

Contemporary Flat-Tax Reforms in Eastern Europe: Causes of Diverse Approaches

A comparison of Slovakia, Czech Republic and Germany

by

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Abstract

The thesis deals with the issue of contemporary flat-tax reforms in Eastern Europe and aims to account for the different approaches that various European countries adopted towards the idea of a flat-tax. Empirically, the thesis is based on detailed studies of Slovakia, the Czech Republic and Germany. The analysis considers three factors being decisive for the flat-tax feasibility: 1./ party system institutionalization, 2./ coalition/opposition cohesiveness, 3./ labor unions' institutionalization. First, the study is concerned with each of the factor's influence on the political decision-making process in the three country cases. Secondly, on country paired comparisons the findings for each of the countries are mutually contrasted. Although all identified factors seem to be at play with regard to flat-tax feasibility, I argue that it is either the strength or the weakness of labor unions' institutionalization and welfare identity that underlie the political decision-making in the East and the West and as a result determine the flat-tax (un-)feasibility. The absence of welfare identity in the East allows for higher coalition cohesion in favor and weaker opposition against the flat-tax adoption in contrast to the West.

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Introduction

The so called “flat-tax tide” that has recently swept the emerging markets in Eastern Europe (EE) characterizes their attempts to catch up with the advanced Western part of Europe. The term is used to describe tax reforms in a number of EE countries that have introduced flat rates in their tax systems (either on personal incomes, corporate incomes, VAT, or all of them). The emergence of the flat-tax tide faced harsh criticism coming especially from the large states in Western Europe, most prominently Germany and France. This is largely due to the fact that the Eastern European flat-tax reforms were simultaneously accompanied by a considerable lowering of tax rates. The countries of EE were accused of “social dumping” and proposals preventing them from accessing the financial resources from the Social and Cohesion funds of the European Union (EU) were put forward. The key observation informing this paper, however, is that the critical voices became loud only once such tax reforms proved politically unfeasible in Western Europe. At the same time, a closer look at EE shows that not all countries have chosen the path of adopting flat taxation and those that have, differ significantly.¹

The question that offers and needs to be addressed briefly is what motivations lead the countries to consider the implementation of the flat-tax. The fact that they were initiated in Europe by the post-communist countries is the result of the need for reform of the inefficient and complex tax systems characterized by high rate of tax evasion (black economy) the countries inherited from the previous regime. The tax evasion was a particularly problematic issue given the rising budget deficits of the post-communist

¹ The flat-tax introduced in EE differed in: the level of the flat rates, flat-tax application in all PIT, CIT, VAT or exclusively in some of these, introduction of equally high flat-tax rate for all PIT, CIT, VAT or different flat rates for each of them, etc.

countries. Also a tax reform was needed that would increase the country's competitiveness and stimulate economic growth. Therefore, the key expectations that the new tax system was to meet were: simplification, transparency, efficiency, stability, business attractiveness. The adoption of flat-tax seemed to be the right step towards achieving all four requirements, whereas lowering the tax rates should additionally stimulate the business environment (this is what largely explains the observed interconnection of flat and low taxation in tax reforms in Eastern Europe). From the above mentioned features of flat-tax, what appeared particularly attractive to the Western European countries, for example to Germany, was its simplification (given the complex German tax system with numberless tax exemptions.) What, however, was less appealing to Germany were the low tax rates, which could hardly finance the expensive welfare state, unless a structural reform of welfare system was initiated simultaneously. A seeming "triviality" that could, however, impede the feasibility of flat-tax in Germany.

The thesis sets the goal to understand what factors can account for the flat-tax feasibility in some countries, but not others. Therefore, it thesis asks the following question: what are the causes of divergence in the approaches to flat taxation between Western and Eastern Europe on the one hand (Germany vs. Slovakia, Germany vs. the Czech Republic), and among the countries in the East on the other (Czech Republic vs. Slovakia)? More specifically, the thesis develops a comparison of the country cases and assesses the similarity of the reasons given for the (un-)feasibility of (radical) flat taxation in the East (Czech Republic) and those in the West (Germany).

The analysis will be based on the study of three countries: first, Germany as the representative of the Western part of Europe and an example of a country where such

reform proved politically unfeasible. As a result, the unfeasibility led to criticism of similar reforms/reform attempts in Central and Eastern Europe (CEE). The second country case, the Czech Republic, is a representative of the Eastern part of Europe that has not introduced flat taxation, but is currently undergoing the process of tax reform (in which, interestingly, flat taxation has become of central focus). Finally, the last country case studied in the thesis is Slovakia, being in the position of a proponent of flat taxation in EE.

