Enhancing Ukraine's integration chances by transferring Slovak reform know-how

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Abstract

The document offers a brief overview of recent economic and political development in Ukraine. It describes major reforms adopted after the 2014 “Revolution of Dignity” as well as major flaws in the reform process. For inspiration of further reforms, it includes an overview of the best practices of structural reforms adopted in Slovakia during its transition from a centrally planned economy to a market economy. The overview shows that one of key success factors was establishing an informal pro-reform coalition of think-tanks and anti-corruption NGOs, free media, experts engaging in public debate as well as reform-minded politicians and policy makers. The overview focuses on Slovak reforms adopted after 1998 including transparent privatization of banks and state monopolies, reforms of taxes, labor market, pensions, and education, fostering public finance sustainability, increasing transparency and fight against corruption. Based on the Slovak and other V4 countries´ experience, the document concludes with recommendations to be followed by Ukrainian reformers.

Content

"In fact, Egypt is poor precisely because it has been ruled by narrow elite that have organized society for their own benefit at the expense of the vast mass of people. Political power has been narrowly concentrated, and has been used to create great wealth for those who possess it (…) Whether it is North Korea, Sierra Leone, or Zimbabwe, we´ll show that poor countries are poor for the same reason that Egypt is poor. Countries such as Great Britain and the United States became rich because their citizens overthrew the elites who controlled power and created a society where political rights were much more broadly distributed, where government was accountable and responsive to citizens, and where great mass of people could take advantage of economic opportunities."

Daron Acemoglu, James Robinson: Why Nations Fail, 2012

Introduction

The authors of a book "Why Nations Fail" Daron Acemoglu and James Robinson[1] examined the history of many nations in their search for the root causes of economic growth and prosperity. As quoted above, they came to a conclusion that the key factor is to free countries from the rule of autocratic elite and to establish institutions that would distribute the political and economic power more broadly. In other words, the "extractive" institutions should be replaced by "inclusive" institutions that would include democratic political system, protection of private property, effective anti-monopoly policy, rule of law, independent justice, and free media, among others.

The authors warn that the transition from "extractive" to "inclusive" institutions is by far not easy. In fact, the country has to break the "Iron law of oligarchy"[2] saying that the new elite will always want to use the acquired power for its own benefit and at the expense of others. To break it, the country has to have a broad and strong coalition interested in setting up "inclusive" institutions and to distribute political and economic powers in such a way that they cannot be monopolized by narrow elite.

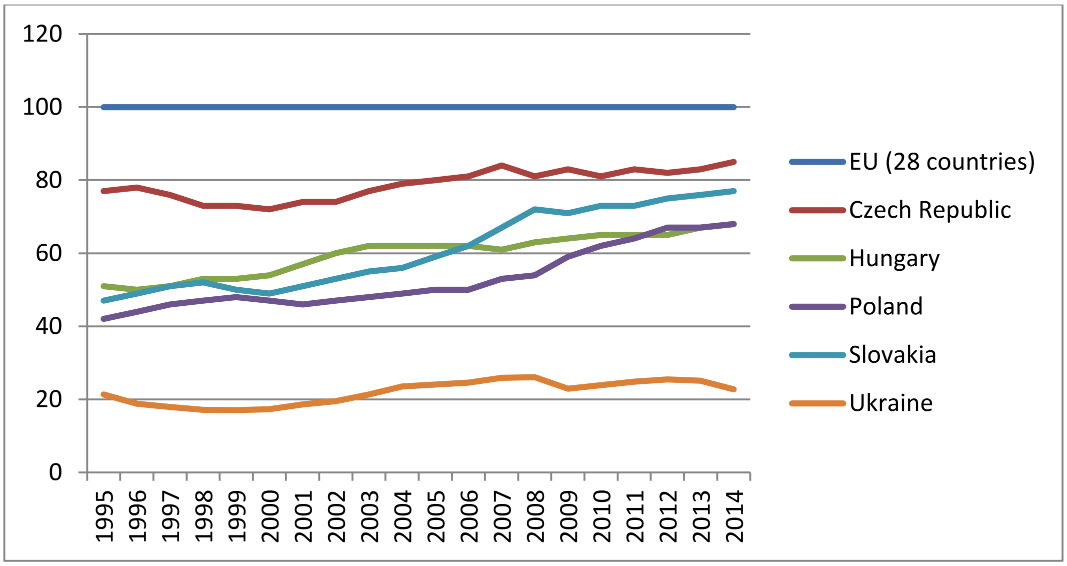
The Association Agreement between Ukraine and the European Union signed in 2014 is an essential step towards implementing "inclusive" institutions in Ukraine. The agreement commits Ukraine to economic, judicial, regulatory and financial reforms to converge its policies and legislation to those of the European Union. Despite signing the treaty the integration of Ukraine to the EU is by no means inevitable and, if ever, it seems to happen in a distant future. Even the ratification process will probably be put on hold after the April 2016 referendum in Netherlands rejected the approval of the treaty. It becomes evident that to enhance its integration chances Ukraine needs to be active in implementation of necessary reforms on its own. Among other challenges, the deep economic divide between the EU and Ukraine needs to be overcome. The experience of Visegrad 4 countries may serve as an example how to do it.

A brief look on economic development of Ukraine and Visegrad 4 countries over past 20 years indicate, that the V4 countries have been more successful in establishing "inclusive" institutions compared to their eastern neighbor. In Ukraine the GDP per capita in terms of the average of the EU28 increased from

[1] Acemoglu (2012)
[2] See Wikipedia, Iron law of oligarchy, https://en.wikipedia.org/wiki/Iron_law_of_oligarchy

21% in 1995 to 25% in 2013, i.e. by 4 percentage points and fell to 23% in 2014. The amount of GDP per capita based on purchasing power parity seemingly lags behind levels achieved by the Visegrad 4 (V4) countries – the Czech Republic (85% of the EU28 average in 2014), Slovakia (77%), Hungary (68%) and Poland (68%). Over 1995-2014, the Ukraine's economy grew less than economies of V4: According to Eurostat, the Czech Republic improved from 77% of EU28 average in 1995 to 85% in 2014, i.e. by 8 percentage points. Slovakia jumped from 48% to 77%, i.e. by 29 percentage points; Hungary was up from 51% to 68%, i.e. by 17 percentage points; and Poland was up from 43% to 68%, i.e. by 25 percentage points.

Figure 1: GDP per capita in Visegrad 4 countries and Ukraine (in purchasing power parity, as % of EU28 average)



Source: INEKO based on data from Eurostat (for V4 and EU28) and the World Bank (for Ukraine)

The official GDP numbers do not give a complete picture of the size and dynamics of the economies. Especially in case of Ukraine the shadow economy has to be taken into account. According to Schneider (2015), the size of shadow economy in Ukraine was 44% of GDP in 2012 which is significantly above the values recorded in V4. There has been a decrease in the size of shadow economy over past 10 years both in Ukraine and V4.

Table 1: Size of shadow economy in Ukraine and V4 (in % of GDP)

	Ukraine	Czech Republic	Hungary	Poland	Slovakia	EU28
2003	49.7	19.5	25.0	27.7	18.4	22.6
2015	44.0 (2012)	15.1	21.9	23.3	14.1	18.3

Source: Schneider (2015), Schneider (2012)

The stronger GDP growth and smaller shadow economies in V4 countries suggest that their transition from socialism and centrally-planned economies to democracy and market-based economies has been rather successful. The case of the Czech Republic indicates that the sole integration into the EU, NATO, OECD and other international organizations is not a sufficient precondition for rapid GDP growth. It seems that the country benefits more from the integration potential if it implements structural reforms improving its business environment, attracting foreign investors with advanced know-how and culture and increasing transparency. The intensive privatization process together with the structural reforms in taxes, labor market, pensions, and other sectors as well as the measures aimed at increasing transparency and fight against corruption seem to be among the most important causes of rapid GDP growth in Slovakia.

Since 2014 “Revolution of Dignity” Ukraine supported by the International Monetary Fund has launched a series of reforms including simplifying tax system, reducing social insurance contributions, downsizing subsidies of gas prices or setting up anti-corruption institutions. However, political turbulences in 2016 threaten to stop the reform process. For stabilization and successful integration of Ukraine, it is crucial that the reforms continue. The international community and particularly the Visegrad countries can and should give it a hand. Transferring their transition reform experience is a unique and efficient opportunity. It is also in their utmost interest because due to geographical and cultural proximity, the Visegrad countries would be among countries mostly benefiting from the stable and prosperous Ukraine.

Brief overview of recent economic and political development in Ukraine

The "Revolution of Dignity" (known also as "Euromaidan Revolution") from February 2014 marks a critical change in the country´s recent history. It was triggered when the president Viktor Yanukovych refused to sign the Association Agreement with the European Union and, instead, signed a treaty with Russia. Thus the revolution was a manifestation of the will of the most active part of society to "go west instead of east" and to remove the authoritarian and corrupt regime. It was also a manifestation of the citizens´ will to embark on reforms aimed at democratization of society and building the market economy. The revolution led to a dramatic political development when Yanukovych was ousted, the new interim government was formed, the Association Agreement with the EU was signed, and the preliminary presidential and parliamentary elections took place. The growing tension with Russia and part of Russian speaking people in Ukraine resulted in the Russian annexation of Crimea and military conflict in the eastern part of Ukraine.

The resulting instability had strong negative impact on Ukrainian economy, particularly in the eastern regions of Donetsk and Luhansk. After zero growth in 2013 the Ukrainian economy shrank by 6.6% in 2014 and 9.9% in 2015. The inflation rate rose from 0.5% in 2013 to 24.9% in 2014 and 43.3% in 2015. This reflects government's decision to gradually decrease subsidies of the energy prices and mainly the sharp weakening of the national currency that depreciated from 8.24 Ukrainian hryvnia (UAH) per USD at the end of 2013 to 15.82 at the end of 2014 and 24.03 at the end of 2015. The exchange rate depreciation contributed to the public debt soaring from 39.9% of GDP at the end of 2013 to 69.4% at the end of 2014 and 79.4% at the end of 2015. The exports and imports dwindled in 2013-15. In fact, the country came to the brink of bankruptcy.

Table 2: Overview of key economic indicators of Ukraine

	2013	2014	2015	2016 (p)
Real GDP growth	0.2%	-6.6%	-9.9%	1.3%
Inflation	0.5%	24.9%	43.3%	14.1%
Hryvnia per USD exchange rate	8.24	15.82	24.03	26.73
Key interest rate	6.50%	14.00%	22.00%	16.38%
Public debt (% GDP)	39.9	69.4	79.4	-
Fiscal balance (% GDP)	-4.3	-4.5	-1.6	-
Unemployment rate	7.2%	9.3%	-	-
Consumption (annual change)	6.9%	-8.3%	-20.2%	-
Industrial production (annual change)	-4.3%	-10.1%	-13.0%	2.3%
Exports (annual change)	-8.3%	-14.5%	-29.9%	-
Imports (annual change)	-5.8%	-29.0%	-32.8%	-
International reserves (in months of imports)	20.4	7.5	13.3	-

Source: FocusEconomics, April 12th 2016, http://www.focus-economics.com/countries/ukraine; (p) - Prognosis

To stabilize the economy, the International Monetary Fund (IMF) approved in April 2014 a USD 17 billion stand-by loan to Ukraine to be disbursed over two years. In March 2015, the IMF reacted to negative economic development and replaced the stand-by loan by a new USD 17.5 billion bailout package to be disbursed over four years. At that time, USD 4.5 billion had already been distributed from the first bailout package. Thus the IMF's total financing was raised to USD 22 billion. In the reasoning of the second bailout package the IMF (2015) quotes:

"The economy has been hit hard by the disruption in trade and industrial production, and the subsequent loss of confidence, which fueled capital outflows and led to a sharp exchange rate depreciation. Banks have come under increasing stress, public debt dynamics have worsened, and international reserves have fallen to critically low levels. New financing needs have emerged. Addressing these challenges now requires broader and deeper reforms over a longer horizon, as well as significant new international assistance."

In addition to IMF funds the US, the EU and other countries promised loans to Ukraine. In total, the international support should cover part of Ukraine's financing needs of USD 40 billion over 2015-2019. However, Ukraine should provide USD 15.3 billion of this package by reaching an agreement with creditors through a debt restructuring program. The loan from the IMF is conditioned on adopting far reaching reforms which include bank recapitalization, cutting pensions, increasing the retirement age, trimming the state budget expenses, cancelling the gas subsidies, adopting anti-corruption measures, deregulation and tax administration reform, and many other measures. The government formed in December 2014 has shown strong will to implement the reforms. As the IMF (2015) reports:

"The (government) program provides Ukraine with a unique opportunity to fundamentally reform its economy. (…) Political leaders have made repeated public commitments to deep reforms and the new parliament has approved the government's program on reforms to address deep-rooted governance challenges and improve the business climate."

