

Increasing value-added: Slovak Republic

Abstract

The Slovak Republic is the European value-added leader, increasing value added by 2.8 percent annually between 1995 and 2009. At independence in 1993, Slovak manufacturing was oriented towards heavy industry, but it was able to quickly diversify. First, productivity growth was possible due to employees moving from farms to high-growth manufacturing and services. Second, exporting enterprises in medium- and high-tech manufacturing industries were able to add value through new solutions: Slovak companies produced the second highest number of export discoveries in chemicals and third highest in animal products and raw materials in the region. Third, perhaps the biggest part of the story has been FDI, which grew from negligible amounts in the late 1990s to over 10 percent of GDP by 2010. Good policies encouraged this investment through a stable macroeconomic environment, targeted tax incentives, and a good business climate - which scored 41st in the World Bank's Doing Business in 2011, including top marks for new business registration. Fourth, unit labor cost growth has been more moderate in the Slovak Republic than in other CEE economies: in 2006, the minimum monthly wage in Slovak Republic amounted to €181 as compared to €223 in Poland, €230 in Hungary, and €280 in the Czech Republic. With its flexible factor markets and supporting policy environment, the Slovak Republic may remain a European leader in value added for some years to come.

Enhancing productivity allows economies to grow in the long run. Since independence, the Slovak Republic managed to undergo a substantial transition, and the country currently has the third highest GDP per capita in the region, after Slovenia and the Czech Republic. Even more importantly, after years behind the iron curtain, Slovak became an attractive location for foreign direct investment from around the world. Between 2002 and 2010 South Korea was the second biggest investor in Slovak Republic (12 percent of total FDI projects), after Germany (17 percent).¹

Leader in productivity

Thanks to FDI-facilitated productivity growth, the Slovak Republic is one of the European leaders in terms of value-added. According to the World Bank estimates, the Slovak Republic was able to grow productivity by 2.8 percent annually between 1995 and 2009.² The country was able to maintain high labor productivity growth between 1995 and 2009 (figure 15).

The influence of foreign FDI in the country's manufacturing is reflected in the sectoral composition of gross value added (figure 17, in the appendix). In 2010 manufacturing accounted for a third of gross value added, nearly a 10 percent increase from 1995.³ Agriculture's share remained practically intact at around 5 percent, while the role of financial intermediation and real estate diminished from 20 percent of gross value-added in 1995 to 15 percent in 2010. The share of services remained stable: Fernandes (2007) estimates that on average service sector accounted for around 50 percent of value-added between 1997 and 2004.

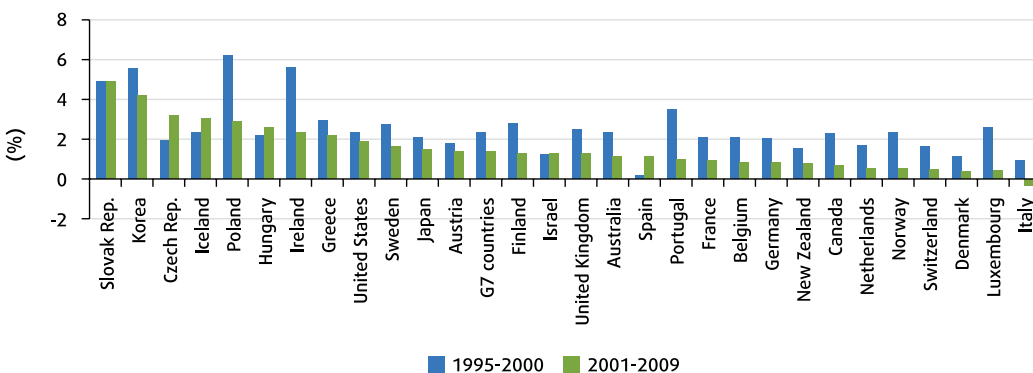
How to grow value added

Since the collapse of the Soviet Union and the country's independence, the Slovak Republic has undergone a difficult transition from a planned economy. The macroeconomic situation in



the 1990s was far from favorable: unemployment surged from 12.8 percent in 1992 to 15.6 percent in 1998, many companies in the industrial sector were struggling to remain solvent, and the state-owned banking sector was ineffective. It was only after 2000 that economic growth accelerated, surpassing 4 percent in 2002. Thus, starting from such a difficult position how was Slovak Republic able to keep its productivity growing at high and steady pace?

