

# SLOVAKIA'S ACCESSION TO THE EUROPEAN UNION

## OUTSETS AND OPPORTUNITIES

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*The accession to the European Union represents a unique historical chance and an existential necessity that has no reasonable alternative in the term of Slovakia's national and state interests. 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. The study 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 aim of the presented study was to elaborate relatively comprehensive scientific arguments on economic and social relations justifying the existential necessity of Slovakia's political and strategic orientation on the EU. While doing so, it attempts to provide a balanced view of both the benefits and the risks. On the one hand it identifies several potential problems and probable, in particular those at the beginning, time-limited risks, the reduction or elimination of which will require to focus attention already in the preparatory stage. On the other hand, it explains a wide range of benefits, the rational use of which guarantees the undisputable long-term advantage of the SR's integration into the EU.*

*The study's results should also contribute signifi-*

*cantly to overcoming the low and insufficient level of information flow and the illusions, unrealistic expectations, exceedingly pessimistic expectations and myths. In a relation to this, there is a relatively widespread idea that the wide extent of the problems and difficulties of our economy, in particular the pains concerning their solution are or will be connected with or brought about by the accession to the EU. In this context, the task of the study is to show that we would anyway have had to solve a large part of problems in the conditions of sharpened global competition and that it is precisely our participation in the integration process that has facilitated and hastened the inevitable adaptation to the globalised environment. If we prepare for EU accession effectively and rationally take up the chances and opportunities connected with it, the integration into the single economic area will act as a catalyst for the effective adaptation of our economy. In this sense, the study has a certain mobilizing aim to assist in overcoming the passive wait-and-see opinions and attitudes and to contribute to raising motivation so that all the structural components of our economy at every level utilise the time remaining before the SR's accession to the EU and thus improve our readiness to take full benefit of the advantages and to manage the risks of the integration.*

### The Macroeconomic and Institutional Framework of EU Accession

The development of transitional economies and its comparison with economic development in the EU countries proves that an essential condition for ensuring a permanent and sufficiently (for convergence tasks) high rate of growth, is its balance. This, in turn, (on the basis of practical experience) is largely conditional upon keeping the economy in a state of balance, which requires both a responsible economic policy and foremost completion of reform, as well as in other transitional economies, in Slovakia indeed.

In the relations between stability and growth, the causality works in the both directions. 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 properties of the functioning of the Slovak economy that are the main risk factor threatening its stability. A chronic tendency toward imbalance caused by an insufficient level of competitiveness has been already eliminated several times by various packages of stabilisation measures.

The high demand for intermediate consumption and demand for imports embedded in production makes the economy vulnerable. This is further magnified by the predisposition of public finances to produce deficits and debt.

The final stage of preparations for EU accession 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 creating of the conditions necessary for enabling the Slovak economy to operate as a standard market economy and thus eliminate the transformation factors operating on cycles affecting the cycles of balance fluctuation.

The systematic maintenance of a high rate of investment in the Slovak economy may be seen as a comparative advantage contributing to maintaining its long-term high rate of GDP growth. Compared to other transitional economies, the investment intensity of economic growth in Slovakia reached quite a satisfactory level. It was also lower than the EU 15 average and in its southern areas.

In the years 1993 – 2000, own accumulated resources of the SR were increased by outside sources to a larger extent than in other transitional economies. This on the one hand strengthened Slovakia's investment potential, but on the other hand threatened its macroeconomic stability since before 1998 the outside sources were composed of more credit (in large part also with state guarantee) than foreign direct investment.

A serious question is the effect EU accession will have on development in the labour market situation. The analysis of the trends acting upon it indicates that in Slovakia's transforming economy there are already forces at work that (after overcoming the current weakening of the global economy) in the medium term, i.e. now in the time horizon of Slovakia's possible accession to the EU, will be able to bring about a more permanent turn-around in the so far negative development in employment and unemployment.

The development in public finance bears witness to the fact that its reform has not yet been implemented to an extent that would ensure their permanent positive influence on macroeconomic stability.

