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Slovak Republic

Summary of Joint IMF/EC Technical Assistance Follow-up Mission in Support of Public Expenditure Review

David Coady, Tom Boland, Jason Harris, and Claude Wendling



Aide Mémoire

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I. BACKGROUND

1. A joint IMF/EC technical assistance team visited Slovakia in May 2017 as part of its ongoing support for the Slovak Public Expenditure Review (PER) project. The purpose of the mission was to:

- Review progress in strengthening the institutional infrastructure supporting the PER project.
- Review progress in building on the results of the first round of spending reviews covering health spending, transport spending and IT spending.
- Review the interim reports from the second round of spending reviews covering environment, education and social benefits.
- Discuss next steps in the PER project and areas where ongoing technical support is most useful.

The discussion below summarizes the key issues discussed during the mission, including areas where further action is needed to enhance the effectiveness of the PER.

II. STRENGTHENING INSTITUTIONAL INFRASTRUCTURE

2. The creation of a dedicated Implementation Unit (IU) for the PER project is a significant milestone, and priority should be given to making this fully operational as quickly as possible. This is crucial for ensuring adequate monitoring and implementation of measures agreed under the spending review. The unit has been set up in the Office of the Deputy Prime Minister as of June 1, 2017, and a unit head has already been appointed. An additional four staff members will be added over the coming months.

3. Capacity is also being strengthened in other areas. Two more senior advisors will be appointed in the Ministry of Finance (MoF). In addition, staff at the VfM unit have gained very valuable experience in conducting the early rounds of the spending review thus enhancing the analytical capacity and increasing the effectiveness of the ongoing spending review. The spending review has also enhanced the capacities of the MoF, IFP and VfM to better understand sectoral policy issues and more effectively engage with line ministries.

4. A recurring issue is the importance of establishing clear spending baselines and the need for strengthening the engagement of the budget department of the MoF in the PER process. Clear baselines are needed to better understand spending pressures and to facilitate the implementation and monitoring of reform measures. It is also key to demonstrating the effectiveness of the PER at enhancing spending efficiency and value for money to the public and other stakeholders, especially in the context of expanding fiscal envelopes. The development of a more comprehensive medium-term budget framework would greatly facilitate this objective as would enhanced engagement of the budget department.

III. PROGRESS WITH FIRST ROUND OF REVIEWS

A. Health

5. The MoH has made significant progress in realizing the cost savings that were identified in the expenditure review and incorporated into the budget. The budget included a total of Euro 174 million in cost savings, mainly related to decreasing the cost and volume of health inputs (e.g., lower costs for drugs and equipment, and consolidation of hospital services and staff), including through standardizing prices across providers. It is expected that around Euro 130 million of these savings will be realized in 2017. A rationalization plan for the state General Health Insurance Fund has been drawn up with indicators for monitoring progress clearly specified and an emphasis on increasing transparency on different cost components to better understand the sources of ongoing cost pressures. However, although some progress has been made in reducing prescription costs, overall progress has been slow, partly because of the need for new legislation (e.g., to reduce exemptions from prescription limits). While the volume of medicines consumed has continued to increase, the pace of growth has at least declined. A Fund for Innovative Medicines is to be put in place, as well as an e-prescription portal (by October 2017).

6. The framework of the expenditure review has been crucial in ensuring that different stakeholders remain focused on realizing the identified savings. The explicit commitment to savings in the budget and the monitoring role of the MoF combine to reinforce efforts by stakeholders (including providers and suppliers) to deliver on these savings. It is therefore important that the new IU and MoF ensure that savings are indeed realized and clearly identified in budget line items. However, in the absence of a clear health spending baseline, savings continue to be absorbed by increasing spending elsewhere without a clear assessment of the cost-effectiveness of these spending increases. To further strengthen the expenditure review process, the MoF and IFP plan to devote additional analytical capacity to the health spending review.

B. Transport (and IT) Investment

7. While there has been little progress in realizing any operational savings, there has been significant progress in developing the process for selecting investment projects and improving the CBA methodology. The updated Framework for Assessment of Investment Projects (or “Green Book”) sets out clear guidelines on key ingredients in the investment appraisal process, including when to undertake a feasibility study and whose responsibility it is—the line ministry has responsibility for the investment process while the MoF has a responsibility to review this process and project evaluations. For motorway projects, these guidelines have been summarized in a two-page document along with key analyses and parameters that need to be applied. Specific methodology guidelines for transport and IT investments have been developed, and further sector specific methodologies will follow—projects funded through the EU already have their own methodology.