Figure 15: Labor productivity in OECD countries: average annual compounded growth rate 1995–2000 and 2001–09



Source: OECD.

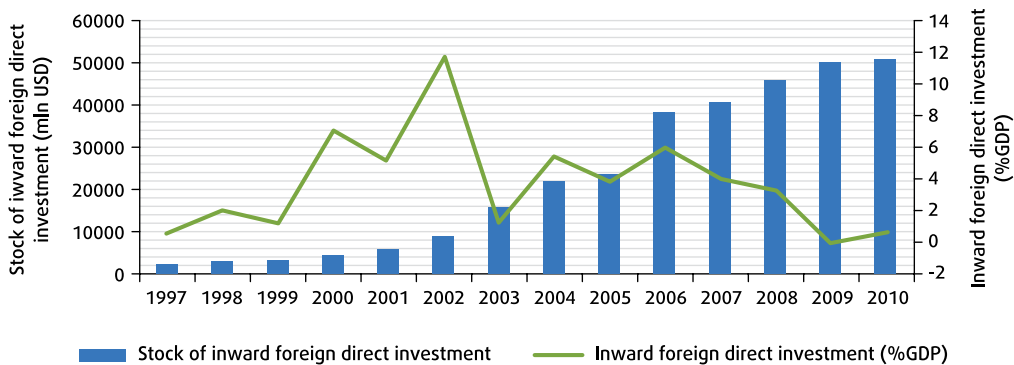
First, at independence in 1993, Slovak manufacturing, oriented on heavy industry, was able to expand its base into a variety of products. Increases in productivity were possible due to transition of employees from farms to high-growth manufacturing and service industries. Moreover, the structure of Slovak agriculture, consisting of large farms, allowed for greater capital investments and productivity increases in this sector. Exporting enterprises in medium- and high-tech manufacturing industries were added value through new solutions: Slovak companies produced the second highest number of export discoveries in chemicals and third highest in animal products and raw materials in the region.⁴ Alam et al. (2008) estimate that ICT-using manufacturing in the Slovak Republic contributed greater to a surge in value added than the ICT-using services.

Second, since the transition, the Slovak Republic has enjoyed growing inflow of FDI (figure 16). Foreign investment had a positive impact on productivity through a quicker capital build-up and transfer of technology. Companies ranging from German Siemens, T-systems, Volkswagen, and Deutsche Telekom; American HP, IBM, and DELL; French Peugeot, Citroën and Alcatel R&D; Korean Kia Motors, Hyundai, and Samsung; as well as Japanese Yazaki, Sumitomo, Panasonic, and Sony invested in the Slovak Republic. A bulk of these investments went to the manufacturing sector, most notably automotive. Although Volkswagen started investing in the country as early as in 1991, other investments came after 2000 (French PSA Peugeot Citroën in 2003 and Kia in 2004). Currently, the automotive industry remains a strategic sector for the Slovak economy: cars account for a quarter of manufacturing output. In 2009 machinery and transport equipment added up to more than a half of country's exports.

To stimulate foreign investments the government provided tax incentives; in 1999, the tax allowance for VW amounted to €31.2 million. A fairly skilled labor force seems to be more disciplined than those in other CEE countries; between 1998 and 2008 there were around 26 strikes and lockouts, in comparison to 77 in Hungary and 15,575 in Poland. Slower growth of unit labor costs was also beneficial for the productivity growth, especially when high appreciation of

real effective exchange rate after 2002 is taken into account. In 2006 the minimum monthly wage in the Slovak Republic amounted to €181 in comparison to €223 in Poland, €230 in Hungary, and €280 in the Czech Republic.

Figure 16: FDI in the Slovak Republic, 1997-2010



Source: Economist Intelligence Unit.

Finally, some also point out the policy improvements that allowed for higher productivity growth in the region. Slow at first, the pace of reforms accelerated after 1998, including reforms in the business environment, bank restructuring, and fiscal consolidation. After 2001 the government increased its commitment to joining NATO and the European Union. The government implemented reforms of tax rates: setting personal income and corporate taxes at flat 19 percent together with a single VAT rate.⁵ The country ranks 41st in the World Bank's Doing Business 2011 and does particularly well in registering property and getting credit. Alam et al. (2008) estimate that productivity gains from policy improvements, though moderate in comparison to other CEE countries, were the highest in terms of financial development, infrastructure stock and education.