Even though the lagging behind in 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 field of institutional reforms at present is the harmonisation of the SR legal system with that of the EU (adoption of the *acquis communautaire*). Slovakia has managed relatively quickly to catch up with other candidate countries in adopting accession chapters.

A component of the institutional reforms is also the

strengthening of law enforceability, in respect of which reform of the judiciary is currently being undertaken and which is aimed at improving the work of judges and shortening terms connected with resolving individual cases.

### Slovakia's Initial Level of Competitiveness

The main priority for candidate countries in the preparation for EU accession is real convergence of the economy from the position of the level of economic competitiveness achieved. Slovakia also faces the task of fulfilling the mentioned criteria since the level of the SR's competitiveness in general is relatively low at the moment. Slovakia's GDP per capita at PPP is only 49% of the EU average.

Low competitiveness is also manifested in the level of the trade balance deficit, where Slovakia, in the period of 1994 to 1999, had a 7.2 % deficit in GDP terms. The Slovak economy in comparison with other candidate countries has the lowest share of domestic product to domestic demand (in consumption as well as investment).

The most serious, however, is the fact that the risks to the Slovak economy's competitiveness at the threshold of its entry to the EU are caused by a profound backwardness in productivity. It achieves roughly a half of the level of the EU average (GDP, USD, PPP per worker), or only approximately 20% when converted at the current exchange rate. Low productivity is the main cause of the low comparability of the price level, which at the end of 2000 was only 36% of the EU average.

The low qualitative competitiveness is still reflected in unfavorable absolute terms of trade. In 2000, kilogram prices of export were still lower compared to import prices, even though there was some improvement. The greatest disparities are observed in energy- and capital-intensive commodities (in essence goods with a low level of manufacture), what is also a sign of their best competitiveness by price. It is gratifying that the gap between export and import kilogram prices was significantly converged in the case of sophisticated products. The main problem to be faced in increasing the competitiveness of the Slovak economy lies in reducing the backwardness of labour productivity in combination with increasing the rate of added value in gross production.

In 1997 Slovakia achieved a labour productivity level in the case of tradable (industrial) goods of only 32% of added value in advanced EU countries. This was the result of a substantially higher productivity from gross production (49%), and conversely a substantially lower rate of added value (23%).



In connection with low labour productivity and the level of added value in the SR industry against the EU average, Slovakia also has a low level of wages per employee.

The nominal monthly wage per employee in the production of tradable goods in the SR in 1997 represented only 10.3% of the level of developed EU countries, 11.1% of the level in Austria, 9.1% of that of Germany and 17% of the level in Spain. Naturally, real wages per employee (at a recalculation to PPP) were higher. They were still however only 28% of the selected EU countries.

Since 1989, the sectoral structure of the SR economy has significantly approached the proportions typical for EU member states. In the layers of the production and services structure classified in more detailed segmentation, there is evident a lower share of modern technology and knowledge intensive activities.

A relatively high level of labour productivity is achieved by Slovakia in the service sector, both in terms of international comparison as well as on the basis of inter-sectoral comparison within Slovakia. Especially significant is the fact that labour productivity in this sector is increasing along with a growth in employment in this sector. In an international comparison of the more detailed structure of the service sector it is, however, shown that those services developing dynamically in a modern economy (financial services, research services and the whole array of business services) are less developed in Slovakia. Their share on employment reaches only half the level of that in developed economies. The insufficient development of this group of services clearly indicates a backwardness in comparison to developed economies in a field which creates an essential background for increasing the success of the export sector in a qualitative competition.

The changes in the structure of manufacturing industrial production made over the course of transformation indicate that this is gradually approaching a structure characteristic of developed EU countries. The main problem of the SR manufacturing industry is thus no longer its structure at the sectoral level, but primarily the slow course of its introduction of technology- and knowledge-intensive products in the framework of different sectors, without which any faster increase in qualitative competitiveness is not possible. The SR's economic development has been accompanied by the occurrence and deepening of disparities between regions (also especially between districts).