Drawing on the relevant literature, discussed in more detail in the first chapter of the thesis, I will look at the flat-tax reforms (and reform attempts) in all country cases and will address the question of the feasibility of the flat-tax adoption. I propose three key aspects as decisive in the flat-tax implementation debate: 1./ the political parties' institutionalization² 2./ the factor of government coalition cohesiveness and 3./ the level of the institutionalization of social actors. With regard to the social actors, the focus is made particularly on the position of labor unions in the political system and the society more generally. Such narrowing seems viable as the workers' organizations from among all interest groups are expected to be most biased against such radical and neoliberal reforms (favoring mostly businesses) as is the flat-tax. The expectation is, the higher the political parties' and labor unions' institutionalization, the less prone is a country to flat-tax implementation. Also the lower coalition cohesion appears to work rather against the flat-tax. In addition to the already mentioned factors affecting the flat-tax reform feasibility, the analysis will briefly sketch the initial conditions and motivations for the flat-tax adoption in each of the countries, in order to build an understanding of the reform impetus.

The thesis is structured as follows: the first chapter offers a critical overview of the relevant literature and is useful in narrowing down the scope of my argumentation, as well as

² as suggested by O'Dwyer (2006). See the Background and Literature Review chapter for more detail.

in identifying the research gap and the potential determinants affecting the feasibility of flat-tax. The second chapter deals with flat-tax approaches in the East. Using the individual cases of Slovakia and the Czech Republic the feasibility of flat-tax is being assessed based on the three factors of political parties' institutionalization and their ability to form cohesive coalition (and opposition) and finally, the labor unions' institutionalization. A similar approach is used in the third chapter devoted to Germany, the representative of the West European flat-tax resentments. The fourth chapter is crucial due to its comparative analysis integrating the findings. The paired comparisons of Germany and the two East European countries suggest the persistent divergence between the old and the new members of the EU. The paired comparison of Slovakia and the Czech Republic shows a variation within the EE region. At the same time, the comparative approach will try to determine which of the studied factors plays the most decisive role in the flat-tax adoption process. The conclusion will summarize the argument and the solutions to the research question raised in the introduction.

1. Background and Literature Review

Extensive literature already exists dealing with the issue of persisting social and economic divergence between the old EU members and the new Eastern European members. Most recently, the dividing line between the two parts of the EU could be observed with regard to the perception of tax competition. Tax competition is hardly a new phenomenon and the numerous attempts on the EU/EC level, as well as under OECD auspices to regulate or harmonize the tax rates have failed repeatedly.³ Since the spread of the low and flat taxation in Eastern Europe, the tax competition and harmonization have again become pressing issues.

The authors Dehejia and Genschel⁴ address the issue of tax competition and tax rates harmonization in the EU through the perspective of economic integration. In answering the question of why the international or regional collective action in tax competition failed, they refuse the argument of prisoners' dilemma proposed by political scientists and argue that the major drawback of such explanation is that it "suggests that all competing states suffer from competition and therefore share a mutual interest in tax cooperation."⁵ On the contrary, Dehejia and Genschel claim that some countries can profit from tax competition, when they say: "small states can actually gain from tax competition and may be reluctant to support cooperation."⁶ Based on their analysis, they observe that "while tax competition reduces world aggregate tax revenue, it improves the individual

³ Roháč, Dalibor. "Evidence and Myths about Tax Competition." *New Perspectives on Political Economy*, Vol. 2, No. 2 (2006): 86-115.

⁴ Dehejia, Vivek H. and Philipp Genschel. "Tax competition in the European Union." *Politics & Society*, Vol. 27, No. 3 (Sept. 1999): 403-430.

⁵ Dehejia and Genschel (1999): 405.

⁶ Dehejia and Genschel (1999): 405.

revenue position of small states.”⁷ In the debate on the EU tax harmonization it is indeed the large states that have become its traditional supporters, most prominently Germany, France and Italy. They oppose the Eastern European “flat-tax tide” most harshly and accuse the EE countries of creating “unhealthy tax competition.” The fact is, however, that as there is no common taxation policy within the EU, there is also no framework on which the West European countries could build up and justify their argumentation and force the new Member states to increase or stop lowering the tax rates (especially corporate). Even the most recent developments on the tax harmonization do not seem to change anything on this situation, as they are limited only to the decisions of what is being taxed within the EU, but not under what rate. As the EU Commissioner for Taxation and Customs László Kovács proclaims: “the Commission does not intend to harmonize tax rates, these are for Member states to decide.”⁸ However, most recently, the Commission proposed an initiative of Common Consolidated Corporate Tax Base (CCCTB) which would establish single tax base for European companies by 2010.⁹ As expected, the proposal faces strong opposition from the rows of the Member states, especially those with low corporate (Ireland, Malta, Cyprus) and flat-tax rates (Slovakia, Lithuania, Latvia), as they view the Commission’s initiative as an infringement on their sovereignty regarding the tax issues. These fears are present despite the Commission’s reassurance that the proposal would not in any way affect the corporate tax rates. That said, the tax policy questions indeed appear to be a very sensitive issue, carefully protected especially by the countries that might most profit from tax competition.