How to maintain the momentum

Although productivity grew at remarkable rate in recent years there is a room for improvement. Slovaks still lag behind other industrialized European economies in labor productivity, accounting for less than a third of the EU15 average.⁶ Between 1995 and 2004 Lithuania, Poland, and Estonia were able to obtain higher labor productivity growth in manufacturing. In services, between 1994 and 2004 Slovak labor force was on average less productive than in Hungary, Poland, the Czech Republic, Slovenia, and Estonia but higher than in Latvia and Lithuania.

Another challenge for the future will be to raise country's competitiveness. According to the Global Competitiveness Report 2010-2011, the Slovak Republic ranks only 60th, behind the Czech Republic (36), Poland (39), Slovenia (45), Lithuania (47), Montenegro (49), Hungary (52), and Azerbaijan (57). The IMF (2009) recommends a continuation of structural reforms, keeping wage growth under control as well as improving the education system. The latter is particularly important as the inflow of foreign investments uncovered a shortage of skilled labor force, despite one of the highest unemployment rates in the EU (14.5 percent in 2010). Deficiency in an educated workforce is reflected in the education attainment levels: only 15 percent of Slovaks aged 25-64 obtained tertiary educations, just one percentage point more than half of the OECD average (28 percent). At the same time, DB (2011) indicates that paying taxes remains complicated.



Nonetheless, taking into account country's starting point, the improvements in productivity seem remarkable. IMF forecasts productivity growth to oscillate around 3.5 percent in the next years. Despite the downturn in 2009, FDI flowing to the country created more than 5,000 jobs, 44 percent more than a year before. Finally, thanks to the tripartite wage agreements signed in 2009, it will be easier to keep growing wages in line with productivity.

Sources

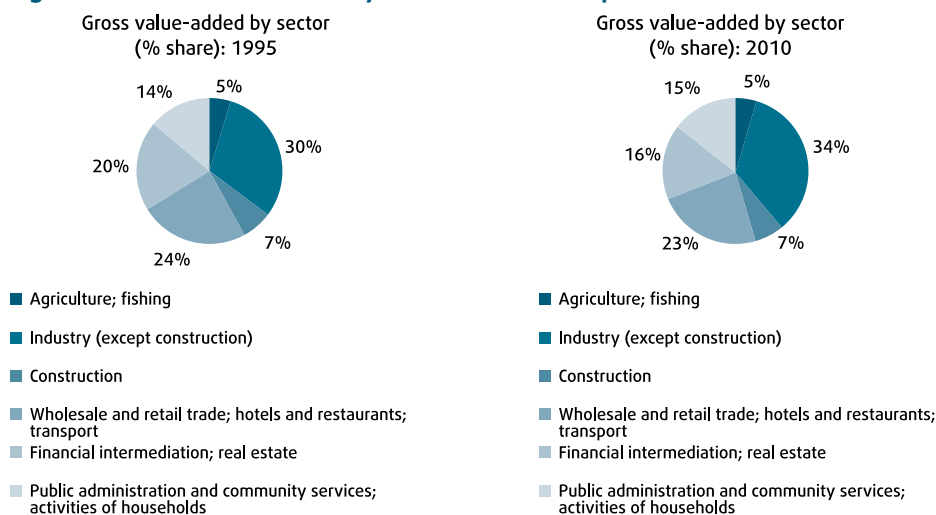
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Notes

- 1 Slovak Investment and Trade Development Agency data on finished FDI projects.
- 2 Compound average growth rate of value added in industry and services, constant prices in USD 2005.
- 3 Gross value added (at basic prices), Eurostat.
- 4 Region understood as Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia, Croatia, and Turkey.
- 5 Since then there have been some adjustments, but the basic architecture of the tax system has remained intact.
- 6 Reference period: 1995–2004, Alam et al. (2008) estimates.

Appendix

Figure 17: Gross value-added by sector in Slovak Republic in 1995 and 2010



Source: Eurostat.