Indeed, the then-elected Ukrainian government led by Arseniy Yatseniuk, with heavy Western support and pressure, started to implement radical reforms. Among others, following measures have been adopted:

- Macroeconomic stabilization: With the help from the IMF the government has introduced floating exchange rate and stopped the depreciation of the UAH, increased foreign currency reserves, made the national bank more independent and partially reduced the foreign debt thanks to an agreement with Western creditors – debt reduction amounted to USD 3.6 billion.
- Privatization: Ukraine is slowly starting to privatize its roughly 3,300 state companies, many of them highly inefficient and corrupt, accruing approximately USD 5 billion losses annually. President Poroshenko has signed a law that will allow the process of privatization of strategic state enterprises to be transparent. Managers at the largest companies are being dismissed and new managers appointed based on competitive selection.
- Tax and social reforms[3]:
    - In 2014, numerous tax exemptions and special tax regimes have been abolished: exemption on medicines and medical supplies produced and consumed in Ukraine; preferential taxation of undertakings for collective investments; hotel services;

[3] Source: Povoroznyk (2015)

electricity industry enterprises which produce electricity exclusively from renewable energy sources; activities on timber cutting, industrial wood production, fuelwood production, deforestation for making land suitable for agricultural production; biofuel production; extraction and use of gas (methane) of coal deposits; light industry; sale of electricity; shipbuilding industry; aircraft construction industry; machinery construction for agriculture; publishing houses and organizations; printing enterprises; housing and communal services, etc.

  - Ukraine is continuously increasing its revenue from taxes thanks to more transparent VAT refund claim system that was often subject of bribes.
  - Fighting grey economy that amounts to almost half of its GDP by introduction of cash registers has also made a positive impact on the budget along with several social reforms that aim to limit fraudulent activities in pension and social claims.
  - Since 2016, the unified social contribution is cut to 22% from 41%. Meanwhile, the taxable base of the unified social contribution increases from 17 to 25 minimum statutory monthly salaries (about 34.45 thousand UAH).

- Bank clean-up: New legislation on banking sector created a more transparent and in turn less fraud-prompt environment that is already showing positive effects. Fifty out of total hundred and eighty banks face liquidation, cleaning the market from insolvent and questionable banks that were allegedly used by both oligarchs and senior officials for money laundering and funds transfer.
- The Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU came into force in January 2016 and is in fact an ambitious program of modernization of the Ukrainian economy. According to the European Commission[4], the treaty aims at boosting bilateral trade in goods and services between the EU and Ukraine by progressively cutting tariffs and by aligning Ukraine's rules with the EU's in selected industrial sectors and for agricultural products. In the DCFTA Ukraine has committed itself to harmonizing a large number of rules, norms and standards in a number of trade-related areas with those of the EU. These areas are competition, public procurement, trade facilitation, protection of intellectual property rights and trade-related energy aspects, including on investment, transit and transport.
- Severe austerity program has been launched: Pensions have fallen by about 40% in real terms over 2014-2015 and the number of teachers has been cut by about 15%.[5]
- New anti-corruption bodies/institutions have been created:
  - National Anti-Corruption Bureau investigates high-level corruption. It is independent from political influence where staff selection and operation is supervised by experts from civil society.
  - National Agency for Preventing Corruption monitors the income and asset declarations of government officials. In tandem with National Asset Recovery Office and Asset Management Office (still in the process of formation) they are tasked with tracing,

[4] Source: http://ec.europa.eu/trade/policy/countries-and-regions/countries/ukraine/
[5] Source: Economist (2016a)

investigating, recovery and management of illegally acquired assets with mandate to operate abroad.

  - Specialized Anti-Corruption Prosecutor's Office began its work and has launched 56 criminal investigations.
  - A number of cities have established new police forces to bypass the old corrupt ones. Eka Zguladze who was in charge of reforming the police force held the same position in Georgia. She has created a whole new police force that aspires to be immune to corruption and is slowly gaining popularity across the country.
  - Information on public spending is available online and updated daily and thus exposed to public scrutiny.
  - Ukraine has also launched an electronic public procurement system ProZorro that will be mandatory for all public tenders as of August this year. This tool is expected to reduce the corruption margin and save public funds significantly.
- Judiciary reform: The Parliament has passed two laws, on the restoration of trust in the courts and on the prosecutor's office, aimed at a far-reaching shakeup among judges and prosecutors.
  - Supreme Court's position has been strengthened while all judges have to undergo a certification process that assesses their professional competency and integrity. The certification process does have drawbacks as most (60%) of the old judges have been re-elected and some call for more drastic measures such as dismissing all judges and rehire them through competition procedure. However, this would have significantly disrupted the judicial system's functionality.
  - Supreme Council of Justice, an independent body charged with appointing of new judges has been created. Only then are judges sent for presidential approval. This measure should improve independence of judges.
  - The parliament, or "rada", can no longer dismiss the prosecutor general through vote of no-confidence.
  - Immunity of judges and Members of Parliament has been limited through constitutional amendment.
- Crucial energy reform initiated:
  - The artificially low gas prices for consumers have increased rapidly since the Maidan revolution. Naftogaz has increased them four-fold in April 2015 and doubled them more recently in May. This caused the demand to fall by 21%.[6] Different winter and summer tariffs were discontinued and the unit price for companies and households was unified at UAH 6,879 (USD 273) per 1,000 cubic meters as of 1st of May 2016.[7] The gradual liberalization of gas prices helps to financially stabilize the gas monopoly Naftogaz that was generating enormous losses (7 % of GDP in 2014) and improve energy efficiency,

[6] Source: Åslund (2016) , Why Ukraine Needs Market-Based Gas Prices, http://voxukraine.org/2015/06/17/why-ukraine-needs-market-based-gas-prices/

[7] Source: Choursina, K.; Kudrytski, A. (2016), Ukraine Revamps Gas Prices for IMF Loan as Nuland Warns on Graft, Accessed on 30th June 2016 at: http://www.bloomberg.com/news/articles/2016-04-27/ukraine-revamps-gas-prices-for-imf-loan-as-nuland-warns-on-graft

which would decrease the dependence on imported gas.[8] Similarly, prices of electricity and heating have been gradually increased.

Gas price for households (in UAH per 1,000 cubic meters, heating season from October 1 to April 30)

	Consumption up to 1,200 cubic meters	Consumption above 1,200 cubic meters	Note
Until May 1st 2014	UAH 721		
May 1st 2014	UAH 1,089		
April 1st 2015	UAH 3,600	UAH 7,188	UAH 7,188 in summer
May 1st 2016	UAH 6,879	UAH 6,879	Whole year

Source: UNIAN (2014)[9], Ukraine Today (2015)[10], Bloomberg (2016)[11]

- New competition based management was appointed to Naftogaz. A condition from European Bank for Reconstruction and Development to release USD 300 million for gas purchases from western suppliers.[12]
- Ukraine has successfully diversified gas imports, which decreased its dependency on Russian gas. In 2015 Ukraine has doubled imports from Europe and halved gas imports from Russia. The gas from Europe represents 63 percent of the entire gas import, however most of the "European" gas comes through reverse flows from Poland, Slovakia and Hungary who get the gas from Russia.[13] Currently, Ukraine is buying 1,000 cubic meters gas under USD 200 from European suppliers and willing to buy Russian gas at price just above USD 200, which is still above European average of USD 180, but less than half of what it was paying until 2014. This is considerable change even if global market gas prices drop is taken into consideration. However, Ukraine has imported no gas from Russia during the first 3 months of this year.[14]
- In April 2015, the Parliament passed the long-awaited law on the natural gas market, which provides for creating a competitive market based on the rules of the EU third energy package, lifting the Naftogaz monopoly and dividing this corporation. Moreover, a piece of legislation creating an independent energy regulatory body is being developed that should be in line with EU standards.

• Decentralization: Several legislative acts have been adopted delegating competences previously vested in the center to the local level. Newly created communities held their first elections in

[8] Source: Konończuk (2015a)
[9] Source: UNIAN (2014), http://www.unian.info/economics/1045216-utility-tariffs-for-gas-and-heat-in-ukraine-to-be-increased-quarterly.html
[10] Source: Ukraine Today (2015), http://uatoday.tv/news/ukraine-raises-natural-gas-price-for-public-413105.html
[11] Source: Bloomberg (2016), http://www.bloomberg.com/news/articles/2016-04-27/ukraine-revamps-gas-prices-for-imf-loan-as-nuland-warns-on-graft
[12] Source: Konończuk (2015b)
[13] Source: Naftogaz (2016), http://www.naftogaz.com/www/3/nakweben.nsf/0/8FD7A9A348A0844DC2257F4C005802FD?OpenDocument
[14] Source: Naftogaz (2016) Naftogaz released gas imports statistics for Q1 2016, http://www.naftogaz.com/www/3/nakweben.nsf/0/B691EA20A5DD65B7C2257FB20033C2C4?OpenDocument&Highlight=0,prices

autumn 2015, which increased their credibility and in fact established full-fledged local governments. Their budgets have been made more independent from the center by delegating the right to collect real-estate tax and excise duties to the local level. On top of that a capacity building grant amounting to USD 38 million has been released to build up local governments' infrastructure. In early 2015 Ukrainian Parliament "rada" has passed an act enabling "silradas" (village councils) to unite into larger communes and thus enjoy greater fiscal and organizational opportunities, however only about 20 % out of 800 that were planned have actually been created so far. The remaining part of decentralisation legislation is to be embedded into the constitution. Since it contains provisions of special status for the Luhansk and Donetsk districts it has not found necessary support in the parliament and is now on hold.

Besides IMF, the reform process is being forged also by a civil society supported by international donors. Around 50 non-governmental organizations (NGOs) have formed a coalition named "Reanimation Package of Reforms" (RPR), which is proposing, monitoring and advocating for reforms. The network also includes independent media organs and some 40 young members of parliament who call themselves Euro-optimists[15]. Thanks to this pressure, the corruption scandals receive more media exposure which may be a reason for increasing corruption perception among public. The public opinion polls name corruption as a leading problem to be solved. At the same time, more than half of Ukrainians believe that the situation in this area is worse than before the revolution.

Despite unprecedented reform effort, the actual implementation has been lagging behind IMF requirements. As a result, the IMF postponed the disbursement of a loan tranche scheduled for October 2015. At the time, the IMF had only disbursed about one half of its USD 22 billion package. In February 2016 the finance minister who was viewed as a key reform figure, resigned. Shortly after, the IMF's managing director Christine Lagarde declared:

"I am concerned about Ukraine's slow progress in improving governance and fighting corruption, and reducing the influence of vested interests in policymaking."

The political instability culminated in April 2016 when the Prime Minister Arseniy Yatseniuk resigned from his position. His popularity decreased rapidly after adopting unpopular measures and due to corruption scandals. The new government was formed led by Volodymyr Groisman, the former speaker of parliament and a close ally of President Petro Poroshenko. Shortly after coming into power, the Groisman's government agreed with the IMF on a rapid increase of gas prices since May 1st 2016 and continuation in other reforms. The IMF, in turn, should restart funding suspended in September 2015. However, the new government has only a thin majority in the Parliament which is not good for its stability needed to go on in the reforms.