⁷ Dehejia and Genschel (1999): 424.

⁸ Kovács, László. *The European Agenda for Taxation*. Speech delivered at the 10th General Assembly of Intra-European Organization of Tax Administrations (IOTA). 22 May, 2007. 22 Jan. 2007 <http://ec.europa.eu/commission_barroso/kovacs/speeches/speech_IOTA_22_05_2006.pdf> .

⁹ Currently, there are 27 different systems in Europe for calculating a company’s taxable earnings, making it costly and burdensome for businesses to operate in several member states. Source: EurActiv. “Commission plans EU company tax despite opposition.” *EurActiv.com*, 16 May 2007. 17 May 2007 <<http://www.euractiv.com/en/taxation/commission-plans-eu-company-tax-despite-opposition/article-163497>>.

Ronen Palan addresses the issue of low tax countries through the perspective of tax havens. He claims that the tax havens did not originate as development strategies for boosting the economy of a country; they evolved in different periods and different places.¹⁰ Only later have some countries used the adoption of substantially lower tax rates from average to stimulate its economic growth and development. Yet, despite his argument that “modern tax havens did not originate as part of a conscious state or firm strategy,”¹¹ in the context of Eastern Europe it is reasonable to claim that the low taxation was used by the CEE countries as a “rational advantage-maximizing strategy.”¹² The post-communist countries clearly recognized the immense benefits they can obtain from luring investments from abroad: new job opportunities, innovations, foreign capital – factors that stimulate the development and economic growth of an emerging economy. The capability to offer business friendly tax regimes in combination with relatively cheap labor, was to serve as the main enticement for FDI. The hope was to increase competitiveness of the post-communist countries in the globalizing world. Although the Eastern European countries evidently can not be labeled as tax havens in the proper sense of the phrase, a broader definition of tax havens as “countries that have enacted tax legislation especially designed to attract the formation of branches and subsidiaries of parent companies based in heavily taxed industrial nations”¹³ is fitting enough to embrace the East European countries as well. As a result, the governments of WE (mainly the German and the French one) feared that the domestically based businesses would leave their countries in search of a less costly business environment, if they were to measure up to the low tax rates and cheap but relatively skilled labor that the

¹⁰ Palan, Ronen. “Tax Havens and the Commercialization of State Sovereignty.” *International Organization*, Vol. 56, No. 1 (2002): pp. 159- 162.

¹¹ Palan (2002): 159.

¹² Palan (2002): 159.

¹³ Palan (2002): 154.

states in EE were offering. In fact, these tax rate differential of the states are assuming greater importance in company decision-making as the other differences between the countries within the EU diminish.¹⁴ The resentment of the WE developed countries was sparked particularly by the increasing unemployment rates at the domestic level but also by the inability of these countries to “clean up their own tax systems”¹⁵ and substantially decrease the tax rates mainly due to the high welfare expenditures. A suitable example is provided by Germany, a country with a complex tax system with countless exemptions, where attempts of introducing the idea of lower- and flat- taxation emerged but were quickly swept off the table.

The determinants of what fiscal policy a country pursues, or more accurately, what the “social processes behind taxation and public finances”¹⁶ are, forms the subject of a relevant study in fiscal sociology. In his essay, John Campbell reviews and categorizes the scholarly work on fiscal sociology and develops a conceptual model of the determination of taxation. His model is shown in *Figure 1* (please see the next page) and it “seeks to explain major transformations in levels of taxation as well as the structure of tax systems.”¹⁷ Campbell starts out with the proposition that for a tax policy change there has to be an immediate pressure, either geopolitical, fiscal and/or economic. However, as he says: “the effect of crisis on taxation is mediated in complex ways by a variety of additional factors.”¹⁸ Among these he first identifies the pressure of social actors and interest groups on the transformation process of the tax policy. According to the model, the pressure of the

¹⁴ Houlder, Vanessa. “Corporate tax contest underway in EU.” *Financial Times on the Web* 23 Nov. 2005. 13 May 2007 <<http://search.ft.com/searchArticle?queryText=Corporate+tax+contest+underway&y=0&javascriptEnabled=true&id=051123006906&x=0>>.

¹⁵ Barysch, Katinka. “Is Tax Competition Bad?” *Centre for European Reform Bulletin on the Web*, Aug/Sept. 2004, Issue 37. 26 Jan. 2007 <http://www.cer.org.uk/articles/37_barysch.html>, accessed on Jan. 26, 2007.

