for different incomes: 10% (for the lowest), 20%, 28%, 35% and 38% (for the highest). The reform introduced one flat rate – 19% for all incomes. This should limit the economic disincentives caused by higher taxation of higher income cohorts. The equal opportunities should increase labour productivity, as it encourages higher work effort at any income level.

**Tax-free income up substantially:** The basic tax allowance deductible from the tax base went up from 38,760 SKK to 80,832 SKK yearly. As a consequence, everybody with wage below approximately half the average wage in the economy is not paying any taxes at all. Others are paying 19% from the difference between their income and tax-free income. Thus, a new system is tax-free for low income cohorts but it still ensures slightly progressive taxation for middle and high income cohorts. Raising the basic tax allowance was an important precondition for viability of the whole reform as it compensates low income cohorts for higher imposed flat tax rate.

**Value added tax rates unified:** In the old system there were two rates: standard rate of 20% and reduced rate of 14%. Tax reform unified both and introduced one rate of 19%. This was politically and socially the most difficult reform decision, as it directly conveyed into higher prices of goods and services taxed formerly at a reduced rate. These included, for example, basic food, medicaments, electricity, coal, construction works, books, newspapers, magazines or hotel and restaurant services.

2. **Elimination of all exceptions, exemptions and special regimes.** The Business Alliance of Slovakia surveys quoted the excessive complexity and frequent changes in the old tax law as one of the major business barriers. The old system included 90 exceptions, 19 sources of un-taxed income, 66 tax-exempt items, and 37 items with specific tax rates. The reform abolished virtually all of them, making the tax system much simpler and transparent. For example tax base reductions for certain sectors, such as agriculture and forestry, have been cancelled. Besides simplicity, the new system also eliminated speculation aimed at paying lower tax rates.

**Pension reform:** The goal of the reform was to ensure long-term sustainability of the pension system. In the old system, there were little differences between pensions, regardless of how much people had been earning in their active age. This enforced motivations to avoid paying contributions and to hide earnings in the shadow economy. At the same time, the unemployment increased to its record levels in 2000-2002. The pension system ran into deficit. Accepting the World Bank's recommendations and learning from similar reforms in Hungary and Poland, the government decided to build a pension system based on three pillars: mandatory social insurance (pay-as-you-go or PAYG - 1st pillar), mandatory saving (Funded - 2<sup>nd</sup> pillar), and voluntary saving (Funded - 3<sup>rd</sup> pillar). First stage - the reform of the old PAYG system - became effective as from January 2004 and changed calculation of new pensions. Compared to the old formula, the new one gives higher pension to those who earned more and paid higher contributions during their working life and vice versa. The highest-to-lowest new pension ratio will rise from 1.8 to 5.8 at the end of transition period. Second stage of the reform – the introduction of mandatory saving – became effective as from January 1, 2005. Until the end of June 2006, more than 1.5 million citizens decided to divert 9% of their gross wage from the PAYG to their personal accounts managed by private pension companies

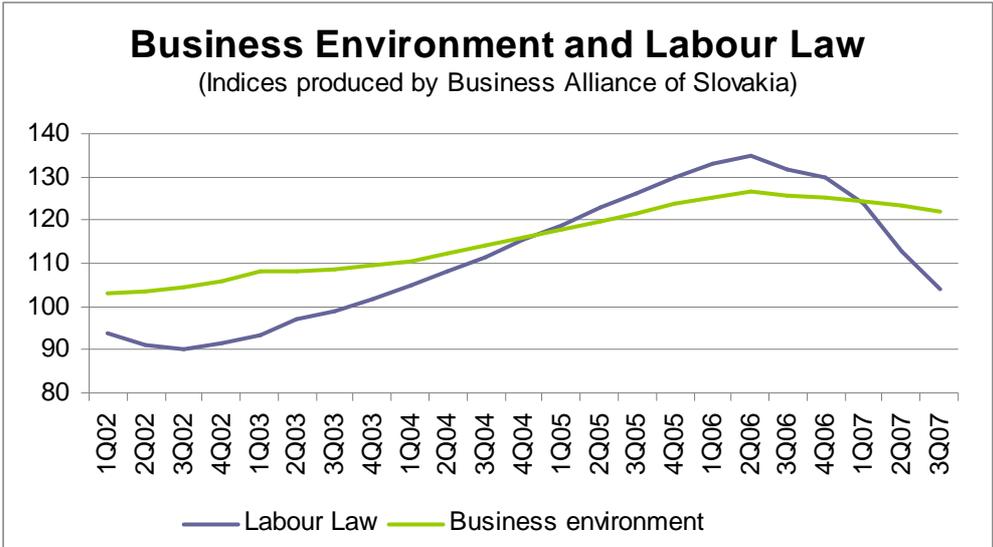
competing on the market. Money saved on the accounts remains private ownership of savers and may be inherited.

Both measures – changes in the first pillar and introduction of the second pillar – strengthen the link between earnings and the amount of pension. This should **increase the motivation to pay contributions, eliminate evasion, and bring people back from the shadow economy to the legal system**. However, it also endangers people with too low income, who will receive much lower pensions and will have to be supported directly from the state budget.

