What reforms are required to achieve a sustainable convergence and how should they be implemented?

Written by Ivan Mikloš

Looking in retrospect at the experience gained during the 25 years of transition process in the post-communist countries, certain important insights and lessons emerge.[1]

In principle, a general rule applies – the more extensive are the reforms, the higher growth and the faster convergence they will generate. In terms of convergence, the top performers were five countries – Poland, the three Baltic States and Slovakia. In the period of 2000-2012, the average rate of convergence in these countries amounted to 21.4% of EU-15 average and, in all them, exceeded the 20% mark. By comparison, Slovenia and Hungary achieved only a 3% and a 7% rate, respectively. It is no coincidence that compared with less successful countries, the top performers have a much higher level of economic freedom (for instance, a much lower share of public expenditure in the GDP and a higher share of private sector in the economy).

In other words, economic policy based on liberalisation, deregulation and privatisation, on a free, open and fair competition, improves the business environment and makes it attractive for domestic and foreign investment. This kind of policy brings higher economic growth which, in turn, entails faster convergence.

When I speak about reforms, I refer mainly to macroeconomic stabilisation and to institutional and structural reforms. Macroeconomic stabilisation means primarily fiscal consolidation and financial restructuring, especially of the banking sector. Institutional reforms mainly concern the legal, regulatory and institutional framework of a functioning market economy, while structural reforms refer especially to those reforms that improve the business environment, increase economic freedom, ensure long-term sustainability of public finances and efficient public sector.

The Slovak reform story is the proof that consistently implemented, sufficiently vigorous, deep and comprehensive reforms bring not only very impressive, but also relatively quick results.

At the end of the 1990s, Slovakia's situation was very difficult and its economy faced similar challenges as are those faced by Ukraine today. Under Vladimír Mečiar's governments (1992-1998), the country sunk into international policy and economic isolation. Foreign investment was almost inexistent, the industry sector was obsolete and unrestructured, large state-owned banks were on the verge of bankruptcy, natural monopolies and large industrial enterprises owned by the state were poorly managed

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[1] Åslund, Anders, and Simeon Djankov. 2014. *The Great Rebirth: Lessons from the Victory of Capitalism over Communism.* Washington, DC: Peterson Institute for International Economics.

and systematically stripped of their assets, overemployment was artificially maintained, and privatisations were performed exclusively for the benefit of government cronies who paid only symbolic prices for privatised property. The government became the motor of corruption, insolvencies were on the rise, the government was unable to meet its obligations and had to borrow money at increasingly higher interest rates, which eventually exceeded 25%. The country was excluded from the first wave of EU and NATO enlargement and did not gain the membership of the OECD in the first wave of its enlargement, either (unlike the Czech Republic, Poland and Hungary). Mečiar openly advocated Slovakia's shift towards Russia. At that time, U.S. Secretary of State Madeleine Albright called Slovakia a "black hole of Europe".

A political turnaround occurred towards the end of 1998 with the advent of the first government of Mikuláš Dzurinda. By 2002, major deformations of the past period were eliminated, banks and certain natural monopolies were restructured and privatised, and the country caught up with its neighbours from the Visegrad Group (Poland, Czech Republic, Hungary, Slovakia) in the EU integration process. For all accounts and purposes, that government ensured partial macroeconomic stabilisation and accelerated the reform process (acquis communautaire). The second government of Mikuláš Dzurinda (2002-2006) completed the macroeconomic stabilisation and institutional reforms needed for EU integration and, in particular, implemented deep structural reforms. They included the public finance reform, tax reform, fiscal decentralisation, social reform, pension reform, labour market reform and healthcare reform. Most of these reforms were drafted in 2003 and launched at the beginning of 2004. The World Bank named Slovakia the world's leading economic reformer for 2004. The reforms literally brought a leap in the convergence during the years that followed their introduction. In the years 2004-2008, when the rate of convergence with the EU15 average was + 2% for Hungary, + 3% for the Czech Republic and + 6% for Poland, Slovakia's convergence rate stood at + 14%. The reforms introduced under two Dzurinda's governments, especially the second one, were the main driving force behind boosting Slovakia's per capita GDP to a level comparable with the Czech Republic, even though at the time of the split of Czechoslovakia in 1993 it was less than two thirds of the Czech GDP (62%). Also many other facts give evidence of the relatively fast pace of reforms. While as recently as 2000, the S&P rating of Slovakia was four grades lower than the rating of the Czech Republic and Hungary and three grades lower than that of Poland, in 2005 Slovakia had the highest rating of all the V4 countries (one grade higher than the Czech Republic and Hungary, and two grades higher than Poland).