8. The VfM team have started to more routinely and rigorously assess projects, giving greater public and political visibility to resource allocation decisions. This helps to create an expectation that big projects should be properly evaluated against other alternatives. To date,

projects totaling 1.6 percent of GDP (or 1.3 billion euros) have been evaluated by the VfM team, including investments in highways, hospitals, rail wagons, and IT projects. These developments have also facilitated more regular engagement between investing ministries and the VfM team, and help promote more discussion on projects earlier in the project cycle. However, insufficient access to project level data and the use of often outdated transport models limit the quality of investment assessments made by the VfM team. It is often not possible to evaluate the data underlying the evaluation (e.g., cost data, traffic projections and sensitivity to key parameters) or to compare projects to alternative options (including better maintenance of first-class roads as opposed to new roads). These shortcomings should gradually abate as newer projects are required to do more complete and transparent evaluation.

9. The new Implementation Unit can play an important role in ensuring that recent commitments to enhance the investment process are achieved. The procedural measures recommended in the final report have all been approved by Cabinet and the MoF have been instructed to ensure these are implemented and to report on progress. However, this will require setting clear milestones and key performance indicators against which progress is evaluated. It will also require improvements in transparency of the data, assumptions and parameters that are used in project evaluations, and adequate sensitivity analysis to these and across various investment options.

IV. PROGRESS WITH SECOND ROUND OF REVIEWS

10. Given the timeline of producing draft final reports by the end of June, it is important for the technical teams to quickly move from diagnostics to identifying and costing specific policy proposals. All three interim reports were delivered on time and contained very valuable technical analyses. However, whereas the material in the interim environment report already identifies reform proposals, the education and social benefit reports contain mainly detailed diagnostics. It is also recommended that the final reports should be relatively short with limited diagnostic details and focused on a restricted number of targeted measures that are adequately costed out. The final reports could include recommendations for further analysis in areas where additional technical work is needed to support specific proposals. The interim reports could be appended to the final reports to provide technical support for the final proposals.

A. Interim Environment Report

11. The report has clearly identified key performance gaps in the sector within a framework that facilitates the identification of specific policy measures supported by efficient spending reallocations. The report has made very effective use of available data and existing reports, and interactions between the Ministry of Environment (MoE) and the MoF have been very effective. The key gaps identified are: a low recycling rate, low levels of wastewater treatment, and poor air quality. Public spending in the sector has been carefully mapped to the various sectoral activities, which will allow identification of savings and areas where spending needs to increase to help close performance gaps. The establishment of a clear baseline should also help to explicitly identify and monitor savings and reallocations going forward. The baseline

shows spending increasing from its current 0.6 percent of GDP to the EU average of 1.1 percent of GDP by 2019.

12. The report has already identified policy measures that can support improved spending efficiency. These include:

- *Solid waste management:* With the exceptions of bio-waste and paper, unused recycling capacity exists, so low recycling rates reflect insufficient incentives for separation of waste by users and for more efficient disposal of waste by collection agencies. The report identifies two policy levers that can address this: increases in landfill fees and complementary investments to facilitate separation of waste by households and enterprises—the current “pay as you throw” system is also apparently optional. Higher landfill fees are likely to act as a strong catalyst for redirecting waste from landfills towards recycling thus reducing landfill and incinerator costs. Consideration should be given to a gradual introduction of higher landfill fees as complementary measures are introduced to support behaviors conducive to increased use of recycling (including a strong communications campaign and possibly subsidies to local authorities). Based on discussions with the technical team, landfill closures could provide savings of one-third of current spending on landfills, while providing households bio-containers would cost less than EUR 40 million. There is also a need to improve the collection of data on recycling and the methodology for calculating recycling rates and patterns.
- *Wastewater treatment:* A key factor in low rates of wastewater (sewerage) treatment is the lack of connection by residents to the existing public sewerage system. In 2014, approximately 280,000 residents with access have not connected, and these reside mainly in small municipalities that are not eligible to access EU funds and therefore need to rely exclusively on funds from the state budget. This nature of this barrier to connections needs to be analyzed further to identify appropriate policy remedies, including the roles of public and private financing. In addition, there is a need for greater transparency regarding the factors behind the choice of projects by the Environmental Fund and their performance; resources seem to be spread across many small projects without specifying clear deliverables and timelines to facilitate monitoring of performance. This may also contribute to a better understanding of the reasons behind low connection rates.
- *Flood protection:* It appears that project selection does not currently rely exclusively on calculated prioritization scores required by the EU OP Environment; the report has calculated that strict compliance to scores would have significantly increased performance in terms of averted damage by a factor of three or four. It is therefore important to better understand why selection deviates from these scores to help identify possible solutions. It may be that the first-come first-served basis unduly biases selection towards municipalities with higher administrative capacity and financing options, or varying challenges related to land ownership and the need for planning permission. There is also a need to assess the evaluation methodologies to ensure they are consistent with best practice. The final report could request the relevant bodies to propose a clear plan for addressing these issues.
- *Air pollution:* Air pollution levels are above average for the EU. This appears to be due to high use of solid fuels, especially outside of cities and in more rural areas. This is thought to partly reflect high use of low-quality wood, which is available free from forests, and coal. Deeper