¹⁶ Campbell, John L. “The State and Fiscal Sociology.” *Annual Review of Sociology*, Vol. 19 (1993): 167.

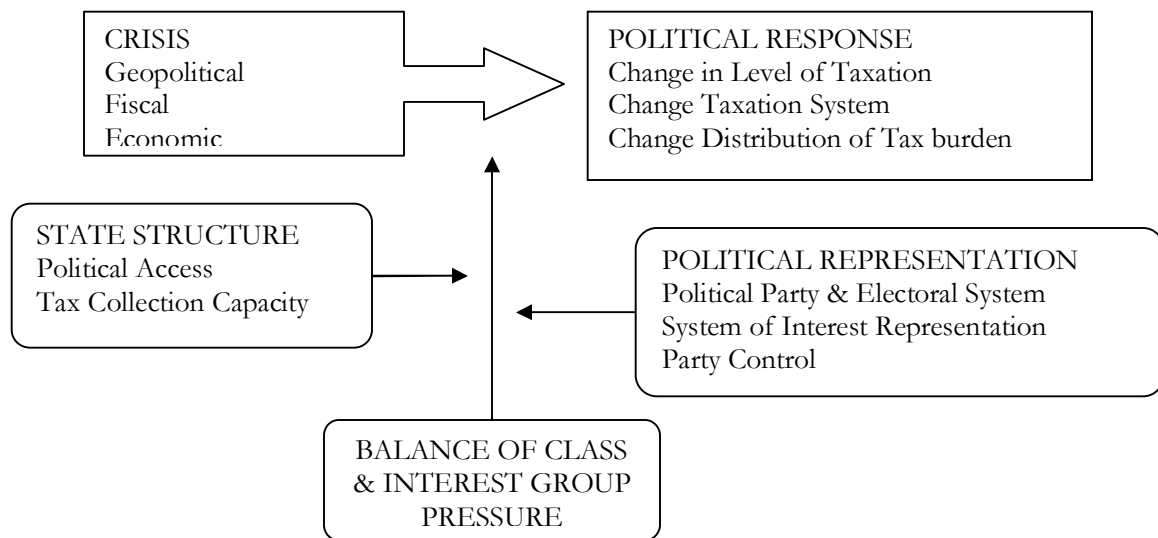
¹⁷ Campbell (1993): 173.

¹⁸ Campbell (1993): 173.

interest groups on the tax policy change is mediated by two other elements: the factor of political representation and the factor of the political institutional arrangement of the state.¹⁹

I shall refer to his concept later in this chapter when constructing my own thesis model of the determination of the flat-tax adoption.

Figure 1 Campbell's Conceptual Model of the Determination of Taxation



Source: Campbell, John. "The State and Fiscal Sociology."²⁰

In addition, in his work Campbell briefly addresses the role of the interest groups in the tax policy making process and offers a possible explanation of the unfeasibility of low corporate income taxes in unionized societies such as the German one. The author asserts that "corporate tax rates fall as organized labor becomes weaker."²¹ Going in line with his hypothesis, one might expect that the traditionally well-organized labor makes it increasingly difficult for Germany to lower its corporate tax rates. It is a serious claim that requires deeper verification whether the variation in labor organization could possibly account for the variation in the level of taxation.

¹⁹ Though Campbell admits that more causal variables could be added. In Campbell (1993): 174.

²⁰ Campbell (1993): 174.

²¹ Campbell (1993): 167.

Many authors (Ost 2000, Crowley 2004, Bohle and Greskovits 2005, Vaughan-Whitehead 2003) point to the East-West divide in the labor unions institutionalization. David Ost concludes the weakness of East European labor from a closer study of their tripartite structures and he talks of “illusory corporatism”²² in Eastern Europe. What he proposes is that despite the establishment of tripartite structures in the EE countries, they do not fulfill the function of effective mediation between the tripartite partners (government, businesses, labor unions). Anna Pollert similarly warns that the formation of tripartite structures with weak and fragmented labor representation inexperienced in the capital-labor bargaining should not automatically lead to conclusions of neocorporatist relations emerging in the post-communist countries.²³ Like Ost, Stephen Crowley also ascribes the labor’s weakness to the ideological legacy of communism and questions the fact that the European “social model”, as promoted by the West European countries, can expand to Eastern Europe. As he says: “while labor relations in the [East European] region have indeed been transformed the result resembles American-style flexibility more than the model of “social Europe” that many in the EU hope its new entrants will adopt.”²⁴ Bohle and Greskovits ask similar question and are skeptical about the prospects of the European social model in EE.²⁵ All in all, the general underinstitutionalization of labor in the new East European Member states of the EU may according to Vaughan-Whitehead “bring serious risks for Social Europe and endanger the survival of the European Social Model.”²⁶

²² Ost, David. “Illusory Corporatism in Eastern Europe: Neoliberal Tripartism and Postcommunist Class Identities.” *Politics & Society*, Vol. 28, No. 4 (2000): 503.