Between 2000 and 2008, the country recorded the highest rates of economic growth in Europe, reduced unemployment from 20% to less than 10%, cut public deficit from 12.3% to 2.1%, reduced sovereign debt from more than 50% to 28% of the GDP, and decreased the risk of poverty to 10.9% (the third lowest in the EU), while the share of public expenditure in the GDP dropped from 51.2% to 35% of the GDP. At that time, we had the largest inflow of foreign direct investment in the region.

Finally, even though we were initially excluded from the first group of countries that applied for EU membership, we not only joined the EU in the first enlargement wave in 2004, but we also became the second country of that group (after Slovenia) that joined the Euro area, as the only V4 country to do so by now. From a country that 25

years ago did not make a single car, Slovakia became the largest per capita car producer in the world.

Slovakia is thus clearly an example of reform success; at the same time, however, it can become an example of getting stuck in the middle income trap due to the slackening of reform efforts. Where is the problem?

After 2006, reform efforts were significantly scaled back. The first government of Robert Fico reaped the benefits of the reform-driven economy but, although it did not reverse the existing reforms, it did not adopt any new and necessary reforms, either. The level of corruption went up and the public deficit and public debt rose significantly during the crisis years of 2009-2010. Although the short-lived centre-right government of Iveta Radičová of 2010-2012 achieved a partial consolidation of public finance and increased the flexibility of the Labour Code, it lacked the necessary time to carry out deeper reforms. The second government of Robert Fico (from 2012 to present) partly reversed certain reforms (such as tax, pension and labour market reforms), but it introduced practically no new and necessary ones. Nonetheless, Slovakia is still achieving a relatively high economic growth rate. This is largely due to the reforms adopted in the past; however, their effect is gradually wearing off. Thus, in the last two years, Slovakia has had the lowest inflow of foreign direct investment of the V4 countries.

We are trapped in a situation where thanks to the reforms and EU accession we became highly competitive in the large-scale industrial production (cars, white goods, TV sets, computers, etc.). Economic success means rapid growth. However, the faster the economy grows, the faster it loses its competitiveness because of the primary significance for large-scale industrial production of price competitiveness, based mostly on low labour costs. But rapid economic growth is also accompanied by a relatively fast wage growth which is, after all, the aim and desirable effect. Due to the fierce global competition in large-scale industrial production, price competitiveness risks to be gradually eroded. In some sectors, this has already become evident.

The only solution is the restructuring of the economy in favour of more sophisticated activities, services and production with higher added value. In other words, as soon as simple activities are relocated to cheaper countries, they should be speedily replaced by other, more sophisticated ones, with higher value added.

This logic finds a fitting expression in the classification of countries based on the level of their economic development and competitiveness, as is the one applied in the annual Global Competitiveness Index (GCI)[2] of the World Economic Forum (WEF). The countries of the world are divided into three basic groups depending on their economic maturity. The least advanced are "factor driven economies". Since their production factors (labour, capital and land) are not fully utilised, better use of these underutilised factors may generate economic growth. Economies of the second group are "efficiency driven"; this means that, in principle, production factors are fully utilised, but there is considerable room for improving the efficiency of their use. Policies and measures in this area will bring economic growth. The third group is represented by the so-called "innovation driven economies", in which there are no free production factors or significant possibilities for improving the efficiency of their

[2] http://www.weforum.org/reports/global-competitiveness-report-2014-2015

use. The key indicator, based on which individual economies are assigned to one of these three groups, is their economic level measured by their GDP per capita. The logic is clear – the more developed and richer are the economies, the less room there is to improve the use of production factors and their efficiency, and the more they depend on the innovation driven growth.

Thus, these economies must use innovation as the main source of their growth. In the latest GCI 2014-2015 ranking, the post-communist countries assigned to the third group of “innovation driven economies” include the Czech Republic, Estonia, Slovakia and Slovenia (based on the criterion of GDP per capita of more than 17 000 USD).

It is very important especially for these “innovation driven economies” to implement the reforms needed to avoid the middle income trap and enable their successful restructuring, moving from the assembly line economy (large-scale industrial production) to a sophisticated knowledge-based economy and society. In other words, to enable their successful and rapid convergence also after they have achieved economic and wage growth. Or, to put it differently, to enable them to reduce the weight and importance of price competitiveness and to increase the weight of non-price competitiveness (based on innovation, quality, originality).

Such restructuring calls for economic policies and reforms based on four key priorities and assumptions:

1. Sound and sustainable public finance
2. Efficient public sector
3. Positive and steadily improving business environment
4. High standard of education, science, research and innovation

Sound and sustainable public finance depends mostly on dealing with aging problem. Therefore pension reform, healthcare reform and social system reform will be the most important.