The reform process is, indeed, far from optimal. Here are some of the flaws[16]:

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[15] Source: Economist (2016b)

[16] Source: Kononczuk (2016)

- Corruption remains to be one of the main threats to Ukraine's transformation. Although anti-corruption bodies have been created (e.g. National Anti-Corruption Bureau, National Agency for Preventing Corruption), there has been no breakthrough in this sphere, and the public funding provided for them is too low to make them efficient. As a result of the long process of building these institutions, political bargaining around the nominations of their bosses, and the protracted recruitment of their officers, they are still inoperative. Consequently, without real improvement in the fight against corruption it is difficult to expect changes in other areas.
- The judiciary reform has met with strong resistance from the judicial circles and procurators offices. Public confidence in the system has not improved.
- The energy reform has been facing considerable resistance from big players on Ukrainian energy market who are losing their influence and profits. Ever since Ukraine gained independence from USSR, energy sector has been subject to corruption, clientelism and remained in the hands of a handful of oligarchs. Coupled with one of the highest energy inefficiency, heavily regulated gas prices and intermediary companies that had ties with both Ukrainian and Russian government officials, the energy sector had accumulated debt that went into percentage points of GDP (2014 Naftogaz debt equaled to 7% of GDP). Introducing transparency and new standards in the energy sector would remove the corruption from the gas market when local private firms buy cheap gas from Russia or state-owned firms and sell it for much higher price. According to Kononczuk (2016), this "corruption tax" has been since the 1990s one of the main sources of illegal income for the ruling elite, making them very reluctant to reform the sector. Indeed, there are significant delays regarding the law on a new energy regulator, and splitting Naftogaz into smaller energy companies.
- In 2015, the decentralization reform was prepared, necessary to create properly functioning local government structures, which is intended at stimulating regional development. The document, well received by most experts, passed successfully its first reading in the Parliament in August. The second reading was scheduled for December 2015, but it was postponed, as the government predicted that it would not receive sufficient support from the deputies. Decentralization involves changes in the Constitution and thus requires a qualified majority. Yet, some members of the ruling coalition refused to support the bill, because it contains clauses on the "special way of functioning of local government in some districts of the Donetsk and Lugansk provinces." According to some deputies, this would open the way to endowing the Donbass with an autonomous status. These clauses are an implementation of the Minsk Peace Agreement from February 2015. As we can see, merging devolution with special status for Donbass blocked this very important reform, and the prospects for its passing now seem remote.
- There is no comprehensive approach to improving the operating conditions for small and medium-sized businesses, which would allow them to emerge from the unofficial economy, estimated to be worth about half of the GDP. The deep economic crisis induces Kyiv to look for

sources of income without always looking at the negative impact of imposing these taxes. The actions of the Ukrainian authorities in improving conditions for economic activity are well illustrated by the most recent Doing Business 2016 report, which registered improvement just in three out of ten categories studied, which ultimately ranked Ukraine at 83rd place in the world.

- After the revolution there was also no change in the mechanisms of Ukrainian politics, where most of the parties still have an "owner," who finances them and expects them to take care of his interests in exchange. According to the Economist, civic activists are trying to change election rules to limit the private funding of election campaigns and prevent political parties from serving as the oligarchs' poodles.
- The reforms in recent months have been introduced with more and more difficulties and with growing resistance of strong interest groups, including some oligarchs, who invariably remain key political players. A serious obstacle in the process of reforms is the often visible lack of political will on the part of the authorities, for only this can explain their often surprising procrastination. For example, the General Prosecutor's office headed until recently by Viktor Shokin, a protégé of Mr. Poroshenko, has refused to pass information to National Anti-Corruption Bureau and attacked the Anti-Corruption Action Centre.[17]

[17] Source: Economist (2016b)

Best reform experience of Slovakia

This section describes key success factors leading to rapid economic growth in Slovakia peaking in 2005-08. The aim is to offer inspiration for reforms to be implemented in Ukraine in order to start the economic convergence process toward EU countries and thus, to increase Ukraine's chances for successful integration into the EU.

<u>Forming a broad and influential pro-reform coalition</u>

Despite their potential to boost the economy and living standards, there are many barriers to adopt necessary structural reforms. Many of them are unpopular, in conflict with vested interests or technically difficult to design and implement. Based on Slovak experience, to overcome these barriers it is crucial to create an influential group of people supporting democracy and reforms who are willing to advocate their benefits in the public discourse and who are able to implement them. In Slovakia, following key players participated in this informal coalition:

(1) Strong non-governmental organization (NGO) sector with think-tanks and advocacy NGOs playing crucial role, active in public debate, advising politicians and sometimes even directly participating in the implementation process. The generous and long-term financial support from foreign donors such as the international foundations, the U.S. government, etc. was crucial for development of this network. The foreign aid had been intensified particularly in a reaction to authoritarian rule of Vladimír Mečiar who was Slovak Prime Minister until 1998;
(2) Free media;
(3) Experts and particularly bank analysts who were independent from the government, frequently commented in media on ongoing changes, and sometimes even advised ministers on particular reforms. The transparent privatization of banks to foreign investors with good governance practice was crucial for development of this network;
(4) Pro-reform well educated politicians and policy makers implementing reforms. In Slovakia, key person was Ivan Mikloš, Minister of Finance in 1998-2006. In his public speeches after ending his top political career in Slovakia, he has repeatedly explained that there are three most important preconditions for successful implementation of reforms:
    - Leadership – the reforms need to have leaders who will advocate for them and face negative reactions;
    - Ownership – the reform leaders need to have a sense that they are the owners of the reform ideas, i.e. they need to understand clearly why the reforms are good for the country; it is not enough to implement reforms because foreign institutions such as the IMF require them;
    - Communication – the reform leaders and their teams need to engage in an intensive communication explaining to the public why reforms are necessary, what has to be done and how.

Transparent privatization in 1999-2006 (international tenders, direct selling to strategic investors)

After 1994 the government used mostly non-transparent methods of privatization preferring local investors linked to politicians. This way of privatization included sell of the steel producer (later re-sold to U.S. Steel), and the oil refinery (later re-sold to Hungarian refinery MOL). The disadvantages of this system of privatization include low public budget revenues and creation of local oligarchs with sometimes lower ethical standards, lower support for democracy and heavy influence on some of politicians. Some of these oligarchs together with others who got rich by speculative private transactions later proved to be major obstacle in implementation of further pro-democratic and anti-corruption reforms.

After 1999 the government started to privatize shares directly to strategic investors chosen in transparent international tenders with price as the single winning criteria. The key assumption was that the investors from democratic and developed countries would bring the advanced knowledge and the culture that would increase the speed of transformation of the whole industries and foster their competitiveness. At the same time the transparent competition for the best price would ensure the highest possible revenues for the state budget. The important feature of privatization to strategic investors was that the investors gained managerial control even if they bought just a minority share of company. For instance, the government sold just 49% of shares in the energy companies but the investors gained majority in the Board of Directors. Thus, they were willing to pay higher amount even for a minority stake.

Key privatization projects realized after 1998:

- Banking and insurance sector (full privatization). Investors:
  - Banking: Erste, Raiffeizen, Intesa, UniCredit, etc.
  - Insurance: Allianz, Generali, etc.
- Telecommunications (full or majority). Investors:
  - Fixed line operator: Deutsche Telekom (51% majority, in 2015 increased to 100%)
  - GSM: Orange, O2 (100%)
- Energy (majority or 49% with managerial control, i.e. majority in Board of Directors). Investors:
  - Three regional electricity distributors (49%): E.ON, EDF, RWE
  - Gas industry (49%): Gaz de France & Ruhrgas (in 2014 replaced by the Czech energy holding EPH)
  - Power producer (66%): Enel
  - Oil pipeline (49%): Yukos (in 2006 bought back by government)

To prevent the abuse of monopoly power, the privatization of state monopolies required establishing new independent regulators. Separate regulators have been created for the energy sector and the telecommunication sector. The regulation of the financial sector has been taken by the National Bank of Slovakia. The privatization was also linked with gradual increase in prices with negative short-term impact on population particularly in energy sector. Over 1999-2002, the prices of electricity and gas increased by around 100%. The increases had been necessary in order to bring prices to levels reflecting real costs and thus to avoid threatening defaults of energy companies as well as in order to incentivize consumers to more efficient energy consumption. At the same time, more realistic prices have gradually opened ways for new investors to enter the retail market and thus, to introduce the competition to monopolies. To moderate negative impact the price increases had been implemented in several-year transition periods over 1999-2004. The newly created regulation authority continued to regulate the prices; however, in later period, gradual deregulation had been implemented for the end-prices for the business sector. Besides energy (gas, heat, electricity), the deregulation included increases in prices of water and public transport.

The transparent privatization to foreign companies with better ethics, culture and know-how contributed heavily to decreasing corruption in Slovakia and to improving the efficiency of companies and, consequently, stronger development of the Slovak economy. For example, before privatization of the banking sector, the state-owned banks were a huge source of corruption and inefficient management. As a consequence, ahead of privatization, the government had to clean-off their balance sheets of bad assets mainly consisting of non-performing loans. The total cost of restructuring the banking sector before privatization is assumed to be around 14% of GDP. Since privatization, there have been no major problems with the financial sector and it became a real backbone of the Slovak economy. The economic analysts employed by the banks after privatization became important stakeholders in public debates about necessary structural reforms and economic development of the country. The healthy banking sector as well as good access to financing became one of the biggest competitive advantages of Slovakia.

Similarly, privatization helped to deter corruption in the energy sector and stabilize companies which had been badly managed under the full state ownership and in some cases (e.g. the Slovak Gas Industry and the Power Generation Company Slovenske elektrarne) even on the verge of default. The exemption to success stories was a privatization of the oil pipeline to Russian Yukos. After arresting Mr. Chodorkovskij and the Russian government crackdown on Yukos, the Slovak government decided to buy back the privatized share and regain the full state ownership.

Tax reform in 2003-04 bringing simplicity and lowering direct taxes

The tax reform implemented in 2003-04 is perceived to be the major reason for attracting foreign investors and strong economic development of Slovakia in 2006-08. The reform was based on following assumptions:

- The investors welcome simple system and lower taxation on corporate profits
- Lower direct taxes have positive impact on work incentives and reduce tax evasion
- Lowering direct taxes requires higher indirect taxes, which is unpopular. Therefore, compensation for low income people is one of key preconditions for successful reform.

The reform and the entry of Slovakia into the EU in 2004 were followed by a huge foreign direct investment inflow. Compared to previous investment which was mainly driven through the privatization this time it was mainly green-field investment. New investors arrived in the automobile and electronic industry (2005: Peugeot-Citroen, Kia; expanding production at Volkswagen; Sony, Samsung), later also in the IT sector (IBM, Dell). The launch of the production in newly built factories contributed to a strong GDP growth mainly in 2005-08. For instance, in 2006 the real GDP growth was of 8.5% and in 2007 of 10.8%. Since 2012, Slovakia has been the biggest automobile producer per capita in the world with annual production of around 1 million vehicles[18]. Automobile industry accounts for around 40% of total Slovak exports. In 2015, Slovak government signed another contract with Jaguar Land Rover to build a new automobile factory by 2018. In full operation, it should deliver up to 300 thousand vehicles annually.

Key measures[19]:

- Introducing flat tax – Unifying direct income taxes to 19% for individuals and businesses. The old system was strongly progressive with 5 personal income tax rates ranging from 10% for the lowest income to 38% for the highest income. The reform also decreased the corporate income tax rate from 25% to 19% and cancelled the dividend tax rate of 15%. The combined statutory corporate income tax rate and dividend tax rate dropped from 36.3% in 2003 to 19% in 2004. Thus, Slovakia had one of the lowest composite taxation of capital income faced by a private investor in the EU and OECD countries. In 2013 the government reintroduced the upper 25% rate of personal income tax and increased the corporate income tax to 23%. In 2014 it decreased the corporate income tax from 23% to 22%.
- Increasing the indirect consumption taxes. In the old system there were two value added tax (VAT) rates: standard rate of 20% and reduced rate of 14%. The tax reform unified both and introduced a single VAT rate of 19%; later, lower 10% rate for books, drugs, medical supplies and some basic food had been introduced. The tax reform included an increase in the excise tax rates on mineral oils, tobacco, and tobacco products, spirits and beer.
- Radical simplification of the tax code. 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 most of them, making the tax system much simpler and transparent, and

[18] Source: http://www.eubusiness.com/news-eu/slovakia-economy.sva
[19] See also Goliaš (2005).

eliminated speculation aimed at paying lower tax rates. The reform also cancelled three minor taxes – gift tax, inheritance tax and real estate transfer tax.

- Increasing the basic personal allowance deductible from the tax base from €968 to €2,021 per taxpayer in 2004 (€3,803 in 2016). As a consequence, everybody with wage below approximately 36% of the average wage in the economy (the average wage was €883 in 2015) did not pay any income tax at all. Others paid a uniform tax of 19% on the difference between their income and the tax-free income (or 25% since 2013 in case of high income). In 2007 the government introduced gradual reduction of the tax allowance for people with higher income down to zero (known as a "tax for millionaires").
- Introducing tax bonuses for children. The bonuses are deductible directly from the personal income tax (€257 in 2015). As a result, working parents pay lower taxes or, with too low income, they get money back from the state – principle of "negative tax". The tax bonus is conditional on at least one parent being employed. This condition was aimed at increasing incentives to work. Besides child tax bonuses, parents get the universal flat benefits regardless of income or employment status (€282 per child in 2015).

