

Economic and Social Contexts of Slovakia's Accession to the EU

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The accession to the European Union represents a unique historical chance and an existential necessity, which, from the standpoint of national and state interests, has no reasonable alternative. The elaboration of an initial study on the economic and social contexts of Slovakia's accession to the EU is an organic part of the successful endeavour to catch up with the first group of candidate countries. It was elaborated by the Institute of Slovak and World Economy of the Slovak Academy of Sciences on the basis of Governmental Resolution No. 248 of 13 March 2002.

The basic goal of the present study was to elaborate relatively comprehensive scientific arguments on economic and social contexts explaining the existential necessity of Slovakia's political and strategic direction to the EU. At the same time, it attempts to provide a balanced view of both the benefits and risks. On the one hand, it identifies certain potential problems and probable, in particular initial time limited risks, the reduction or elimination of which will require attention already in the preparatory period. On the other hand, it explains a wide range of benefits, the rational utilisation of which will give a guarantee of clear long-term advantageousness of Slovakia's integration to the EU.

The results of the study should significantly help overcome the low and insufficient availability of information and the consequential unrealistically optimistic and overly pessimistic expectations. Also related to this is the somewhat wide-spread presumption that a large scope of problems and difficulties in our economy and, in particular, the demanding nature of their resolution are or will be connected with and brought about by the integration into the EU. In this context, the study is designed to show that amid sharpened global competition we will have to cope with a major section of the problems anyway and the integration process is something that can facilitate and speed up the necessary adaptation to globalisation.

If we prepare for accession to the EU effectively and make use of the chances and possibilities related to it efficiently, the integration into the single economic area will act as a catalyst of the effective adaptation of our economy. In this respect, the study also pursues a certain mobilisation goal to help overcome the passive wait-and-see opinions and attitudes and increase motivation so that all structural parts of our economy, at every level, make the best use of the time remaining before Slovakia accedes to the EU and thus improve our readiness to make use of the advantages and manage the risks of integration.

Slovakia's economic and social position on the EU's doorstep

Macroeconomic and institutional framework of accession to the EU

Developments in transition economies and their comparison with economic development in EU countries prove that steadiness of growth is an indispensable condition for ensuring permanent growth at a pace sufficient to resolve the convergence task. This in turn (as experience shows) is largely conditional upon maintaining the economy in a state of balance, which requires both responsible economic policy, and, in Slovakia and in other transition countries, in particular the full completion of reforms.

The causality works in both directions in the relationship between stability and growth. The reason why emphasis was placed on just one of its sides, in particular on the direction of impulses flowing from balance to growth, is that Slovakia, endeavouring to accede to the EU, has a transition economy with strong imbalance creating factors and a poorly effective balance creating mechanism.

It is not the integration itself, but rather the current internal characteristics of the functioning of the Slovak economy that are the main risk factors threatening its stability. The chronic inclination toward imbalance caused by the insufficient level of competitiveness has been, on a number of occasions, eliminated only temporarily through various packages of stabilisation measures.

The high intermediate consumption and import intensity embedded in production makes the economy vulnerable. This is further amplified by the inclination of public finance to reproduce deficits and debts.

The final stage of preparations for accession to the EU must therefore be a phase of prudent fiscal policy combined with an effort to reform the problematic areas of the public sector. Along with the elimination of other deformations of the market environment, this should lead to the creation of conditions enabling the Slovak economy to behave as a standard market economy and thus eliminate the specific transformation factors affecting the cycles of balance fluctuation.

The maintenance of permanently high amount of investments in the Slovak economy can be regarded as its comparative advantage helping to preserve the long-term high-rate GDP growth. Compared with other transition economies, the investment intensity of economic growth in Slovakia reached a satisfactory level on the whole. It was also lower than the average in the EU-15 and in its south wing.

In 1993-2000 Slovakia's accumulation resources were extended by foreign resources to a greater extent than in other transitive economies. This on the one hand strengthened Slovakia's investment potential, but on the other hand endangered its macroeconomic stability, because, in particular before 1998 inclusively, loans (to a substantial extent state-guaranteed loans) prevailed over foreign direct investment in foreign resources.