Effective public sector is connected with the best output (public services) under the least possible costs. Hence state has to provide **only** those functions that are inevitable in market economy. It means small but effective state.

Business environment improvement in all areas covered by Doing Business Ranking. Very important is interconnection between above mentioned priorities. For instance low tax burden as necessary precondition for good business environment but only in economy with effective public sector it is compatible with sound and sustainable public finance.

Education, science and innovation priority means that countries have to provide structural reforms based on opening system for more competition and strengthening motivation for public and private subjects to participate at this sector development.

Successful countries will be those that will implement economic policies and reforms necessary to systematically meet the above priorities and assumptions. In principle, this means ensuring macroeconomic stability and adopting institutional and structural reforms. These are, however, closely interlinked and interdependent issues. For

instance, fiscal consolidation aimed at ensuring sound and sustainable public finance should not be implemented at the expense of the business environment, or the short-term deficit reduction should not be pursued at the expense of the future. To illustrate this point, we may refer to the current Slovak reality. It is true that the government is cutting the deficit, but the manner of doing it worsens the business environment, fails to improve the efficiency of the public sector and, moreover, undermines the long-term sustainability of public finance. Consolidation efforts include virtually no cuts in unproductive public expenditure and, in principle, rely only on increasing taxes and contributions. Moreover, tax increases target direct rather than indirect taxes, although it is a known and generally accepted fact that raising direct taxes is a very harmful measure for growth and competitiveness of the economy. Instead of reducing non-productive costs (such as over-employment in the public sector, waste and corruption in public procurement), cuts are made in public investment expenditure, inhibiting future growth and development. The significantly reduced amount of contributions to the second pillar of pension savings and the decrease in the number of savers helped the government to achieve an immediate decrease of public finance deficit but, on the other hand, it has significantly increased the risk of the deficit of the pension system and of unsustainability of public finance over a longer term.

Interlinkages between and conditionality of the above assumptions and priorities thus mean *inter alia* that, to achieve successful restructuring and continued rapid convergence, it is necessary to meet assumptions in all the four groups. It is not sufficient to have sound and sustainable public finance, excellent business environment and efficient public sector, if we are not able to prepare and train qualified people capable of performing sophisticated, higher value-added work tasks. We will not be able to maintain stability of public finance without reforming healthcare and pension systems, we will not be able to improve the quality of education without reforming the school system, we will not be able to cut taxes and contributions without reforming public administration and streamlining the public sector, etc.

Thus, in the current reality of Slovakia, regression rather than progress is witnessed in all the four key assumptions. The public finance situation is admittedly improving, but in a harmful manner described earlier. The business environment is deteriorating, no efficiency improvements are achieved in the public sector, and the quality of education, science and research goes down rather than up.

Sustainable reform effort in above mentioned areas is the most important tool not only for further convergence but also for decrease regional disparities, reduce unemployment, fighting against corruption, poverty reduction, etc.[3] There is still strong underestimation of the free market reforms and overestimation of the state interventionism. Slovakia became biggest car producer without having any explicit industrial policy focused on this particular industry. We achieved it just by doing deep and comprehensive reforms.

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3 Ivan Mikloš: *Slovakia: The Latecomer That Caught Up* in Åslund, Anders, and Simeon Djankov. 2014. *The Great Rebirth: Lessons from the Victory of Capitalism over Communism.* Washington, DC: Peterson Institute for International Economics.

Global competition is a reality, and one of the few certainties we have is that it will be stronger and fiercer. In fact, global competition means competing for two key commodities – capital and talent. For "innovation driven economies", it is vitally important to succeed in the competition in order to avoid getting stuck in the middle-income trap. Reforms are a never-ending process, those who make them move ahead, those who stop making them, fall behind. Clear evidence is provided by the different performance of the countries that were in an identical or similar situation twenty-five years ago. I believe that this will be even more the case in the future than it was in the past. The complexity of the challenges we are facing in this respect is, however, enhanced by the reform fatigue and also the overall mind-set. In the stereotype that exists in many countries, needed changes and reforms are introduced only when the situation gets really bad and there is no other option, no other course of action. In such case, reforms may or may not be adopted and succeed (see Greece). But there is a problem that, after the most pressing problems have been addressed, reform enthusiasm quickly fades away. We should start to systematically build the culture of permanent change, culture of continuous improvements and reform of the country and its economy in the direction of creating prerequisites for a successful restructuring and convergence, for building consensus on change initiatives.

As was the case in the previous reforms, also today the key will consist in the political leadership and ownership of the reforms.