When deciding about the final tax rates, the government's goal was to ensure a fiscally neutral outcome in the first year after the reform. To keep the same tax revenues, the reduction of direct taxes required higher indirect taxation. By choosing 19% rates the government took more conservative estimate in order not to underestimate the revenues. The outcome was hardly predictable, as the major changes in taxation evoke new behavioral patterns of individuals and firms. Lowering taxes usually means lower tax revenues; however, as long as it brings more people to work and more investment, the effect may be exactly opposite. The actual tax revenues in 2004 exceeded both plans and revenues collected in 2003 (Table 3). Especially the direct tax revenues were higher than plans, although the tax rates decreased substantially. However, this optimistic development cannot be attributed solely to the tax reform – for details, see Goliaš (2005).

Table 3: Tax revenues in 2003 and 2004 (in SKK billion, ESA 95, on accrual basis)

	2003 (before reform)		2004 (after reform)			
	Reality	Share on total	Plan	Share on total	Reality	Share on total
Tax revenues	**217.6**	**100.0%**	**232.0**	**100.0%**	**233.5**	**100.0%**
Direct taxes (PIT & CIT & WIT)	**82.7**	**38.0%**	**62.2**	**26.8%**	**68.9**	**29.5%**
Personal income tax (PIT)	39.9	18.3%	27.1	11.7%	34.1	14.6%
Corporate income tax (CIT)	33.6	15.4%	23.7	10.2%	29.1	12.5%
Withholding income tax (WIT)*	9.1	4.2%	11.4	4.9%	5.7	2.4%
Indirect taxes (VAT & Excise)	**118.3**	**60.9%**	**157.0**	**67.7%**	**149.5**	**64.0%**
VAT	80.7	41.9%	113.8	49.1%	104.9	44.9%
Excise duties	37.6	19.0%	43.2	18.6%	44.6	19.1%

Source: Ministry of Finance of the Slovak Republic

* includes revenues on dividend tax

The introduction of flat personal income tax eased people with high income. Higher tax deductibles eased mainly people with low income. The unification of VAT and rise in excise duties burdened everybody almost equally, depending on the structure of consumption. As a result, in a static perception, low- and high-income brackets were expected to be better-off after the reform; middle-income brackets (majority of population) were expected to be worse-off. However, the loss would be relatively mild with maximum of 2% of income for singles without children. Families with children would have lower losses thanks to the new tax bonuses for children. In reality, the income had been influenced by dynamic changes such as higher economic activity surging the GDP growth, wages, and employment in the short and long run.

Labor market reform (2003) introducing more flexible Labor Code[20]

The labor market reform implemented in 2003 led to a significant shift of the Labor Code arrangements towards higher flexibility. It restricted the coercive character of the Labor 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. The main measures included:

- Decreasing costs of firing: The reform set a new trade-off between protection of the employees and flexibility in the labor-market relations by changing the rules for the length, size, and concurrence of notice periods and severance payments. Before the reform, the Labor Code ordered concurrence of notice period (3 months) and severance pay (in the amount of 2-month wage of dismissed employee) bringing the cost of firing to 5 months wage of dismissed employee (3 plus 2). The reformed Code ordered to option between taking a notice period and taking compensation after termination of contract (severance pay). 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, **the cost of a termination of contract was brought down from 5 month-wages to 2-month wages in case of employment lasting under 5 years and 3-month wages in case of employment over 5 years**. By decreasing costs of firing the government intended to motivate firms to employ more people legally. However, with later changes of governments, new trade-offs between protection and flexibility have been searched for:
  - 2002: 3-month long notice period plus 2-month wage as a severance payment
  - 2003: 3 or 3 (2 or 2 for contracts lasting shorter than 5 years) – cancelling of concurrence
  - 2007: 2 plus 2 (for contracts lasting shorter than 5 years) or 3 plus 3 (for contracts lasting more than 5 years) – re-introduction of concurrence
  - 2011: 1 or 1 (for contracts lasting less than 1 year); 2 or 2 (for contracts lasting over 1 year and under 5 years); 3 or 3 (for contracts lasting 5 years and over) – re-cancelling of concurrence
  - 2013: Re-introduction of concurrence and gradual increase of protection: 1 plus 0 (for contracts lasting shorter than 1 year); 3 plus 4 (for contracts lasting 20 years and over)

Table 4: Firing costs in effect from 2013 (in months or monthly wages)

	Notice period	Severance pay
Contracts lasting under than 1 year	1	0
Contracts lasting over 1 year and under 2 years	2	0

[20] See also Goliaš (2007) and Zachar (2010).

Contracts lasting over 2 years and under 5 years	2	1
Contracts lasting over 5 years and under 10 years	3	2
Contracts lasting over 10 years and under 20 years	3	3
Contracts lasting 20 years and over	3	4

Source: Labor Code of the SR

- More flexible overtime: Before 2003 reform, the Labour 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. Thus the overtime limit effectively increased from 150 to 400 hours yearly.
- More flexible working hours: 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 3 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.
- More flexible fixed-term and part-time contracts: Before 2003 reform, the Labour 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 3 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). Currently, the extension of the fixed-term contracts is limited to 2 years (with exception of seasonal works) with possibility to sign a new temporary contract not sooner than 6 months after elapsing of this 2-year period.

- <u>Weaker Labor Unions:</u> The Labor Unions lost veto power in organizational changes including firing the employees and introducing flexible work time (the latter was re-introduced in 2007). Moreover, the reform gave equal powers to workers´ councils and trade unions with the exception that the trade unions do collective bargaining and workers councils do not.

In the World Bank´s Doing Business 2005 report, Slovakia was marked as the top reformer. The report praised especially measures introduced by the 2003 Labor Code Amendment.

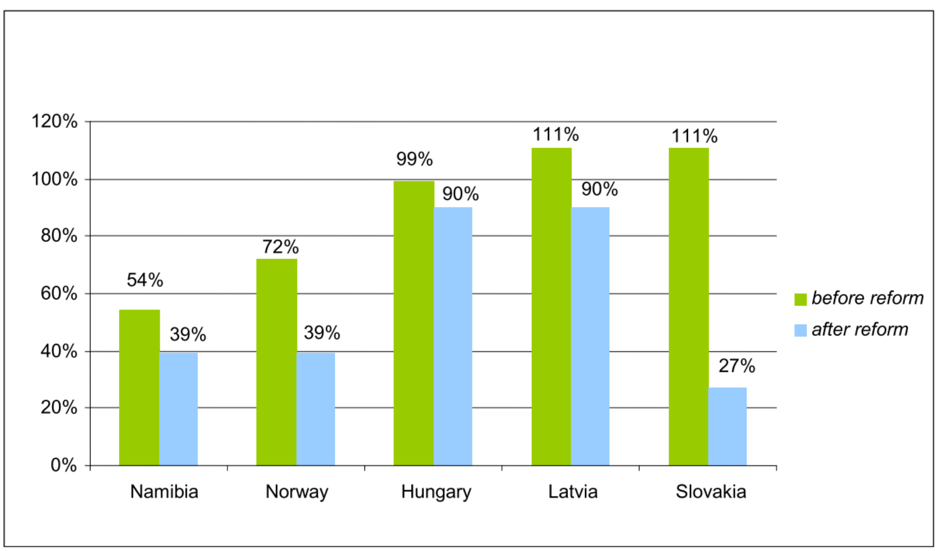
Table 5: Employment Regulation - Sweeping Reforms in Slovakia in 2003

Before Reform	After Reform
No part-time contracts	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 trade union for firing a worker	No requirement
Retraining before dismissal	No requirement
Trade union approval for flexible work time	No approval for shifting hours in a 4-month period
Approval by trade union for group dismissals	Notification for group dismissals

Source: The World Bank Doing Business 2005

The World Bank report also calculated how the labor costs would change if a firm increases its production in a reaction to a temporary increase in demand. It counted the change in labor costs in case of the 50% output increase. As the report explained, the countries that move to more flexible work hours can bring those labor costs down considerably. Thanks to the 2003 Labor Code reform Slovakia cut those costs down from 111% to 27%.

Figure 2: Costs to temporarily expand production by 50% (percentage increase in labor costs)



Source: The World Bank Doing Business 2005

Besides aforementioned measures there are three other frequently used forms of flexible employment in Slovakia:

- Working „agreements“: Concluded only for a limited time (1) per week for regular employment or (2) per year for irregular employment. These agreements offer flexible entry/exit and until 2012 they were also freed from social security contributions.
- Private employment and personal agencies: Specialized agencies employ workers who are then hired by real producers. The agencies organize workers among many producers to minimize costs related to administering and/or closing the job (such as identifying and contacting potential employers, severance payment, etc.).
- Self/employment: Before 2012, self-employed people had been paying substantially lower taxes as well as social and health contributions thanks to relatively generous exemptions. Since 2012, their tax burden has been gradually increasing as a reaction to growing popularity of speculative transfers of regular employees to self-employed status.

Since 2009, the flexible working time account (in Slovak known as Flexikonto) has been introduced. This was a reaction to employers’ problems with sales and with maintaining production and employment after they had been hit by a global economic crisis. When a company announced a production break, flexible working time arrangements valid until the end of 2012 helped to retain skilled workforce and avoid mass layoffs. The “Flexikonto“ allowed employees to stay at home on full basic pay, with the un-worked hours being recorded in individual employee accounts. Later, after the economic difficulties are over, the employee is obliged to work those missing hours in the form of overtime and free of charge. At that time, legal overtime limits were not applied. Some companies, mainly in the automotive (Volkswagen Slovakia) and electric industries used the above mentioned flexible working time account several times in 2009, when their production was stopped for some weeks. In 2013 this arrangement became permanent if agreed between employer and employees (for example in collective agreement). However the limit of 8 hours of overtime weekly was applied and the period for balancing the working time was limited to 30 months.

Pension reform (2004-05) linking benefits to contributions and introducing fully funded second pillar[21]

The pension reform effective from 2004 and later changes aimed at searching for the optimal trade-off between merits and solidarity, meaning the link between how much money an individual would pay to the state during her/his working life and how much money he/she would receive back in the form of state pension. Further it aimed at securing long-term financial stability of the pension system by parametric changes to the pay-as-you-go (PAYG) system and introducing a new fully funded pillar of the pension system with the effect from 2005.

Trade-off between Merits & Solidarity:

The reform introduced a new pension formula guaranteeing 50% replacement rate. Compared to the former formula, the new one gave higher pension to those who earned more and paid higher contributions during their working life and vice versa. The aim was to increase motivation to pay contributions and eliminate evasion. On the other hand, the reduced re-distribution could be dangerous for people with lower income. From this reason, later adjustments have been made to increase solidarity. The reform cancelled minimum pension and people with too low pensions did not have any guaranteed income except for the social assistance. This has changed in 2015 when the government re-introduced minimum pension to protect people with the lowest pensions from poverty.

- Pension formula introduced by the reform: Pension = Average personal wage point (APWP) * Number of years of paying contributions to the Social Insurance Agency (working period) * Constant given by law with the aim to provide 50% replacement rate in the first year after the reform (the constant is indexed annually by the average nominal wage growth in the economy)
- Gradual linking of contributions to benefits: APWP represents the ratio of individual earnings to average earnings in the economy. It is determined as an average of ratios respective to each year since 1984 till the retirement year. Thus, the contribution base was expanded from 5 best of 10 latest years before retirement (regulation valid before the reform) to cover most of the working life of individual. APWP equal to 1 would mean that the worker has earned the average wage in the economy. The maximum value of APWP is 3. The initial aim of the 2004 pension reform was to gradually decrease, with the help of a correction coefficient, the solidarity component in the pay-as-you-go scheme so to have fully earnings-related pensions as from 2015. However, in 2011, the APWP adjustments had been frozen, and since 1 January 2013 values of APWP below 1 are added 17% of the difference between APWP and 1 (the percentage shall increase to a final 22% in 2018) and values between 1.25 and 3 are reduced to 80% of APWP (and shall gradually decrease to 60% by 2018). The aim of the revision is to increase solidarity in the calculation of new retirement pensions.

Parametric changes to the PAYG securing long/term financial stability:

- Prolonging retirement age:

[21] See also Vagač (2013).