analysis is needed to understand this energy consumption pattern, and the possible policy solutions including better management of forests and the potential for introducing more fuel-efficient burners. There may also be significant room to reallocate investments, which currently seem to favor large emission sources despite these accounting for only 20 percent of total emissions. This could be complemented by strengthening of regulations on use of environmentally damaging fuels. At the same time, specific policies for addressing pollution from large emitters, such as U.S. Steel and SE in Prievidza, may be warranted.

13. There is significant room for improving the overall sectoral investment planning, appraisal, selection and management process to bring it closer to best practice. As already indicated above with regard to wastewater treatment, this is especially true of investments financed through the Environmental Fund, which accounts for a large share of total environmental investments. Specific sectoral guidelines for the investment could be developed in conjunction with investment procedures being developed by the MoF; as a first step, standards should be raised to those required for EU funding given the importance of this financing in the sector. For example, improving resource allocation in nature conservancy will require a substantial enhancement of supporting data, the establishment of clear objectives and priorities, careful identification of potential projects and policy levers, strengthening of the administration system (including through better information collection, storage, and analysis), and an evaluation of alternative financing mechanisms.

14. Realizing improvements in spending efficiency will require the development of reform packages that facilitate reallocation of spending. For example, while increased revenues from the landfill would accrue to the Environment Fund, policy initiatives outside of the fund will need to be financed. This will require a reallocation of funds from areas where cost savings are identified as well as effective allocation of EU structural funds. The analysis of the operational efficiencies in the environment ministry and other bodies (Slovak Environmental Inspection; Environment Fund, Slovak Water Management Enterprise SVP) may also provide opportunities for cost savings that could be redirected to more effective uses. A recent consultancy report of SVP identified possible savings of 30 percent in operational costs (or Euro 25 million). In the Environmental Fund, the need for improvements in revenue and expenditure forecasts for better resource management has been flagged, as has the high percentage of unsuccessful applications (80 percent) which increases the administrative burden.

B. Interim Education Report

15. The report has identified a range of challenges facing the education sector that result in poor (and deteriorating) education outcomes and undermine spending efficiency. These vary across the various levels of education:

- *Primary and secondary:* Low teacher salaries raise concerns about the sector's ability to attract high quality graduates, and salaries seem to be particularly low for younger teachers, putting them at a significant disadvantage compared to graduates with similar levels of education working in other sectors. At the same time, there are serious shortcomings in the performance appraisal and professional development system, and thus very weak links between performance and salary increases. There is also a need to consolidate schools—a

commitment made in the government's manifesto—both to facilitate enhancement of the education infrastructure and quality of teaching, and reduce operating and fixed costs.

- *Higher education:* Performance is below international standards, while the current funding formula is not adequately linked to performance in teaching and research and the accreditation system for universities does not meet international good practice. The structure of courses is also skewed towards five-year degree (“Masters”) programs resulting in a very high share of postgraduates to undergraduates compared to other European countries.

16. The report also highlights key policy reforms that are needed to raise education standards and improve the efficiency of public spending. These reforms will require building support among the various stakeholders by developing a common vision centered around the need to enhance education outcomes.

- *Primary and secondary:* There is a need to establish a stronger link between teacher pay and pay progression and teacher performance (e.g., through a system of bonuses). While pay is an important consideration, not least in attracting high quality students to the profession, performance improvements of the kind needed should also be supported by enhanced teacher training and improved teaching development and assessment; the report stresses the need to identify criteria for assessing teacher skills in a school environment as part of teaching certification. In addition, there is a need to develop local incentives to promote school network consolidation, e.g. by linking new infrastructure investments to consolidation and possibly adjusting the funding formula which currently gives higher per capita funding to small schools. Once an appropriate funding formula is in place (e.g., better reflecting the teacher salary structure and cost differences across ISCED 1 and 2), it should be rigorously implemented to ensure that spending trends reflect falling student numbers. This should be motivated by the objective of improving education outcomes, e.g., by demonstrating that well equipped larger schools produce higher quality teaching and education outcomes based on domestic and international studies. The report estimates cost savings associated with optimization of the school network: optimization at the ISCED 1 level would generate annual potential savings of over Euro 15 million; consolidating other levels (different school founders?) would generate around Euro 6.7 million; and closure of schools smaller than 50 students supported by the provision of free school buses would generate Euro 12 million. Gradual consolidation would also allow pupils and their parents to “vote with their feet”.
- *Higher education:* There is a need to establish a financing formula that reflects not only the numbers of students admitted but also teaching and research performance. Enhanced performance of the higher education institutions will also require improvements in the accreditation and quality assurance systems to bring them up to ENQA standards. Consideration should also be given to introducing institutional performance contracts with a clear focus on outcomes and to increasing the share of competitively awarded grants. A focus on outcomes could be supported by the results from employer, graduate and student surveys. The report also estimates that reallocation of funding across undergraduate and postgraduate degrees (possibly by raising postgraduate entry requirements) would save over Euro 50 million annually.