²³ Pollert, Anna. *Transformation at Work in the New Market Economies of Central Eastern Europe*. London: Sage Publications, 1999: 174.

²⁴ Crowley, Stephen. “Explaining Labor Weakness in Post-Communist Europe: Historical Legacies and Comparative Perspective.” *East European Politics and Societies*, Vol. 18, No. 3 (2004): 395.

²⁵ Bohle, Dorothee and Béla Greskovits. “Capital, Labor, and the Prospects of the European Social Model in the East.” Central and Eastern Europe Working Paper 58 (2005): 1-33.

²⁶ Vaughan-Whitehead, Daniel C.. *EU Enlargement versus Social Europe? The Uncertain Future of the European Social Model*. Cheltenham, Northampton: Edward Elgar Publishing, 2003: 493.

In sum, the most common approach among the scholars takes the East European region as a whole and broadly applies the concept of labor weakness, not accounting for the country variations. I expect this is due to the emphasis the authors put on explaining the persistent dividing line between the East and the West of Europe that has not faded away even after the collapse of communism and the accession of the CEE countries to the EU. In line with this argumentation I will also explore the weakness of the Slovak labor and the relative weakness of the Czech labor to that of Germany. However, a deeper analysis of the variations within the East is to be the further step undertaken by other researchers. In fact, the understanding of the “East European divide” has become increasingly important as each of the countries, despite many similarities, is to follow a different, country-specific development path. The differences in the political parties and labor unions institutionalization in the Czech Republic and Slovakia will be shown in the chapters to come, confirming the presence of significant variations in the region.

Contrary to the previous stream of literature, Iankova (1998) and Katzenstein (2003) take a different position concerning the organization of the industrial relations in EE. Iankova observes “spectacular mushrooming of corporatist-like institutions across the CEE region.”²⁷ While some authors doubt the eastward expansion of European social model, Iankova views the European Integration as the means to preserve and maintain social dialogue structures in the CEE region,²⁸ though she admits this varies depending on the country. Katzenstein similarly argues that two processes, transformation from socialism to capitalism and the Europeanization, have served as the necessary pressure to allow for similar reactions to those of small states after the second World War towards the

²⁷ Iankova, Elena A. *Eastern European Capitalism in the Making*. Cambridge: Cambridge University Press, 2002.

²⁸ Iankova (2002): Abstract.

establishment of social partnership and the corporatist type of capitalism.²⁹ Katzenstein goes even further in his argumentation comparing the industrial relations of the EE states with those of the corporatist countries in WE:

“The emerging social market economies are unlikely to resemble statist or neoliberal variants of capitalism. It is more likely that they will have greater resemblance with the institutions of the German variant of capitalism, among the large industrial states the closest cousin of the democratic corporatism of the small European states.”³⁰

Katzenstein’s argumentation is in sharp contrast with the literature on European social divide that talks of “neo-liberal landscape”³¹ spreading in EE and on which also the main argument of the thesis builds up on. In fact, I will try to show that the differences in the labor institutionalization in the West of Europe (including Germany) and the East can largely account for the flat-tax (un-)feasibility.

In sum, the present argument uses the example of the two Eastern European countries to verify the proposition of labor weakness in the East, as suggested in the literature. This will be done through focusing on the role of the labor organizations in the process of flat-tax reform debate. In the case of Slovakia and the Czech Republic I expect to confirm the general weakness of labor compared to the labor institutionalization in the West of Europe. At the same time, however, I claim that there are also variations in the labor unions institutionalization within the East. I believe the factor of either deep or shallow entrenchment of the labor unions in the society can be a valid determinat whether - and what kind of - flat-tax reform a country adopts.

²⁹ Katzenstein, Peter J. “Small States and Small States Revisited.” *New Political Economy*, Vol. 8, No. 1 (2003): 21-22.

³⁰ Katzenstein (2003): 22.

³¹ Vaughan-Whitehead (2003): 497.