One serious issue is the impact of EU accession on developments in the labour market. The analysis of present labour market trends indicates that forces already exist in the Slovak transforming economy, which, in the medium run (after the current downturn of the world economy is overcome), i.e. by the time of Slovakia's potential accession to the EU, will be able to make a more permanent turn in the so far negative development in employment and unemployment.

The developments in public finance in 2002 show that its reform has not reached a state that would ensure its enduring positive impact on macroeconomic stability.

Even though the lagging behind of institutional reforms (typical for the stages of transformation that have taken place so far) has made it possible

to achieve short-term positive results in monetary developments, this was at the cost of greater long-term problems and decrease in the Slovak crown's exchange rate. It has thus turned out that nominal convergence will not become realistically achievable until all structural changes necessary for the Slovak economy to become a standard functioning market economy have been carried out.

The main area of the present institutional reforms is the harmonisation of Slovakia's legal system with that of the EU (the adoption of the *acquis communautaire*). Slovakia has managed to catch up with other candidate countries relatively fast as regards the closing of negotiating chapters.

One part of institutional reforms is the reinforcement of law enforceability to which should help the ongoing reform of the judiciary, focused on improvements in judges' work and reduction of the time necessary for resolving individual cases.

Initial level of the Slovak economy's competitiveness

The key priority for candidate countries in the preparation for accession to the EU is the real convergence of economy from the standpoint of the achieved level of the economy's competitiveness.

The Slovak Republic is also facing the task of meeting the above criterion, because the level of the Slovak economy's competitiveness is as yet relatively low in general.

In gross domestic product (GDP), measured by per capita purchasing power parities (PPPs), Slovakia reaches only 49% of the EU average.

Another manifestation of low competitiveness is the trade balance deficit. In the 1994-1999 period, Slovakia had the deficit as a share of GDP - 7.2%. Compared with other candidate countries the Slovak economy has the lowest share of domestic production in domestic demand (consumption and investments).

The most serious fact, however, is that the main risks to the Slovak economy's competitiveness on the doorstep to the EU are caused by the considerable lagging behind in productivity. It only reaches roughly a half of the EU average (GDP per employee using the US\$ / PPPs) and only

about 20% when calculated using the current exchange rate. The low productivity is the decisive cause of low comparable price level which at the end of 2000 reached only 36% of the EU average.

The low qualitative competitiveness is still reflected in unfavourable absolute terms of trade. Export unit values in 2000 were still lower than import unit values (i.e. in comparison with foreign economies), even though some improvements had occurred. The highest disparity has been recorded in energy and capital intensive commodities (basically goods with a low degree of processing), which is also evidence of their highest competitiveness through prices. It is pleasing that export and import unit values of sophisticated products became much closer in 2000.

The key problem of increasing the Slovak economy's competitiveness lies in the reduction of the lagging behind in labour productivity, combined with an increase in the share of value added in gross production.

In 1997, for tradable goods (in industry) Slovakia reached only 32% of the labour productivity level in selected developed EU countries, when using value added as a measure. This was a result of the substantially higher productivity when using gross production as a measure (49%) and, contrarily, substantially lower value added rate (23%). In connection with low labour productivity and low value added rate in the Slovak industry compared with the EU average, Slovakia also records low per employee wages.

In 1997, Slovak nominal monthly wages per employee in the production of tradable goods reached only 10.3% of the level in advanced EU countries, 11.1% of the level in Austria, 9.1% of the level in Germany, and 17% of the level in Spain. Obviously, real wages per employee (measured by PPPs) were higher. Yet they were still only 28% of the level in selected EU countries.

Since 1989 the sectoral structure of the Slovak economy has become more similar to the proportions typical for EU member states. However, if we divide the structure of production and services into more detailed layers, the lower share of modern technology and knowledge intensive activities is apparent.

Slovakia achieves a relatively high level of labour productivity in the service sector, both in international comparison and intersectoral

comparison within Slovakia. What is particularly important is that labour productivity in this sector is increasing along with the increase in employment. Still, an international comparison of a more detailed structure of the service sector shows that most dynamically developing services in modern economies (financial services, research, and the whole spectrum of business services) are less developed in Slovakia.