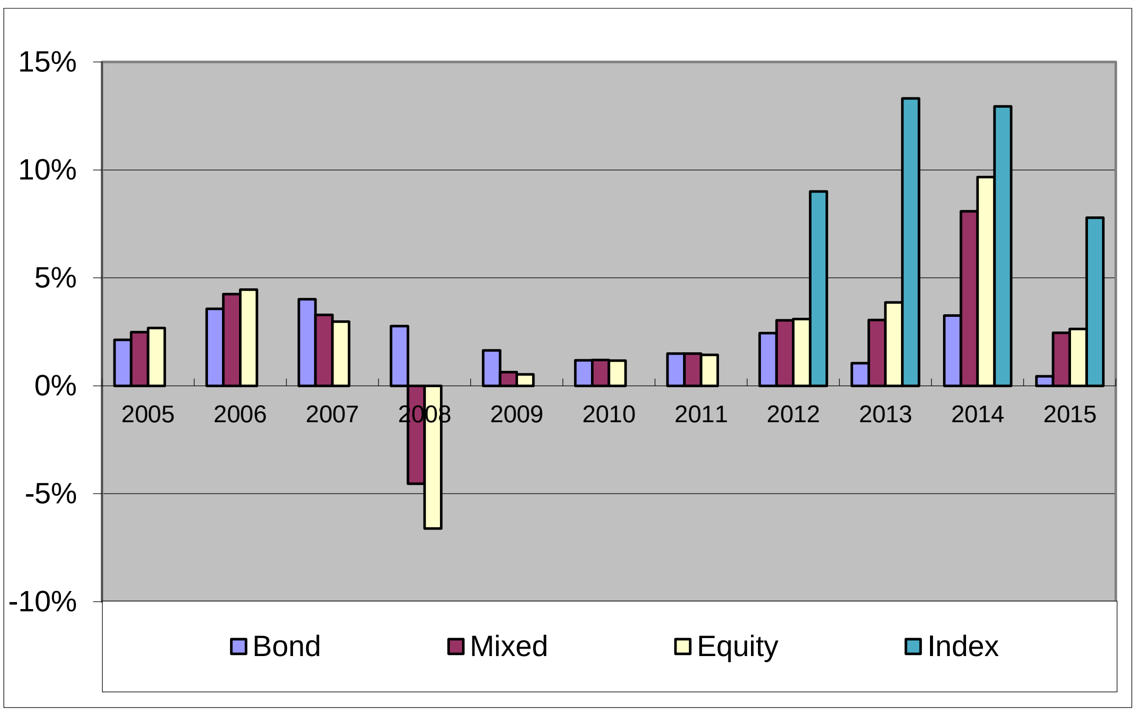
    - Before reform: The average statutory retirement age was 55 years for women (depending on number of children) and 60 years for men
    - 2004: Gradual prolonging to the final 62 years for both genders. All men started to retire at the age of 62 since 2006 and most of women since 2015 depending on number of their children.
    - 2017: Retirement age will be linked to life-expectancy. In line with expected longevity gains, the retirement age could increase by approximately 50 days per year.
  - Indexing pensions:
    - Before reform: Political decision in the Parliament
    - 2004: "Swiss method", i.e. automatic yearly valorization of awarded pensions by the weighted average of the consumer price index (inflation) and the average nominal wage growth in the economy. The weights will be 0.5 for both parameters.
    - 2012-17: The 2012 reform introduced a transition period from 2012-17 in which the pensions are being valorized by a fixed sum computed as the weighted average of wage growth and inflation divided by the average wage in the economy. The weight of inflation is gradually increasing.
    - 2018: Pensions indexed purely by inflation for basket of goods bought by pensioners

Introducing second fully-funded pension pillar from 2005:

  - Before reform: The mandatory pension system was 100% state-run PAYG scheme.
  - 2005: Introduction of a mandatory fully-funded pension pillar with 9% contribution rate (of gross wage).
    - Every socially insured individual could voluntary switch for the second pillar. For young people entering the labor market the participation in second pillar was mandatory from the beginning but later it was changed to voluntary. The government has four times re-opened the second pillar (in 2008, 2008/09, 2012/13, and 2015), i.e. it allowed people inside to return their full contributions back to the PAYG. Approximately 20% of people returned back to the PAYG.
    - The diverting of revenues from the pay-as-you-go pillar to private funds increased the public finance deficit. This transformation cost amounted up to 1.5% of GDP yearly and was covered by privatization revenues (2005-2009), later directly from the state budget.
  - 2012: In order to stabilize public finance deficit, the contribution rate was decreased from 9% to 4% with the effect from September 2013. This change has increased public finance revenues by around 0.6% of GDP annually. The rate is expected to grow up gradually to 6% by 2024. On voluntary basis, savers may contribute with additional 2% and deduct the sum from their income tax base.
  - Investors and funds: Currently there are six private pension administration companies (Allianz, Aegon, AXA, ING, Intesa & Generali, and one local). They are obliged to administer two types of funds, a guaranteed bond fund and an unguaranteed equity fund. They can also

run other types of guaranteed or unguaranteed funds (e.g. mixed and index funds). Until 31 December 2012, pension companies administered four types of statutory funds (bond, mixed, equity, and index funds), while before 1 April 2012 there had been three funds (conservative, balanced, growth). Only bond and cash investments may now be included in bond funds. There is a special guarantee valid for bond funds – the pension administration companies have an obligation to observe 10-year running interval for balancing pension unit value in bond funds and savers have to be compensated for possible decreases. There is an upper limit of 80% on shares and also on bond and cash investments in unguaranteed equity funds. To protect older people from sudden decreases in their assets there is a regulation saying that after reaching the age of 47 years, savers may not have funds in an equity fund, and after the age of 55 in no unguaranteed fund. Since 2012, most of administrators have established so called index funds which are non-guaranteed equity funds with assets linked to certain world or European equity indexes. These funds have the highest risk and just a small fraction of people have their assets invested in them. Nevertheless, these funds have so far offered the highest returns on investment.

Figure 3: Gross nominal returns of funds in the fully funded second pension pillar (annual weighted averages)



Source: INEKO

Education reforms introducing per-pupil financing (2003) and improving measurement of results (2012)[22]

The reform from 2003 introduced the “normative” financing based on number of pupils (i.e. normative = fixed amount of money per pupil) with equal financing of primary and secondary public and private schools. The goals were to increase transparency in financing schools and to increase pressure on their rationalization and efficiency. Besides direct government intervention in school curriculum and inspection, the quality should be guaranteed by free choice of school (students and their parents should choose the best). The normative system replaced the old one based on historical mostly cost-based financing often depending on individual and non-transparent negotiations between the state officials and schools. After the reform, the normative income covers around 94% of schools‘ current expenditure. It consists of wage and operation normative which may vary by a school type. For example, grammar schools have different normative than vocational schools; technical vocational schools have usually higher normative than commercial schools; etc. The normative amount is given by a political decision about the state budget.

The tertiary schools are funded from public sources mainly based on a complex formula with most emphasis on their academic results (research quality) and number of students. The subsidies do not have a specified purpose („block grants“). The only exception is that personal costs cannot exceed 80% of the subsidy used for financing current expenditure. The attempt to introduce fees in tertiary education, as well as to open market to foreign investors failed. The state does not finance private universities with the exception of the social scholarships for students and one-off projects.

Currently, the most discussed topic is remuneration of teachers where Slovakia lags behind most of the EU members. To close this gap, the teachers have for several years had higher wage increases compared to other public employees.

Another discussed issue relates to measuring results (i.e. collecting and publishing school results, rankings) to overcome information asymmetry. In Slovakia, there is rather long tradition in measuring the results of pupils and students by means of standardized national testing at the end of primary and secondary education. However, these results have long been unavailable to the public and later they were published in user-unfriendly format without possibility to rank or compare the schools. This changed in 2012 when the non-governmental think-tank INEKO launched its internet portal http://skoly.ineko.sk/. The portal displays a set of various indicators and ranks the schools by rating. The rating of primary schools is based on two indicators: (1) National exit tests´ results in mathematics and Slovak (or Hungarian) language, and (2) exceptional results rewarded by the Ministry of Education. The rating of secondary schools is based on three indicators: (1) National exit tests´ results in mathematics, Slovak (or Hungarian) language, and foreign languages, (2) unemployment rate of graduates compared to the regional unemployment rate, and (3) exceptional results rewarded by the Ministry of Education.

There are no links between the results and financing the schools from the state budget. However, publishing the results influences decisions of parents and children to choose particular school which has indirect impact on schools budget as they are funded on basis of “normative” which is a defined financial

[22] See also Goliaš (2015a).

amount per pupil. Officially, the quality of primary and secondary schools is examined by the State School Inspection with focus on the school management, education conditions, process of education and testing pupils. However, due to limited capacities, this control is implemented only on a selective basis. Moreover, only general results are publicly available without providing data for particular schools. The impact of this official quality monitoring is generally considered to be rather weak.

In tertiary education, the Ministry of Education launched an internet portal http://vs.iedu.sk/ in 2012 displaying a comprehensive set of indicators including graduates salaries and unemployment rates for particular schools and programs. However, this portal has not been updated and, consequently, has not gained sufficient publicity and impact. In 2015 the Ministry of Education launched another portal http://www.lepsieskoly.sk/ offering smaller set of indicators with fewer possibilities to rank and compare schools and study programs. However, the Ministry´s ambition is to develop this portal and to expand and improve the set of indicators. Besides official activities there has long been a project of NGO ARRA (Academic Ranking and Rating Agency) regularly publishing ranking of all tertiary schools in the country based mostly on their academic results: http://www.arra.sk/.

As mentioned above, public funding of tertiary schools reflects number of students and academic results. There has been criticism that the measuring of academic results is too benevolent and does not reflect real differences in quality. Moreover, the public funding does not reflect results in the labor market; just a small fraction of money is distributed based on the unemployment rate of graduates. In theory, just like in case of primary and secondary schools, students should choose the best schools and money should follow students under normative funding. This should, in the long-term, guarantee quality improvement. However, in reality, there is information asymmetry – students do not have reliable information about salaries and unemployment rates of particular study programs. Officially, the quality of tertiary education should be guaranteed by the Accreditation Commission, which has its own criteria for measuring the quality and subsequent accreditation of particular schools and programs: http://www.akredkom.sk/en/. However, the impact of accreditation on improving quality of particular schools is generally considered to be rather weak.

The biggest opposition to measuring the quality and other results in education is from the side of teachers. Here are the most frequent objections:

1. Most of measurements do not take into account factors beyond education process that influence the pupils' outcomes. The examples of such factors include socio-economic background of pupils, family situation, or differences in quality of students at the entry to the school. This objection partially reflects a lack of measuring the "value added". As a result, the school with better students at the entry will have better results at the exit and vice-versa. Therefore, it is impossible to talk about the school quality based only on the exit results.
2. The measurements cannot objectively assess the real quality because they reflect just a fraction of the education process. For example the national tests cover only a few subjects. Moreover, there is much more to the teaching profession than to teach for the test. In other words, there are things that teachers teach that cannot be assessed by the test, such as interpersonal skills,

values, attitudes towards society, etc. Too much emphasis on the tests´ results may be at the expense of other teaching activities that are important but impossible to check by a test.

3. There is still risk that the school will cheat at the test. The more emphasis on the tests´ result the higher is this risk.

The Ministry of Education reflected the first objection in 2015 by computing a “value added” of the secondary schools. The results have been communicated to particular schools internally without making them public. The “value added” is computed based on a difference between test results at the exit from the secondary school and test results at the exit from the primary school. Thus, it should provide for more accurate information about real quality of particular school.

In November 2015, the Ministry launched national testing of pupils of the 5th grade at primary schools. This will enable to measure “value added” for the second level of primary education (5th to 9th grade, ISCED 2). The tests include mathematics, Slovak language, and Hungarian language for ethnic minority schools.

As for tertiary education, the Ministry of Education tries to develop the methodology for evaluating the success of graduates in the labor market. In 2015, the INEKO institute has taken part in a project proposing such methodology. Among the proposals it recommends to monitor the salaries and the unemployment rates separately for specific professional areas (to account for differences between informatics and education, etc.) as well as for specific regions (to account for differences between richer western and poorer eastern regions, etc.).