The national variations in the CEE region have been recognized by Bohle and Greskovits³² in particular. They address the institutional specificities of modern capitalisms in CEE when stating: “by the early 2000s the whole region adopted the usual standards and institutional underpinnings of economic freedom and openness in western market economies. However, there is a systematic variation in the radicalism of the reform paths leading to this outcome.”³³ In their work Bohle and Greskovits distinguish three types of capitalisms in the region: 1./ neoliberal (the Baltic states), 2./ embedded neoliberal (the Visegrád states) and 3./ neocorporatist (Slovenia). The Baltic states’ type of capitalism is best described as being devoted to free market forces and the reduction of state interventionism in the economy. With regard to the opposition institutionalization, “a neoliberal regime is distinguished by the weakness of state-led countermovements to defend economic organization and other vulnerable groups of society.”³⁴ As a result, the non-elite groups in the neoliberal regime of capitalism are weak and disorganized to bring about protective countermovements even at modest scales. The Visegrád countries’ capitalism is best characterized as embedded neoliberalism. It is “a regime that is primarily driven by the aim of enhancing competitiveness, but relative to pure neoliberalism devotes more attention and more resources to protecting society.”³⁵ In the embedded neoliberal type of capitalism the various social groups (labor unions, domestic small and medium size enterprises) are considered to be in a junior relationship with the elite groups and decision-makers. Finally, the third neocorporatist model, the most similar one to the West European (or German) type, adopted in Slovenia, is characterized by an institutionally reproduced balanced pattern

³² Bohle, Dorothee and Béla Greskovits. “Neoliberalism, Embedded Neoliberalism, and Neocorporatism: Paths Towards Transnational Capitalism in Central-Eastern Europe.” Draft Paper (2006): 1-24. The final version published in *West European Politics*, Vol. 30, Issue 3 (May 2007): 443-466.

³³ Bohle, Greskovits (2007): 3.

³⁴ Bohle, Greskovits (2007): 2-3.

³⁵ Bohle, Greskovits (2007): 3.

of the two protectionisms (both, the economic and social welfare protectionism), while business, labor, and other social groups are accepted as equal partners in shaping that balance.³⁶ With regard to industrial relations, according to Bohle and Greskovits, from among the CEE states “Slovenia is the only country where the negotiation between business and labor, as well as the coordination between social, industrial, and other economic policies is fairly well institutionalized.”³⁷

The conceptual framework proposed by Bohle and Greskovits is helpful in understanding the differences between the CEE countries. The fact that flat tax (associated with the neoliberal concept of capitalism) was introduced in the neoliberal Baltic states but not in neocorporatist Slovenia is consistent with the typology presented by Bohle and Greskovits. What remains puzzling is the variation with respect to the flat tax adoption in the Visegrád group, where Slovakia has so far been the only one to adopt flat taxation. The V4 countries fill the large space between the two models, neoliberalism and neocorporatism, and as a result there is ample room for variation and country specificities. This fact, I argue, calls for a more careful differentiation among the Visegrád four. On the one hand, the concept of Bohle and Greskovits provides a good explanation and justification for why there are differences in flat tax implementation between the Baltic states, the Visegrád states and Slovenia. On the other hand, it does not clearly account for the differences within the Visegrád group. Given the characteristics of the embedded neoliberal regime the question arises, whether the Czech Republic, Hungary, Poland and Slovakia are biased in favor of the flat taxation or against it. I would suggest that it is dependent on the position of the countries on the ‘new capitalism’ scale between neoliberalism and neocorporatism. Also Bohle and Greskovits admit this when stating that “since some states stress industry

³⁶ Bohle, Greskovits (2007): 3.

³⁷ Bohle, Greskovits (2007): 5.

protectionism while others prefer social welfare policies, the pattern of embeddedness varies across cases and over time.”³⁸ Thus, we can expect that greater institutionalization of labor will result in an increased resistance to flat taxation, making a country less likely to implement flat taxation. The present paper will try to position the Czech and Slovak Republics on the broad scale of embedded neoliberalism and do so with regard to industrial relations, labor union institutionalization more specifically.

The variation among the EE countries is recognized and has become a crucial aspect of O’Dwyer’s³⁹ analysis of the reasons of the feasibility of the second-generation reforms in some East European countries but not others. As he observes, “although all governments in the region are discussing second-generation reforms, there has been considerable variation in their capacity to enact them.”⁴⁰ Interestingly, based on his study of Slovakia, Estonia, Hungary and the Czech Republic he confirms his hypothesis that the “second-generation reforms are more likely in weakly consolidated democracies in which incomplete institutionalization attenuates the public’s voice in policy-making”.⁴¹ In other words, the variations in implementation of flat tax, and other equally radical reforms in EE, can be largely accounted for by the level of party system institutionalization. O’Dwyer views the underinstitutionalization as an “enabling tool” helping the reform governments to undertake the radical reforms without facing much the reform inhibiting pressures from various social and political groups. As he says, this is “hard to envision in a more consolidated democracy.”⁴²

³⁸ Bohle, Greskovits (2007): 3.

³⁹ O’Dwyer, Conor and Branislav Kovalčík. “Party System Institutionalization and Second-Generation Economic Reform in Postcommunist Europe.” Working Paper (April 2006): 1-50. The final version published in *Studies in Comparative International Development*, Vol. 41, Issue 4 (Winter 2007): 3-26.