Their share in employment reaches only half of the level in developed economies. The insufficient development of this group of services clearly indicates that Slovakia lags behind developed economies in an area that creates the necessary background for increasing the success of the export sector in quality competition.

Changes in the structure of manufacturing production carried out during transformation indicate that it is gradually becoming more similar to the structure typical for developed EU countries. The key problem of the Slovak manufacturing is no longer its structure at the level of sectors, but above all the slow introduction of new technology and knowledge intensive productions within individual sectors, without which faster increase in qualitative competitiveness is not possible.

The Slovakia's economic development is accompanied by the *creation and deepening of disparities between regions* (administrative regions, but especially districts).

The per capita GDP generated in the economically most developed Bratislava region in 2000 was twice the Slovak average and more than three times the per capita GDP in the least developed Prešov region. In the same year there was 56.7 job opportunities per 100 inhabitants in the Bratislava region, 29.8 in the Prešov region and between 33.2 and 40.8 in other regions. The average monthly income from work per capita in 2000 reached SKK 3328 in Slovakia, while it was SKK 1791 in the Prešov region and SKK 10434 in the Bratislava region. The unemployment rate in 2001 reached 24.8% in the Košice region and 8.3% in the Bratislava region.

These conditions should be created in the pre-accession phase already so that we can acquire finance from structural funds and the Cohesion Fund (SF and CF), preliminary budgeted to reach EU 1.8 billion in 2004–2006, during the first years following accession to the EU.

Benefits and risks of Slovakia's accession to the EU

Integration effects

More intensive inflow of foreign direct investment (FDI) to the Slovak economy is how the integration into the EU can help the most to ensure productivity growth, which is the key factor of a substantial increase in competitiveness. It can be expected that the EU single market will provide more opportunities for Slovakia in the field of foreign direct investment inflow by advancing the processes of intrasectoral micro-specialisation aimed at greater utilisation of economies of scale, as well as by deepening the process of product differentiation in the EU and imitation in Slovakia. Both of these processes will mean the deepening of the process of international redistribution of production within the enlarged EU, which is closely related to direct investment abroad.

This should lead to the gradual alignment of the volume of FDI in Slovakia with the volume usual in EU countries, where per capita FDI volume is substantially higher than in Slovakia at present (approx. US\$ 800 in Slovakia). The EU average is around US\$ 3,000.

According to model calculations, taking into account the above estimate of the developments in the FDI volume, productivity in Slovakia could grow at the average annual pace of 3.7% in 2004–2008.

If productivity grows as expected, the exchange rate deviation could fall from the level of 2.7 in 2001 to 2.0 at the end of 2008, which would be a considerable improvement compared with its stagnation, or rather increase, in the last decade. The comparative price level could become substantially closer to the EU average, from current 36% to around 46% in 2006 and 49.7% in 2008. This convergence should be mainly the result of increased domestic prices, but thanks to the rise in productivity, also the slight appreciation of the exchange rate.

Wages should increase together with the rise in comparative price level. According to a model calculation, compared with 2001 average nominal wages in Slovakia should increase 1.19 fold in 2003, 1.55 fold in 2006 and 1.88 fold by 2008. While for 2002 and 2003 the estimated growth is 8.7% (annual average), the average annual growth in wages in the 2004–2008 period is estimated at 9.7%.

The growth in real wages should temporarily slow down after accession to the EU, from the average annual rise of 3.6% in 2002 and 2003 to 2.7% in 2004–2006, due to the temporarily higher rises in prices in 2004–2006. Their growth could be higher again in 2007 and 2008 and oscillate around 4% (annual average).

Budgetary effects

The aggregate effect of the future tax harmonisation (rise in revenues from indirect taxes and decline in revenues from direct taxes) should be beneficial for the Slovak state budget as well as for the co-financing of structural projects. However, the decrease in direct taxes can be a stimulus for the development of the economy's supply side (introduction of modern technologies, product innovations, etc.).

The total amount of pre-accession assistance for Slovakia in 2001–2004 could reach Euro 414–614 million, which is SKK 18–27 billion.