**Part 5: Impact of reforms on business environment and economic growth**

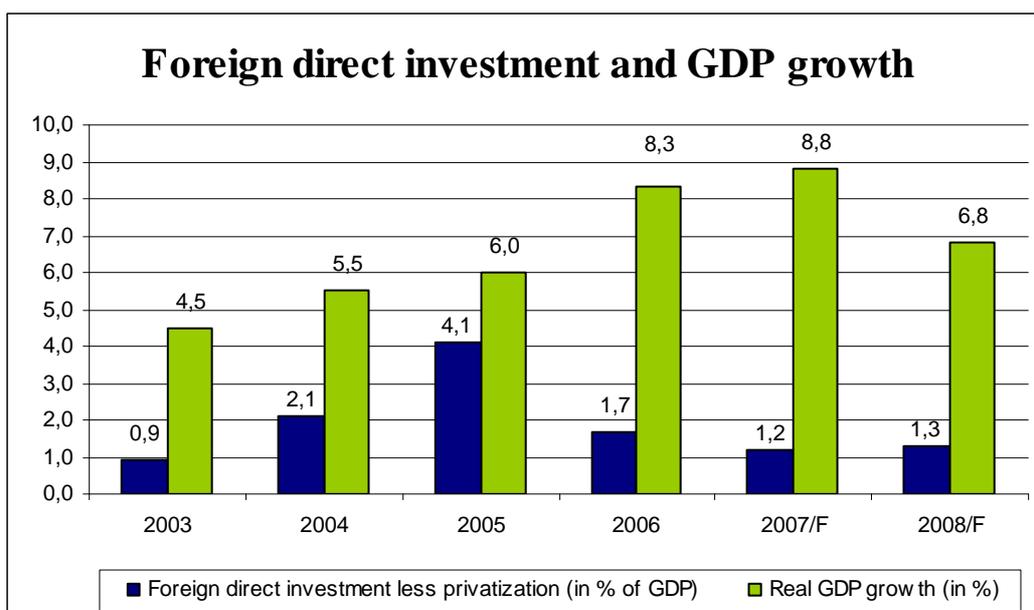
The tax reform together with other reforms helped to improve the business environment (Figure 11). This resulted in attracting foreign investors (particularly automobile producers KIA and PSA Peugeot Citroën in 2005), unprecedented growth of GDP in 2006 and 2007 (Figure 12), and in boosting the employment. Local economic analysts consider the tax reform to be the most important source of the current GDP growth. In March 2007, INEKO organised a survey among 12 local economists asking about the sources of the economic growth. They assigned 21% weight to the tax reform, 17% to the privatisation in 1998 – 2002, 12% to the EU entry, and 10% to the new Labour Code (Table 6).

Figure 11: Business Environment and Labour Law



Source: Business Alliance of Slovakia  
 Note: The Business Environment Index is based on data collected by the Business Alliance of Slovakia in regular surveys among managers in Slovakia. Thus, it displays the managers’ perception of changes in their business environment. The Labour Law Index is partial indicator of the whole Business Environment Index. The chart shows steady improvement in the business environment after 2003 and 2004 reforms and slight decline after 2006 when new government led by Mr. Fico came to the power. The steep decline in the Labour Law Index after 2006 reflects mainly the proposal of the 2007 Labour Code Amendment.

Figure 12: Foreign direct investment and GDP growth



Source: Statistical Office of the SR (GDP), ING Bank – [www.ingfn.sk](http://www.ingfn.sk) (FDI), Ministry of Finance of the SR (2007 and 2008 forecasts of GDP)

Table 6: Sources of economic growth in 2006 and 2007

Sources	Weight
Tax reform	21%
Privatisation by foreign investors (1998 – 2002)	17%
Entry to the EU	12%
Labour Code (2003 amendment)	10%
Pension reform	4%
Others	36%
Total weight	100%

Source: INEKO (2007), opinion survey among 12 local economic analysts, March 2007

## Conclusions

Slovakia introduced deep reforms in a short time, mostly through 2003 and 2004. Some of them took place at the same time. Therefore, identifying the impact of individual reforms is difficult. Local experts think that the tax reform and the reform of the Labour Code had the major influence on economic growth. Social welfare reform helped to decrease unemployment, too.

There is one common feature of all reforms and that is “it pays off to work” principle. All reforms are pro-active. They improve incentives to work and not to rely on support from the state. The new Labour Code improved flexibility in employment relations, the tax reform brought simplicity to the tax legislation and lower taxes on income. All this helped to improve business environment and to attract foreign investors. The results are clear – rapid economic growth, decreasing unemployment (even long-term), and rising employment.

Even after change of the government in 2006, the key reform measures influencing the labour market remain untouched. Perhaps the biggest reversal has been made to the Labour Code. This resulted in a slight decline of the Business Environment Index which reflects managers’ opinions. However, most of key changes introduced in 2003 amendment have survived.

Regarding policy implications, Jurajda and Mathernová (2004) note, that “Slovakia’s experience illustrates how a large set of best practice solutions can be implemented in a short time span by even a very small reform team. While the lack of key personnel did lead to some unnecessary losses for the pro-reform movement, the lack of human capacity was generally overcome using few key advisors with access to key Cabinet members and taking advantage of targeted foreign assistance and advice of international financial institutions.”

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