⁴⁰ O’Dwyer (2006): 5.

⁴¹ O’Dwyer (2006): 5-6.

⁴² O’Dwyer (2006): 1.

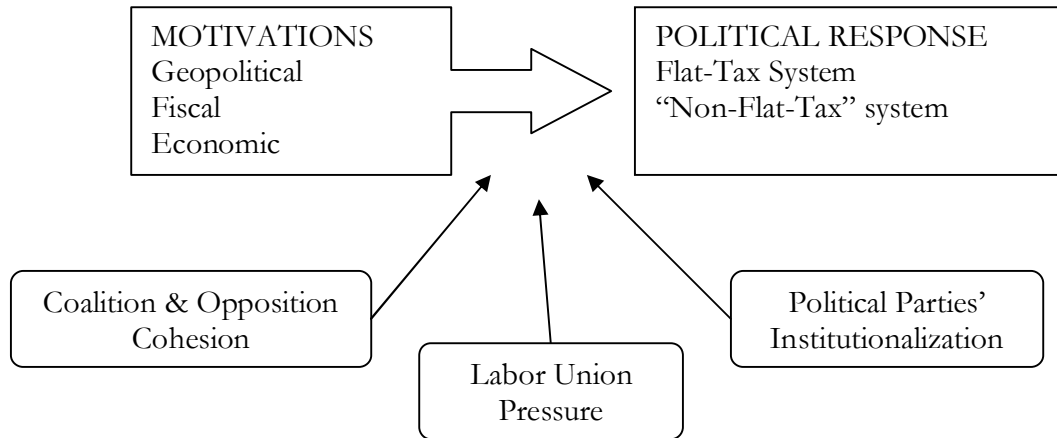
However, I would challenge the method of the voters' volatility by which he measures the institutionalization of political parties because the voters' volatility largely depends on the number of political parties the electorate can choose from. This might cause that there are several like-minded parties, for example with similar economic programs,⁴³ and the voter's choice therefore does not diverge much if he/she chooses from any of these parties. What one has to appreciate, however, is that O'Dwyer looks at the political party system also from the perspective of the opposition, stressing either its cohesion (the Czech Republic) or fragmentation (Slovakia). As he says: "the lack of an organized opposition allows them [reform-minded governments] to proceed rapidly and radically."⁴⁴ Still, to the two factors of political parties' underinstitutionalization and fragmented opposition, I would also point to coalition cohesion of the governments – as the possible factors affecting and explaining the feasibility of such radical reforms as flat-tax.

For the purposes of clarity, the model shown in *Figure 2* (please see the next page) summarizes the factors that I consider based on the literature overview to be the most decisive determinants of flat-tax (un-)feasibility. Namely it is the 1./ party system institutionalization, 2./ cohesion of the opposition and of the government coalition and 3./ labor unions' institutionalization – influence of which on the tax policy change process (specifically flat-tax adoption process) in Slovakia, the Czech Republic and Germany is carefully studied in the following chapters.

⁴³ like the parties SDKÚ, KDH and SMK in Slovakia

⁴⁴ O' Dwyer (2006): 12.

Figure 2 Conceptual Model of the Determination of Flat-Tax Adoption



What offers at this point, is the comparison of the flat-tax determination model developed here with that of Campbell. First, I adopted Campbell’s logical surmise that for a tax policy reform a crisis or some other incentive is needed to motivate the governments to start out the whole process of tax reform. Like Campbell, I similarly recognized the influence and the pressure of different interest groups on the tax policy formation – however, I concentrate specifically on the role of the labor unions. As suggested previously, this is particularly interesting from the perspective of labor unions representing the most resistant group to flat-tax. An extensive elaboration of their argumentation is needed to verify its justifiability. This is, however, a question that goes beyond the scope of the present thesis. Third, Campbell talks of political representation to be the next influential factor in the process of changing the tax policy what largely overlaps with the variable found in O’Dwyer’s paper that the flat-tax feasibility can be accounted for by the underinstitutionalized party system. Finally, as the fourth factor I emphasize the cohesiveness of coalition, as well as of opposition with regard to the question of flat-tax adoption. Campbell, on the other hand, views the state structure (political access, tax collection capacity of the state) as the third determinant factor of the tax policy-making

process. The one possible reason why the two models differ in the last variable is the character of the flat-tax reform itself. It is a radical step in the sense of transforming the progressive tax system to flat taxation which often leads to polarization of the society in which its adoption is being attempted. Therefore, the actual distribution of political power and influence among the actors is crucial for its adoption. I do not mean to imply that the state structure variable is not relevant also in the flat-tax case, though I will stick to the coalition/opposition cohesion as to the more decisive one.