Following accession to the EU, Slovakia will make use of the resources from EU structural funds and the Cohesion Fund. These receipts should not exceed 4% of GDP. The experience from other countries shows that Slovakia's capacity to absorb transfers from the EU will increase only gradually. The study estimates that in the 2004–2008 period Slovakia could realistically absorb funding from EU structural funds amounting to approx. SKK 12–18 billion annually (Euro 0.3–0.4 billion), i.e. approx. 1.1% of GDP. This would require that in the above period Slovakia annually allocate around SKK 15–20 billion in the state budget to co-finance the relevant projects.

The EC has meanwhile specified the procedure for the calculation of contributions from the new member states, which, according to preliminary estimates of the Slovak Finance Ministry, should reach around SKK 13 billion in 2004 (i.e. around 1.1% of GDP). The final amount of the contribution will be determined at the December EU summit.

Costs associated with the implementation of EU standards and regulations

Slovakia's accession to the EU will be associated with relatively high, mostly investment costs. Their basic cause is not the integration itself, but the forty-year long interruption in the development of a market economy in which individual areas were very neglected and destructed. The total cost of achieving compliance with EU standards and regulations in the field of the environment by 2007, or 2015, can be estimated at *SKK 120–140 billion* (in 2001 prices).

The total expenditure of enterprises incurred by the implementation of all safety and health standards is estimated at SKK 20–30 billion.

As regards the implementation of EU standards, the area of *energy* is of great importance. With respect to financial demands, Slovakia's accession to the European Union mainly relates to the security of energy supply and nuclear energy in this area.

One specific area of the negotiation and implementation process is *the area of internal security*, especially the Schengen Agreement. The costs associated with this are estimated roughly at SKK 1 billion.

Basic characteristics of macroeconomic scenarios

Overall economic and social trends on condition of anticipated accession of Slovakia to the EU in 2004 are elaborated in econometric scenarios. The revenue and expenditure effects related to the adoption of the principles of budgetary policy and implementation of the *acquis* will add around 1% to GDP growth. Real economic growth of the Slovak economy in 2004 – 2006 could reach 4,8% annually and as much as 5% in 2007 – 2008. Analogue real growth in overall labor productivity should oscillate around 3,5% - 3,9%.

Household consumption should increase in the 2004 – 2008 period at a pace of 4,4%, while the government consumption should decrease. Gross fixed capital formation in the same period should rise by 4,8% annually, but its share in GDP should decrease from 31% in 2001 to 27 – 29% in 2008. Gross national savings are expected to decrease from 26,6% in 2001 to 25,8% in 2008.

If the anticipated increase in competitiveness does materialize, exports should rise at the average pace of 12,2% in 2004 – 2008. At the same time, imports should rise slightly slower than exports and the current account deficit could therefore be reduced to acceptable –3,2% of GDP in 2008. Inflation rate should span from 7,1% in 2001 to anticipated 3,8 –5% as a result of the postponement of the necessary price de-regulations. These will have to be carried out in 2003, due to which inflation will rise again to as much as 6,1%. Inflation should be maintained at the level of around 6,7% in 2004 – 2006 and then should gradually fall to a level typical for developed economies.

Average nominal wage should increase by 8,7% in 2002 – 2003 and by 9,7% annually in 2004 – 2008. Thus it should be 1,88 fold higher than in 2001. Real wage should increase by 3,6% annually between 2002 and 2003. After slowdown to 2,7% in 2004 – 2006, the pace of its growth could oscillate around 4% (annual average) in 2007 – 2008.

Increase in employment of approximately 1% achieved in 2001 is expected also in 2002 and 2003. Employment should rise by 1,2% annually between 2004 – 2008, consequently the unemployment rate could fall from current 19% to the level of around 15% in 2008.

Model calculations of economic convergence show that GDP per capita using PPPs reached 48,5% of the EU-15 average in 2001. It should increase to 52,1% in 2004 – 2006 and 54,9% in 2007 –2008. Analogue model calculations of comparative price level show that the price level in Slovakia reached 36,9% of the EU average in 2001. It should rise to 44,6% in 2004 –2006 and 49,7% in 2008.

From the nature of model simulation calculations is apparent that presented results have only orientation character.