To improve measuring of results INEKO also recommends:

- Measuring and publishing “value added” based on national testing for every education level of ISCED 1-3
- Monitoring and publishing average salaries of graduates of secondary schools
- Tracking the individual pathways from primary to secondary and tertiary schools – this would enable to assess the school´s performance based on how successful are its graduates in getting to the schools with better results
- Unifying professional school leaving exams at related vocational secondary schools and publishing the results
- On the level of schools, publishing average results of the psychological screening of pupils entering the primary education – this would enable to measure “value added” at ISCED 1
- Collecting and publishing schools´ results in broader scope of competitions (for example to include science in national testing)
- Measuring and publishing efficiency, i.e. results divided by public subsidies in given period, and/or rate of return of public investment in case of secondary vocational and tertiary facilities (based on comparing public funds used for particular school and taxes paid by its graduates)

In near future, the decline in natality will make many schools redundant. It is crucial that the above-average schools will not be closed. Better measuring and publishing results may help to avoid this. More direct solution would be to link the schools´ public funding to the results. However, the Ministry is cautious in this respect and, before it happens, it will probably take more years to fine-tune the methodology of measuring results.

Securing Macroeconomic & Public finance stability[23]

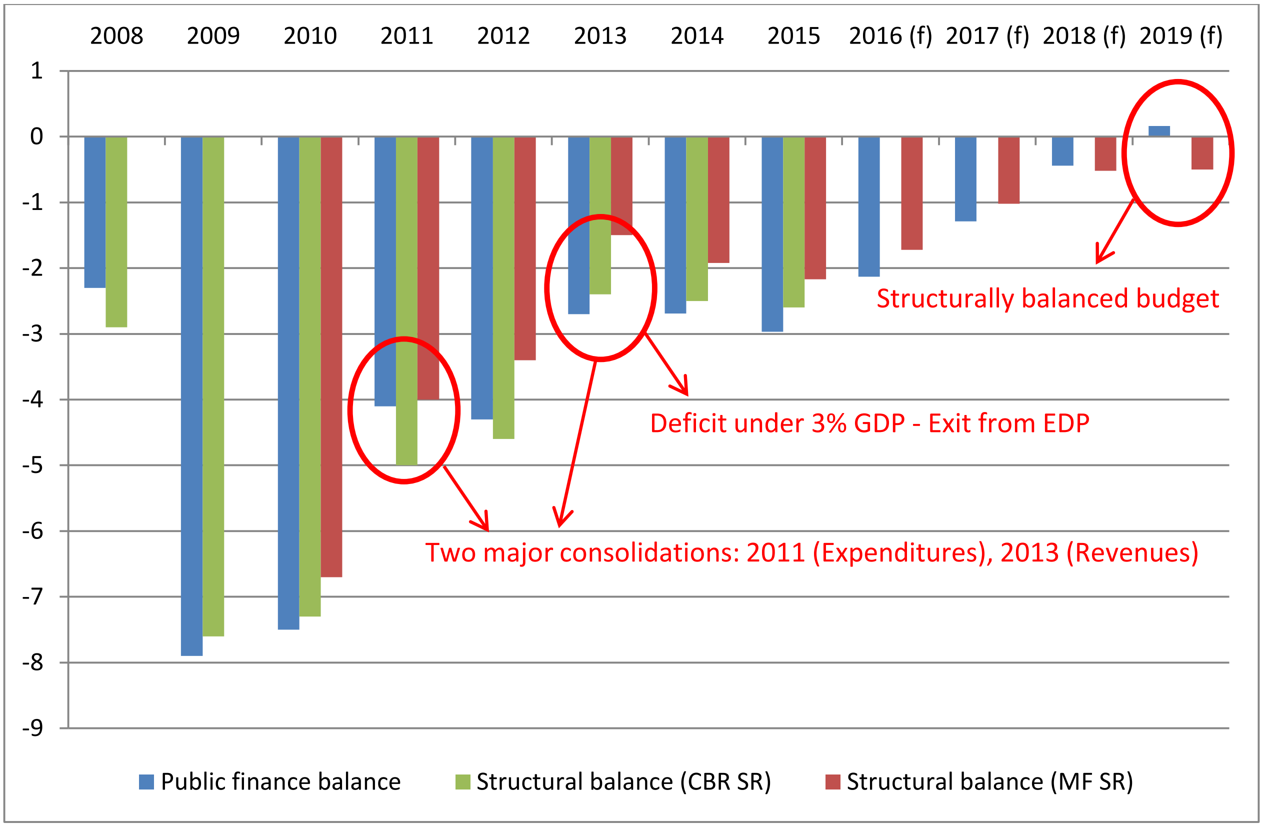
There have been several crucial measures Slovakia implemented to secure its macroeconomic and public finance stability that can serve as examples of the best practices. Here are the most important of them:

- 1990s: Establishing the National Bank of Slovakia independent from the government (key results: low inflation, stable exchange rate)
- Strengthening independent analytical capacities at the Ministry of Finance: Establishing Boards on Macroeconomic and Tax prognosis consisting of representatives of the Ministry of Finance, National Bank of Slovakia, Slovak Academy of Sciences and private banks – majority vote is necessary for approving the prognosis used for the state budget calculations. Establishing the Institute for Financial Policy at the Ministry of Finance (analytical unit).
- 2009: Euro adoption (exchange rate stability, need to comply with the Maastricht criteria in the pre-accession period and with the Stability and Growth Pact and other deficit-guarding commitments in the after-accession period)
- 2012: Constitutional Act on Budget Responsibility introducing the debt brakes and establishing the Council for Budget Responsibility
- Increasing transparency of public finances (disclosing hidden debts, ESA95 & ESA2010 standards, Fiscal Compact – computing and publishing structural deficit and consolidation effort, INEKO portal on financial health of municipalities: http://www.obce.ineko.sk/)
- Since 2013: Improved efficiency in tax collection (disclosing fraud cases, introducing electronic central evidence of invoices)

Public finance balance: The reforms adopted after 1998 and consequent economic boom in 2005-2008 decisively helped to decrease public finance deficit below 3% of GDP. However, the economic crises bursting in 2009 knocked down revenues and the public finance deficit in Slovakia jumped from 2.4% of GDP in 2008 to 7.9% in 2009. After two major consolidations in 2011 – mostly on expenditure side and in 2013 – mostly on revenues side, the deficit decreased to less than 3% in 2014 and the Ministry of Finance plans to decrease it down to zero by 2020. As shown in Figure 4, Slovakia entered the Excessive Deficit Procedure imposed by the European Commission in 2009 and left it in 2014. The deficit increased in 2015 but remained just below the 3% threshold.

[23] See also Goliaš (2015b)

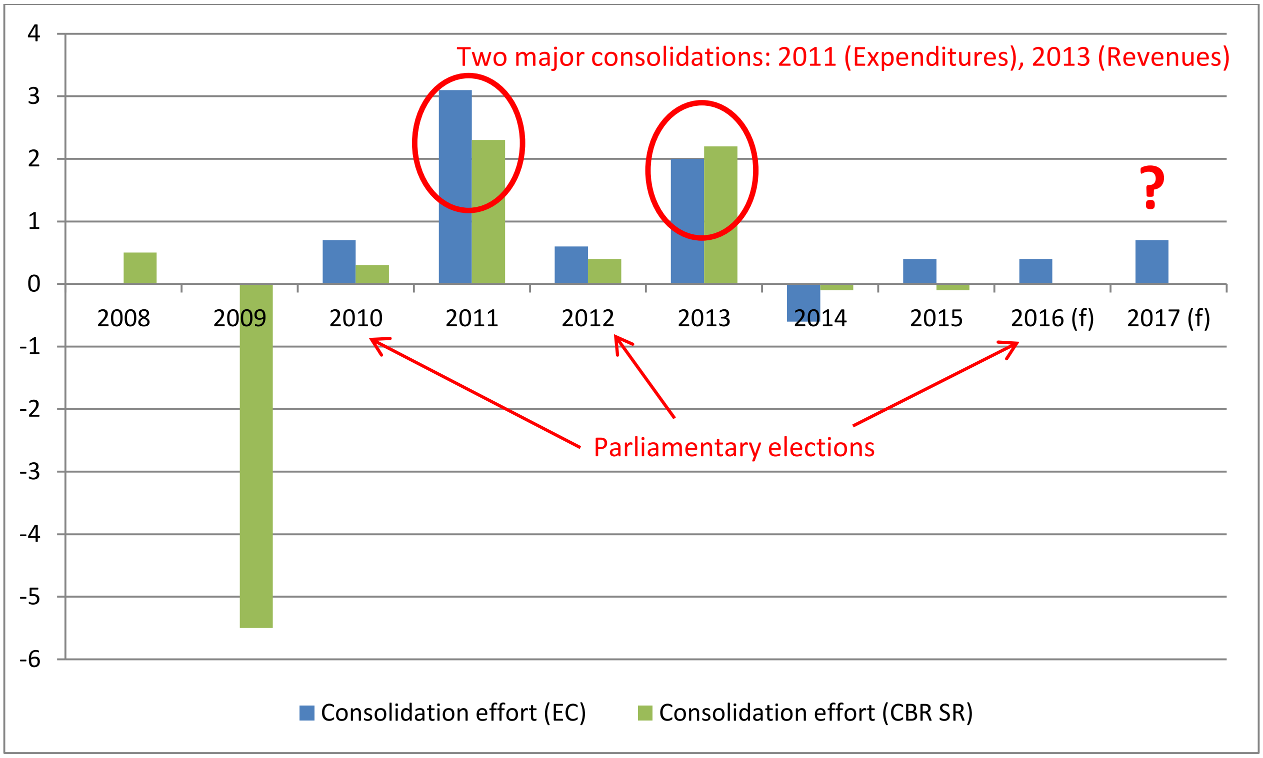
Figure 4: Public finance balance in Slovakia (% GDP)



Sources: Ministry of Finance (MF SR), Council for Budget Responsibility (CBR SR)

The Government plans to have structurally balanced deficit (i.e. cleared by one-off measures and economic cycle) by 2019. To achieve this goal the consolidation must continue in 2016 - 2018. Originally, the balanced budget was planned for 2017 but this goal was postponed after parliamentary elections in March 2016. The Figure 5 shows that major consolidations in 2011 and 2013 came one year after the parliamentary elections. It is crucial that the Government adopts consolidation measures early on in the election period.

Figure 5: Consolidation effort – change in structural deficit (% GDP)

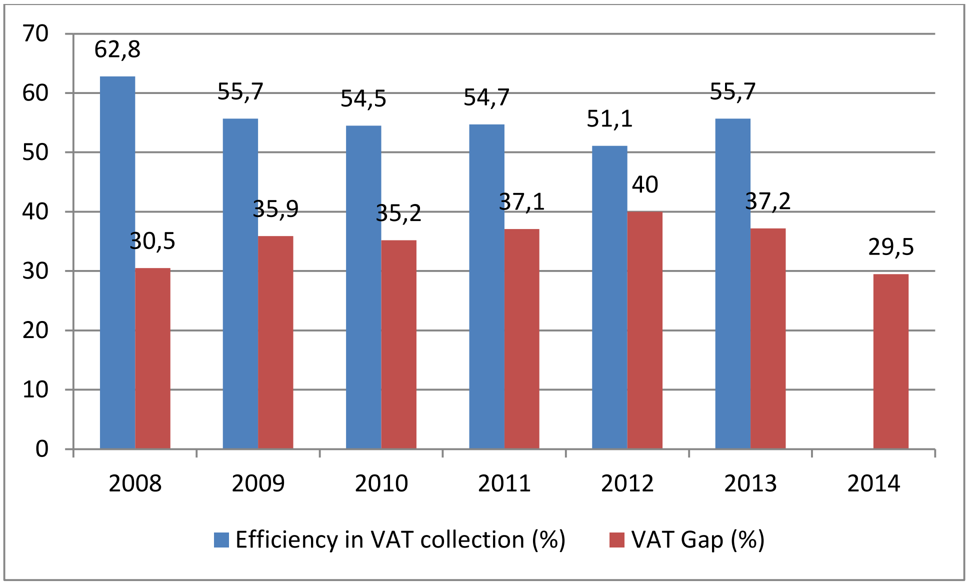


Sources: INEKO based on data from the Ministry of Finance using methodology of the European Commission (EC) and from the Council for Budget Responsibility (CBR SR)

The 2011 consolidation included cuts in expenditure on public procurement, staff remuneration and also increasing the value-added tax (VAT) from 19% to 20%.