17. There is a need to establish a clear spending baseline to facilitate the identification of the spending implications of reform measures identified in the expenditure review. This

includes identifying reallocations within the baseline, and their implications for spending efficiency. This will require projections for different spending components (e.g., wages and operating costs) across different education levels, and should reflect falling numbers of students in primary and secondary education and rising numbers in higher education from the relatively low existing levels. Since the government committed in its manifesto to increasing spending by Euro 2 billion over four years to bring education spending to the EU average by 2020, it is important that these spending increases are accompanied by the reforms discussed in the report to ensure improved education outcomes. Approximately two-thirds of the committed increase in spending is allocated to primary and secondary education, with the remainder allocated to higher education, of which around 50-60 percent is slated for salary increases.

C. Interim Labor Market and Social Policy Report

18. The report provides a very comprehensive analysis of a wide range of social benefits and identifies key policy issues. The analysis covers both universal and means-tested benefits, social care spending (e.g., on the severely disabled and long-term care), the voluntary pension system, and employment trends. The report points to areas where further work is warranted to inform reform efforts:

- Although poverty is relatively low, there is a need to better understand the factors behind remaining poverty. A more granular analysis would distinguish between age and skill groups as well as regional differences.
- A large percentage of spending is absorbed by universal family benefits, which reduce the share of benefits accruing to lower income groups. In particular, the child benefit system is very generous and potentially regressive at older ages if a smaller proportion of lower-income groups enroll in higher education.
- While the unemployment benefit and the minimum income programs are not overly generous, their current design does not reflect good practice. The report should discuss the methodology for establishing minimum income thresholds and their adequacy as well as what income is included and excluded from the calculation of family income to establish the income gap to be filled.
- While incentives for entering the labor force remain strong, they are much weaker for very low income group. It is therefore important to have a clear understanding of the characteristics of this group.

19. The discussion around the report identified a range of issues that should be addressed to facilitate the identification and costing of a package of policy measures to improve spending efficiency. These include:

- The underlying fiscal and spending context of the spending review should be further developed. Slovakia will face significant spending pressures over coming decades, especially in the areas of pension spending and social care as the population ages. Addressing the spending pressures due to population ageing will also require policies to increase labor force participation across the population, and reducing current unemployment levels.

- There is a need for a clearer delineation of the links between the topics covered in the report. The four main issues covered are the design of social transfers, the design of social care benefits, the voluntary pension system, and the objective of increasing employment.
- Reform of the minimum income program to improve coverage of the most vulnerable may require additional resources.
- Efforts to increase female labor force participation may need to be supported by targeted spending measures such as childcare subsidies and tax incentives.
- The discussion of potential reforms of the voluntary pension system needs to be better embedded in a discussion of challenges facing the overall pension system.
- Financing these spending pressures should include measures focused on reallocations within the current spending envelope. These could include reducing the duration of child benefit below its current high level and improving the progressivity of the benefit structure. The reform of benefit indexation may also facilitate gradual reform.
- There is a need to strengthen the involvement of the line ministry to ensure political ownership and support for identified reforms.

20. There is a need to establish a clear spending baseline to capture existing spending pressures and to clearly identify the spending implications of reforms and to monitor their implementation. In particular, baseline spending should reflect demographic trends related to population ageing. The current role of benefit indexation also needs to be clarified. Spending projections could be usefully informed by an analysis of recent trends in different spending components and the underlying forces driving these trends.

V. NEXT STEPS

21. It is important to start thinking of what will be the focus for the remaining spending reviews. Since the big spending ministries have already been covered, the spending in the remaining ministries is not as large and involves mainly staff and operational expenditures. However, the Ministry of Interior, Ministry of Defense, and Ministry of Agriculture still have significant budgets. Horizontal equity considerations would suggest these and other ministries be next in line for a spending review. An alternative would be to focus on economic classification of spending across sectors, such as wage bill spending or spending on goods and services. Other possible areas include the pension system, improving socio-economic outcomes in the Roma community, long-term social care, and cross-sectoral operating costs.