In the year 2000 GDP per capita created in the most developed Bratislava region was double than the SR average and more than three times that of the least developed Prešov region. In the same year

there were 56.7 job opportunities per 100 residents in the Bratislava region. The figure for the Prešov region was 29.8 and in other regions was 33.2 to 40.8. Monthly incomes from working activity per person in 2000 were on average SKK 3 328, in the Prešov region SKK 1 791 and in the Bratislava region SKK 10 434. The rate of unemployment in 2001 in the Košice region equalled 24.8% and in the Bratislava region 8.3%.

The stated conditions should have been formed in the pre-accession stage so that it is possible to obtain financial sources from the structural funds and from the Cohesion Fund (SF & CF) in the first years after the entry into the EU, preliminarily set at the value of 1.8 billion EUR for the period of 2004 to 2006.

### Integration effects

The determinant by which EU integration may contribute to increasing productivity growth as a key factor essential to increasing competitiveness is the greater inflow of foreign direct investment (FDI) into the SR economy. It may be expected that the Single Market will provide greater supply for Slovakia in the field of foreign direct investment, both in developed processes of intra-sectoral micro-specialisation with the aim of greater exploiting economies of scale, as well as a deepening in the process of product differentiation in the EU and imitations in the SR. Both these processes will mean a deepening of the process of an international redistribution of production within the framework of the expanded EU, which is closely connected with foreign direct investment abroad.

In the Slovak Republic, this should lead to a gradual achievement of FDI volumes common in the EU countries, where volumes at per capita recalculation are substantially higher than those at present in the SR (approximately 800 USD). The average for the EU is approximately 3000 USD.

According to modelling recalculations as well as with regard to the mentioned estimate of the development of the FDI level aggregate productivity could grow at an average rate of 3.7% annually over the years 2004 – 2008.

In the forecast productivity growth the exchange rate deviation could decline from the average rate of 2.7 in 2001 to 2.0 by the end of 2008, which would substantially improve against its stagnation or rather growth over the past decade. The comparable price level should significantly approach the EU average from the current 36% to 46% in 2006 and to the level of 49.7% in 2008. This will be brought about mainly by an increase in domestic prices, but also due to a growth in productivity and moderate appreciation in the exchange rate.



Concurrently with the increase in the comparable price level the wage level should also increase. The nominal average wage should - according to modeling calculations - increase in 2006 compared to 2001 by approximately 1.55 times and by the end of 2008 up to 1.88 times. Whereas in 2002 to 2003 its growth is predicted on average at 8.7% annually, in 2004 to 2008 its growth should be 9.7% annually (in the case of a later entry only 8% annually).

Real wages after two years of decline and negligible growth in 2001, should be rising by 3.6% annually between 2003 and 2004, nevertheless in the years 2004 to 2006 wage growth should slow to approximately 2.7% annually. In the period of 2007 to 2008 real wage growth could be around 4% annually.

### **Budgetary effects**

The overall effect of the future tax harmonisation (increase in revenue from indirect taxes and decrease in revenue from direct taxes) will be positive for the SR state budget, as well as for the co-financing of structural projects. The reduction of direct taxation however may be a stimulus for developing the supply side of the economy (introduction of modern technologies, production innovations etc).

The total amount of pre-accession aid for Slovakia in 2001 – 2004 could reach 414 to 614 million EUR, i.e. SKK 18 to 27 billion.

After the accession to the EU, Slovakia will use the sources from the structural funds and the Cohesion Fund. These receipts should not exceed 4% of GDP. The experience of other countries has shown that the SR's capacity to absorb transfers from the EU will increase only gradually.

It was estimated in the study that over the period 2004 to 2008 the SR could realistically absorb receipts from the EU structural funds approximately in the amount of SKK 12 to 18 billion annually (EUR 0.3 to 0.4 billion), i.e. about 1.1% of GDP. This would require the SR to set aside in the stated period roughly SKK 15 - 20 billion annually in the state budget for co-financing of the respective projects.

Meanwhile, the European Commission has set the procedure for calculating the contribution of new member states, which according to preliminary estimates of the SR Ministry of Finance should in 2004 be roughly 13 billion SKK (i.e. roughly 1.1% of GDP).