The 2013 consolidation included increasing corporate income tax from 19% to 23% (since 2014 decreased to 22%), introducing higher rate of the personal income tax for top-earners at 25% (lower rate remained at 19%), increasing social contributions for top-earners, increasing taxes for self-employed, as well as introducing special tax levies for regulated monopolies and financial institutions. Besides increasing taxes the government adopted around 50 measures with the aim to improve tax collection. From among them the most important included more targeted effort to disclose fraud cases (establishing "tax-cobra" commando), introducing electronic central evidence of invoices enabling cross controls, increasing tax transparency (publishing taxes paid by firms), extending "reverse charge" VAT payment mechanism with the VAT paid by buyers, extending the use of cash registration machines (i.e. by hotels, physicians, taxi drivers, etc.), more targeted controls of transfer prices in foreign trade, etc. The results became evident in 2013 when the efficiency in VAT collection increased from 51.1% to 55.7% (see Figure 6) and the VAT gap decreased from 40% in 2012 to 31% in 2015. Thus the additional VAT revenues brought by the improved efficiency in collection amounted to more than 1% of GDP in 2014 compared to 2012.

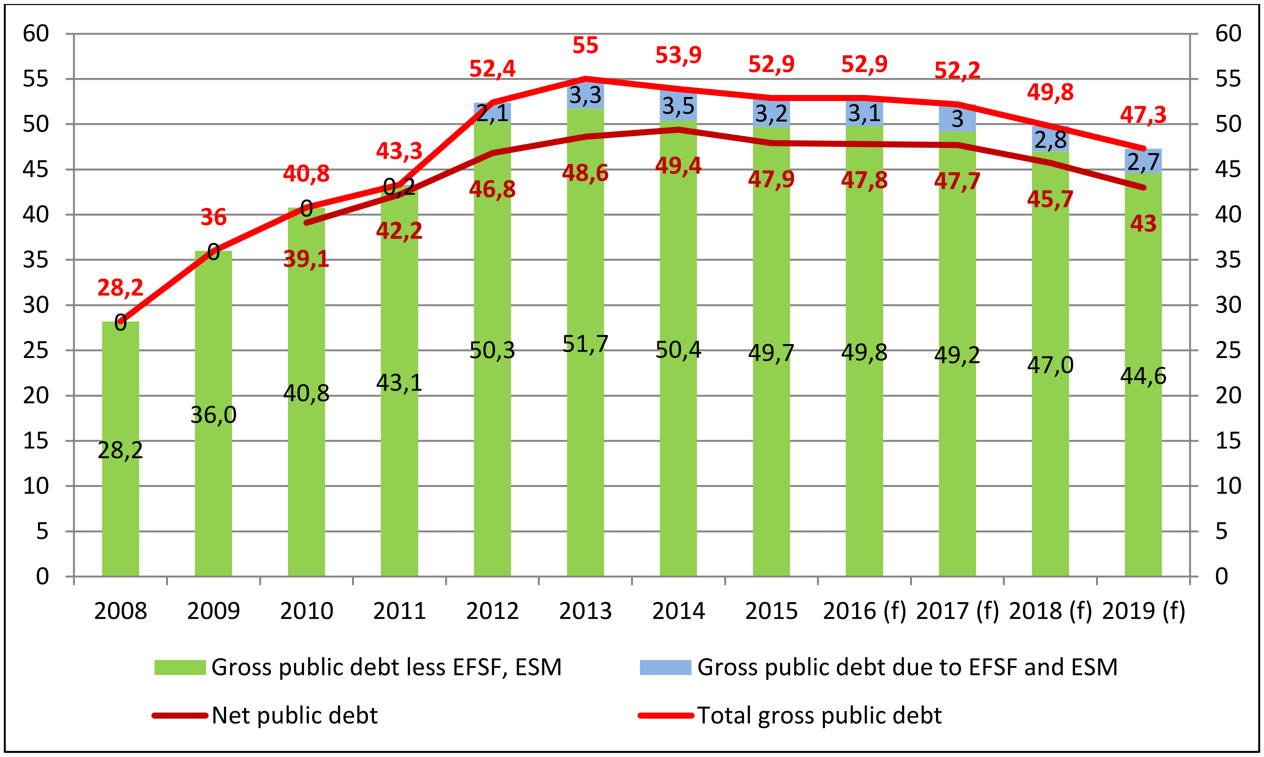
Figure 6: Efficiency in VAT collection



Source: MF SR

Public debt: Slovakia succeeded in stabilizing the public debt growth that almost doubled from 28.2% of GDP in 2008 to 55% in 2013; then decreased to 52.9% in 2015 and should decrease further to 47.3% of GDP in 2019. Since 2012 the public debt has been increased by 2.1-3.5 percentage points due to participation of Slovakia in the European Financial Stability Facility (EFSF) and later in the European Stability Mechanism (ESM), i.e. mostly by the guarantees provided by Slovakia for the debt of Eurozone countries unable to pay their liabilities after the crises. The net public debt, i.e. gross debt less the liquid assets peaked at 49.4% of GDP in 2014 and is expected to decline to 43% by 2019.

Figure 7: Public debt in Slovakia (% GDP)



Source: INEKO based on data from the Ministry of Finance (MF SR)

The debt growth stabilization was supported by the Constitutional Act on Budget Responsibility adopted in 2012 introducing the debt brakes and the new institution for guarding public finance stability – the Council for Budget Responsibility. The Act introduced following levels of public debt brakes:

- Public debt at 50% of GDP:
  - The Ministry of Finance has to inform the National Parliament about reasons of surpassing the debt level and about the measures to decrease the public debt.
- Public debt at 53% of GDP:
  - The Government has to propose to the National Parliament measures to reduce the debt; the salaries of the Government Members are frozen.
- Public debt at 55% of GDP:
  - Additionally to measures adopted under previous levels, the Government has immediately to cut 3% of the state budget expenditure (less the expenditure on (1) public debt service, (2) relations with the EU, (3) transfers from the state budget to the Social Insurance Agency and (4) liquidation of damages caused by natural catastrophes).
  - For the next year the government has to freeze the public finance expenditure (less the expenditure on (1) public debt service, (2) relations with the EU, and (3) liquidation of damages caused by natural catastrophes).
  - At the same time the municipalities have to freeze their expenditure for the next year (less the expenditure on (1) relations with the EU and (2) liquidation of damages caused by natural catastrophes).

    - Moreover, the Government has to stop drawing money from its reserve and from the reserve of the Prime Minister.
- Public debt at 57% of GDP:
    - Additionally to measures adopted under previous levels, the Government and the municipalities have to propose balanced budgets for the next year.
- Public debt at 60% of GDP:
    - Additionally to measures adopted under previous levels, the Government has to ask the National Parliament for the vote on confidence.

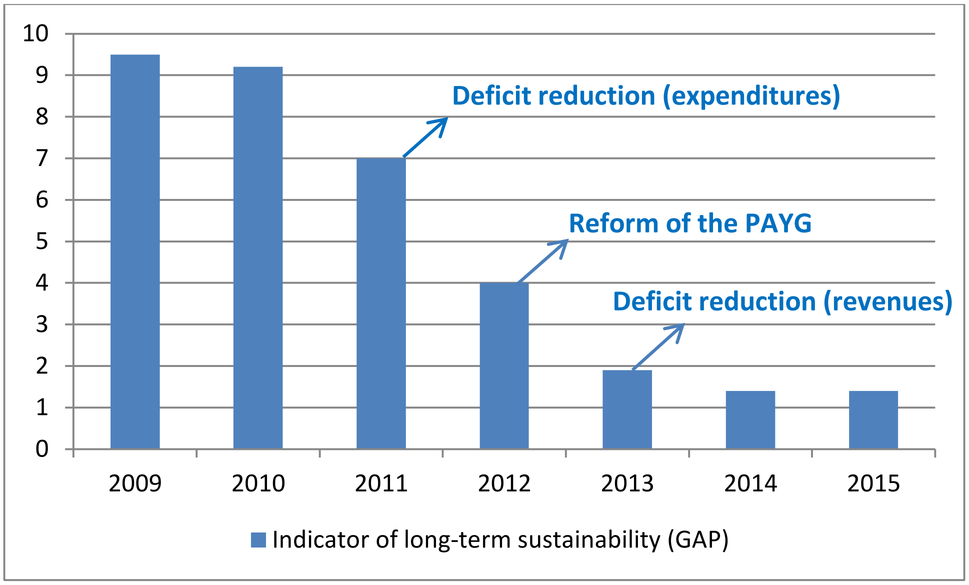
These debt brake levels are valid until 2017. In the transition period from 2018 until 2027 the limits will be decreasing gradually by 1 percentage point every year to final 40% for the lowest level and 50% for the highest level.

As shown in Figure 7 the 50% limit was surpassed in 2012 and the 53% limit was surpassed both in 2013 and 2014. In fact, early in 2014 the Eurostat confirmed even surpassing the 55% limit with the debt at 55.4% of GDP in 2013. However later due to adopting new ESA2010 methodology and especially new methodology for GDP calculation the debt level for 2013 was revised down to 54.6% of GDP and later adjusted to 55% of GDP.

The ESA2010 standards helped to disclose some hidden debt; nevertheless the public-private partnership (PPP) projects and part of the old debt of public hospitals remain off-balance. The biggest liabilities from PPP projects stem from the project on building a highway R1 in the amount of 2.7% of GDP and highway bypass of Bratislava in the amount of 1.4% of GDP. The old debts of state hospitals amount to 0.6% of GDP. Other hidden debt includes the off-public-balance-sheet debt of state and half-state firms (e.g. debt taken to pay-out the super-dividends; debts of firms owned by municipalities, etc.) as well as liabilities conditioned on ongoing court processes or state guarantees. The methodology for calculating this debt has not yet been set but the Council for Budget Responsibility estimated the conditional debt at 17.7% of GDP as of 2014; out of which 3.1% of GDP is EFSF.

Long-term sustainability: Besides public finance deficit reduction the reform to the pay-as-you-go (PAYG) pension system adopted in 2012 helped significantly to improve the long-term sustainability of the public finance when the long-term sustainability GAP indicator decreased from over 9% of GDP in 2009 to 1.4% in 2014. After the 2009 crises, major consolidation measures included cutting public expenses in 2011, binding the retirement age to longevity and gradual introduction of pension valorization by inflation legislated in 2012, as well as raising taxes and improving tax collection efficiency since 2013.

Figure 8: Long-term sustainability GAP indicator in Slovakia (% GDP)



Source: INEKO based on data from the Ministry of Finance (MF SR) and the Council for Budget Responsibility (CBR SR)

The 2012 reform of the PAYG pension pillar (linking retirement age to longevity and inflation indexation of pensions) contributed heavily to the stabilization of the pension system by halving its long-term deficit. However it did not solve the entire problem. According to the Institute for Financial Policy at the Ministry of Finance[24], the pension system deficit is expected to decrease from 1.4% of GDP in 2013 to 1.1% in 2030 but then to increase to 3.7% of GDP in 2060.

Current challenges and lessons learned: The need for public finance stability is becoming less imminent and the problem is less visible in the public discourse after reducing public finance deficit below 3% of GDP and public debt below 55% of GDP. The top government priorities reflecting people's concerns include high unemployment (especially long-term) and low quality of public services (especially in health care and education). Nevertheless the expert attention is still focused on following areas related to the public finance stability:

- Inefficiency and high indebtedness of the health care system; long-term predictions of growing deficit in health care and long-term care mainly due to demography changes
- Long-term pension deficit predictions, growing after 2030
- Inefficient use of the funds of the European Union which is resulting in substantial "corrections" meaning that the European Commission refuses to pay for some projects and the money has to be provided from the state budget increasing the public finance deficit
- Further improvement of tax collection efficiency; increasing revenues from the real estate taxes; deepening tax transparency

[24] Source: http://www.finance.gov.sk/Default.aspx?CatID=10181

The case of Slovakia shows that internal rules guarding public finances might work well if legislated by constitutional majority and controlled by high-quality and credible people in the leadership of the guarding body. The European Commission helped a lot by strengthening its oversight especially under the Excessive Deficit Procedure imposed on Slovakia in 2009-2013 but also by introducing the Fiscal Compact, disclosing some of hidden debts under ESA2010 and strengthening the Stability and Growth Pact. Importantly, the public discourse supportive for fiscal prudence helps a lot with major roles played by media, think-tanks, and economic analysts. As an example of think-tank initiative, early in 2014 the INEKO institute launched a computer game[25] aiming to educate public about the need of public finance consolidation. The game is based on the actual long-term public debt projections. The goal is to decrease public debt by 2062 as much as possible. The game allows for choosing from over 200 consolidation measures and limits the player's options based on his/her political support which depends on measures already taken. The biggest news portal SME.sk displayed the game on its website and helped to attract several tens of thousands of players shortly after launching the game.

[25] Source: http://hra.ineko.sk/

Increasing transparency and fight against corruption[26]

Key measures:

- 2000: Free Access to Information Act allowed everybody to demand almost all information from public institutions, organizations, from municipalities, individuals and legal entities financed by public budgets. The provision of information cannot be refused on the basis of "trade secret".
- Open legislation: The portal http://jaspi.justice.gov.sk offers complete information from collection of laws and official gazettes. It includes actual as well as older versions of particular legislation. The "track-changes" is used to mark most recent changes. The portal http://www.rokovania.sk includes complete information on the consultation of legislative proposals with full texting of comments and reactions. Thus also the process of creating the legislation is fully transparent.
- 2003: Online business registry (user-friendly, searchable)
- 2004: Specialized Court and Prosecutor's Office (focus on big cases, successful in deterring mafia, criticized for not solving corruption and politically sensitive cases)
- 2007: Online Land Registry
- 2011: **Publishing all property contracts and invoices of public institutions on internet.** The contracts are not valid unless they are published. This measure means a shift from on-demand (i.e. based on information demanded by citizens) to automatic transparency. It allowed for creation of searchable portals (such as http://tender.sme.sk) displaying and comparing relevant information such as who were the biggest suppliers to the state, at what prices, etc.
- 2011: Wider use of mandatory electronic auctions and other competition methods in public procurement. According to the Transparency International Slovakia this measure led to rise of bids in public tenders and to 6-15% savings.
- 2011-2012: Compulsory cash registration machines deployed since 1994 in retail services were equipped with a fiscal memory that records identification information about the user and the machine as well as all performed transactions. It is impossible to erase recorded information. The fiscal memory is not available to the user (it is sealed by the Ministry of Finance) and it must be possible to read it from the PC. Penalties if fiscal memory is missing: €330-3,300 after the first control and €660-6,600 after the second control.
- 2012: Publishing court rulings on internet, random selection of judges
- 2013: Ban on cash transactions over 5 thousand EUR for firms and 25 thousand EUR for individuals.
- 2015: Setting up a registry of "beneficial owners" of companies taking part in public procurement – this was a reaction to several scandals and suspicions of local oligarchs manipulating public tenders and hiding behind "shell firms" registered in tax heavens with untraceable real owners

[26] See also Goliaš (2013) and Zachar (2010).

- 2016: Introducing mandatory transparent banking accounts displaying revenues and expenditures of politicians and political parties related to their election campaigns
- Current challenges: “Value for money” project seeking to increase transparency and efficiency of public spending and decision making. The project includes open data initiative as well as measuring quality and efficiency of public expenditure and regulations.

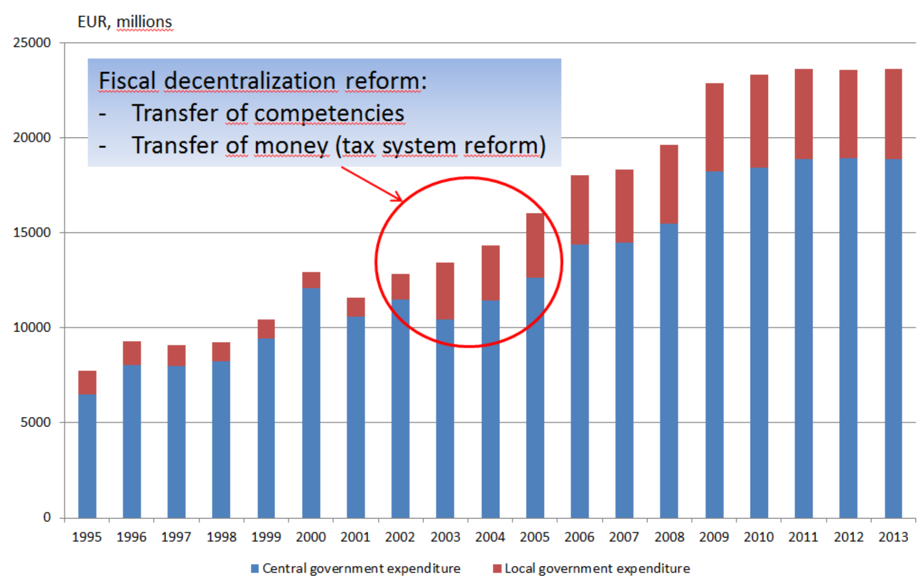
Other reforms

In this section we summarize key information about other reforms adopted in Slovakia after 1998.

Decentralization of power to municipalities and local governments (2002-2005)

- Shift of competences to regional governments and/or municipalities: Schools (pre-primary, primary, secondary), regional hospitals, polyclinics, social facilities, roads of lower classes, transport, construction permits, citizens´ registration offices, etc.
- Shift of money: Fixed share on income taxes revenues transferred to municipalities (68.5% of total personal income tax revenues in 2015) and regional governments (29.2% of total personal income tax revenues in 2015). The reform introduced comprehensive formulas for allocating funds to particular municipalities and regional governments. It is based mainly on the number of citizens of different ages, population density, surface area, altitude, etc. The municipalities and regional governments directly collect property taxes and some other minor local taxes.

Figure 9: Fiscal decentralization reform



Source: INEKO based on data from the OECD

Health care reform[27] (2003, perceived as less successful)

- Health insurers transformed to joint stock companies and some of them privatized (currently there are three insurers, the biggest one is state-owned), regulation of their profits based on waiting queues for selected diagnoses
- Transferring 59 regional hospitals to regional governments and cities; their transformation to non-profit organizations or joint stock companies; privatization of some regional hospitals

[27] See also Vagač (2013).

- Deregulation of prices insurers pay to hospitals; selective contracting with minimum net of providers given by the government; however, Slovakia is the last EU member without DRG payment mechanism
- Failure in introduction of legal marginal fees (per doctor visit, per nights spent in hospital)
- Failure in narrowing the scope of services covered from public money
- Drug prices referencing (based on three countries with the cheapest drugs in the EU)
- Currently: Implicit privatization of the biggest hospital – new hospital is planned to be built in a public-private-partnership project, replacing parts of the biggest state-owned hospital in the country
- Future challenges: Improving information/data, measuring quality, rankings

Social benefits reform (2004)

"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. The most important measures included:

- Introducing social benefits conditional upon activity: Part of benefit in material need payable only upon participation in activation works (20 hours per week) or requalification
- More frequent visits of unemployed at the labor offices
- Flat (i.e. not means-tested) child benefit payable if child attends a school
- Sickness benefits: In the pre-reform system, all sickness benefits were paid by the state. After reform, the period has split into a short-term and long-term part. First 10 days of a sickness leave is being paid by an employer – the benefit in the first 3 days is 25% of daily gross wages; in the other days (4 through 10), it is 55%. From the 11th day onwards, sickness benefits are being paid, as before, by the state, at 55% of the gross wage. 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 the reformed 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.
- Unemployment benefits: Eligibility period for benefits has been cut from 9 to 6 months. The benefits are paid on condition that the unemployed has contributed for at least 24 of the previous 36 months. The replacement rate is 50% of past gross income with certain ceiling.
- Current challenges: Designing tax-benefit scheme in a way that would further support incentives to start working and gradually withdraw from taking social benefits (introducing in-work benefits, gradual decreasing social security contributions for people with low income, etc.).

Recommendations

Ukraine represents a country of strategic importance for the countries of V4 as well as for the rest of Europe in terms of politics, economy as well as security. It should be in the V4 interest to have a stable and prosperous neighbor as it may enhance economic growth in the neighboring countries as well.

After the collapse of the USSR Ukraine and Poland were approximately on the same level. Both countries' GDP per capita was below 2,000 USD. Yet after 25 years Poland's GDP per capita in purchasing power parities is 3.3 times higher than that of Ukraine (based on The World Bank data for 2015). Other Central and Eastern European Countries showed similar GDP per capita and of course political standpoint although Ukraine was much tightly linked to the collapsed Soviet Union through both economy and politics. Now V4 countries are part of NATO, EU and Slovakia and the Czech Republic are part of Schengen. More importantly though V4 countries successfully liberalized their markets, attained rule of law at acceptable level, living standards and life expectancy increased, democratic institutions are well embedded in the system. Although still in transition V4 countries have demonstrated significant progress since the collapse of communism while taking different routes to attain the same goal. These success stories could and perhaps should be examples for Ukraine on how to transform into a modern liberal country.

There is no universal manual on how to execute the transition and indeed V4 countries each took different path however there are commonalities that serve to achieve the same goal that is liberal democracy. De-monopolization, transparent privatization of state monopolies and strategic companies, market liberalization, banking reform, exposure to foreign markets and of course foreign direct investments that are conditioned by favorable factors (rule of law, protection of private property and rights, reasonable taxation system, etc.). All are necessary steps if a country wants to prosper. Of course not all were executed without problems but Ukraine has the opportunity to learn from other countries' mistakes and attempt not to replicate them.

Successful and less likely to be reversed <u>reforms require broad and strong coalition</u> not only in the government but also in the form of inclusive institutions that ensure political and economic power cannot be monopolized by a narrow elite. Among others, the inclusive institutions that facilitate a reform process include:

- Functional democratic political system (e.g. fair competition of political parties)
- Strong property and ownership rights protection
- Strong independent regulatory authorities
- Market competition, effective anti-monopoly policy
- Rule of law, independent justice
- Independent and free media

Below are some of the more specific recommendations that were presented at the international conference "How to increase integration chances of Ukraine" taking place on June 3rd 2016 in Bratislava[28]:

Political economy:

- Mobilize pro-reform forces; create a strong informal pro-reform coalition with following key members:
  - Businesses independent from the government and monopolies
  - Independent and free media that together with NGOs and think-tanks act as watchdogs over the reform process
  - Reform minded politicians and policy makers who are willing to implement even unpopular reforms
  - Independent experts and analysts engaged in public discourse
- Reforms need be driven by motivated politicians who are willing and ready to fight vested interests and wider reform resistance (leadership), who understand why reforms are good for society (ownership), and who keep on explaining the details and the sense of reform process to the public (communication)

Taxation:

- Simplify the tax code (remove exceptions and exemptions, unify tax rates, etc.)
- Reduce direct taxes (on labor, profit) and compensate the budget by higher indirect taxes (on consumption)
- Decrease personal income tax and social and health contributions for people with low income to keep them motivated to work in the legal economy
- Introduce electronic system for monitoring value added tax (VAT) refunds

Labor market and education:

- Introduce flexible labor rules (e.g. weaker power of labor unions, more flexible hiring and firing procedures, more flexible part-time jobs, working hours, etc.)
- Increase risk of employing people illegally (tighter controls and sanctions)
- Introduce per-pupil financing at schools and partial rewards (tertiary and vocational secondary schools) based on the success of graduates in the labor market

Public finance and pensions:

- Strengthen independent analytical capacities at the Ministry of Finance
- Introduce public debt brakes
- Link pension contributions to benefits to keep people motivated to pay contributions

[28] See also http://www.ineko.sk/clanky/final-workshop-in-bratislava.

- Insure long-term financial stability of the pension system by parametric reforms

Privatization:

- Transparent partial or full privatization of strategic state companies to strategic investors by means of international tenders with price as the single winning criteria
    - Full privatization and clean-up of banking and insurance sector
    - [at least] Partial privatization of energy companies and telecom industry – the state can keep 51% majority and sell managerial rights to the investor
- Establishing strong and independent regulatory authorities
- Price liberalization (gas, electricity)

Anti-corruption:

- Empower people by a strong law on free access to information (on-demand transparency)
- Put information on-line (automatic transparency):
    - Obligatory publishing of public contracts (for scrutiny), court rulings, etc.
    - On-line business registry, land registry, legislation portal, subsidies, etc.
    - Open public data (crime, health, transport, budgets of public bodies, etc.)
- Introduce transparent banking accounts for campaigns of political parties and candidates
- Establish specialized courts, prosecutors, offices, agencies for high end corruption and organized crime
- Ensure independent control/disciplinary of police, courts and prosecutors

Efficient administration:

- Professional, well-paid and independent administration
- Central civil service office in charge of recruitment procedures, certification, training, code of conduct, etc.
- Decentralization

Others:

- Attract foreign direct investment (favorable business environment, rule of law)
- Reduce economic and energy (largely successful already) dependency from Russia
- Follow own comparative economic advantages
- Eliminate subsidies that drain the budget
- Protect small and medium enterprises (SMEs) from oligarchic intervention
- Liberalization of economy first and gradual regulation afterwards
- Take advantage of international support and cooperation opportunities (international cooperation as a tool rather than a goal)
- Focus on reforms with broad support to ensure continuity

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