### **Costs associated to the implementation of the EU standards and norms**

The SR's entry into the EU will be connected also with relatively large, mainly investment, costs. Essentially these are not caused by the entry itself, but the

40-year interruption in the development of a market economy, during which individual areas were greatly neglected or even destroyed.

From the aspect of the environment as a whole costs for ensuring accordance with EU standards and norms by 2007, or respectively 2015 are estimated at 120 to 140 billion SKK at 2001 prices. Total costs of businesses for implementing all norms are estimated at SKK 20 to 30 billion. Estimated costs for implementing EU standards in the main areas of the SR agro-food sector by 2006 total SKK 14 to 20 billion. (Financial funds from the pre-accession and structural funds for this sector may be expected in the amount of roughly 10 to 15 billion SKK).

From the aspect of implementing EU standards the energy sector is of especial importance. Slovakia's entry into the European Union from the aspect of claims for financial funds in this field relate in particular to safety in the energy supply and nuclear power.

A specific field in the negotiation and implementation process is the field of internal security, in particular the Schengen Agreement. The costs connected with this are estimated at approximately SKK 1 billion.

### **Basic characteristics of the macroeconomic scenarios**

The overall economic and social trends in case of the expected accession of the SR into the EU in 2004 are displayed in econometric scenarios. Revenue and expenditure effects connected with adopting of the EU budgetary policy principles and implementing the *acquis communautaire* should contribute by approximately 1% to GDP growth. Real economic growth in 2004 – 2006 should be 4.8% annually and 5.2% in 2007 – 2008. Analogously, real growth in total labour productivity should be 3.5% and 3.9%.

Household consumption in the period 2004 to 2006 should reach 4.4%, while the share of state consumption should decline. Gross fixed capital formation during the same period should increase annually by 4.8%, whereas its share in GDP will fall from 31% in 2001 to 27 – 29% in 2008. As regards the savings rates, the forecast is of a decrease from 26.6% in 2001 to 25.8% in 2008.

At the estimated growth in competitiveness, over the years 2004 to 2008 exports should grow on average by 12.2% and imports by slightly less, at 11.0%, which should enable a reduction in the balance of trade deficit to an acceptable -3.2% of GDP in 2008. The rate of inflation should move from 7.1% in 2001, to a forecasted 3.8% – 5% in 2002. In consequence of the postponed necessary deregulation, which

must be carried out in 2003, inflation will then increase to 6.1%. In the years 2004 - 2006 inflation should be steady at the level 6.7% and then gradually decrease to a level normal for developed economies.

The average nominal wage should grow by 8.7% in the years 2002 – 2003 and by 9.7% annually in the years 2004 – 2008, where in 2008 the nominal wage should be 1.88% higher than in 2001. Real wages in the years 2002 – 2003 should grow by on average 3.6% annually. After a slowdown in the years 2004 – 2006 to 2.7% they could grow at around 4% annually during the years 2007 – 2008.

Growth in employment, which reached the level of 1% in 2001, is expected also in the years 2002 and 2003. In the period of 2004 – 2008 employment should grow by 1.2% annually, in consequence of which unemployment should fall from the present level of about 19% to a level of around 15% in 2008.

The model calculations of the convergence of the economic level show that in 2001 the GDP per capita at PPP indicator represented 48.5% of the EU 15 average. In the years 2004 – 2006 this figure should increase to 52.1% and in the years 2007 – 2008 should reach 54.9%. From analogical calculations of the comparable price level it results that the price level in the SR in 2001 reached 36.9% of the EU price level and that over the period 2004 – 2006 this figure should be 44.6% and in 2008 49.7%.

It is obvious from the character of the model simulation calculations, that the presented results are for orientation only.

Furthermore, impact studies, if they are about to fulfil their role, need to be updated repeatedly in order to take account of developments both within the EU as well as in the candidate countries and the specific effects, benefits and risks need to be incorporated into a recalculation under the changed conditions.

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