2. Flat-tax Approaches in the East

This chapter deals with the factors identified in the analysis of relevant literature as critical for the feasibility of flat-tax reform (in fact, for other radical reforms as well). On a country basis, starting with Slovakia, I will first trace the institutionalization of political parties and their ability to form cohesive coalitions, as well as the role of the opposition in the reform process. Secondly, I will discuss the entrenchment of the labor unions in society and their capacity to influence political decisions. A similar structure is applied to the study of the Czech Republic, which follows the section on Slovakia. Lastly, the analysis is interpreted from the perspective of flat-tax discourses in both Slovakia and the Czech Republic.

2.1. Slovakia: Feasibility of Flat-Tax

2.1.1. The Party System Institutionalization and the Coalition Cohesion

The new flat-tax reform became effective in Slovakia in January 2004.⁴⁵ The reform was the product of the centre-right government under Prime Minister Mikuláš Dzurinda and was part of the more general package of radical second-generation reforms that the Slovak government undertook beginning in 2003. In fact, this had already been the second Dzurinda government in the row with one major detail making it distinct from the previous one that the coalition of 1998-2002 comprised not only the centre-right political forces but also the left oriented Democratic Left party (SDĽ). This has in many cases inflicted

⁴⁵ The reform introduced a flat rate of 19% on all PIT, CIT and VAT.

discrepancies in the political program proclamations of the coalition and most likely prevented the conservative parties from passing radical reforms already in the first Dzurinda's term.

The elections of 2002 were marked by the success of centre-right parties from which the second Dzurinda coalition government was formed and lasted until 2006. The coalition consisted of four political parties: the Slovak Democratic Coalition (SDK)⁴⁶, Christian Democratic Movement (KDH), liberal and pro-business New Citizen's Alliance (ANO) and finally, the Hungarian Coalition Party (SMK). These parties profited from the failure of the nationalist parties and most particularly from the communist-successor left which was caught up in numerous internal disputes and scandals.⁴⁷

The opposition was also formed by four parties: party of the former authoritarian Prime Minister Vladimír Mečiar the People's Party - Movement for a Democratic Slovakia (ĽS-HZDS), then Slovak National Party (SNS), Slovak Communist Party (KSS) and finally, the social-democratic and populist party Smer (Direction) of the current Prime Minister Róbert Fico. In sum, it was eight political parties in the National Council of the Slovak Republic, not counting the Members of Parliament (MPs) that have either left their political parties to become independent MPs⁴⁸ or they established their own new parties.⁴⁹ After disagreements between the coalition members in late 2003 and the departure of some coalition MPs, such multi-party parliamentary configuration has later on enabled the Dzurinda government to complete its regular 4-year tenure until 2006 and that despite not being in the position of majority government anymore. What explains the peculiarity of the

⁴⁶ The party Slovak Democratic and Christian Union (SDKÚ) was established only in November 2000.

⁴⁷ Haughton, Tim and Marek Rybář. "All Right Now? Explaining the Successes and Failures of the Slovak Centre-Right." *Journal of Communist Studies and Transition Politics*, Vol. 20, No. 3 (Sept. 2004): 127.

⁴⁸ This has been the case of the MPs Nemcics, Danko and Opaterný who have left the ANO Party. (The MP Opaterný has later helped to found a new political party - Free Forum).

⁴⁹ Towards the end of the year 2003 a group of seven MPs left the SDKÚ Party of Mikuláš Dzurinda and formed a new party called Free Forum (SF) the head of which became Zuzana Martináková.

situation is: first, the fact that the MPs' defections were caused more by the personal disagreements (particularly between the Prime Minister Mikuláš Dzurinda and Ivan Šimko, the former Minister of Defense) and not by programmatic disagreements. The "defected" coalition MPs were in fact reform-minded and supported the crucial governmental proposals of tax, social system, health-care and pension reforms, as well as the budgetary plan for the year 2004. Therefore, what one can infer from this situation, is that the program cohesiveness of the coalition to implement the necessary social and economic reforms was not particularly hurt (despite the defections in seats in the Parliament). In fact, by the number of initiated and approved laws has the second Dzurinda government become the most effective cabinet since 1993.⁵⁰

The second reason that explains why Dzurinda's minority government could complete its standard tenure, is the fact that the MPs' "defections" were common in the opposition ranks as well, leaving more space to the government to negotiate also with former opposition MPs and gain their support. "The lesson is", as Grigorij Mesežnikov, a Slovak political analyst, says "that in a fragmented party system such as Slovakia's, a minority government can triumph without cooperating with the opposition."⁵¹ According to Mesežnikov, "the opposition's weakness, namely its inability to offer an attractive alternative to the conservative-liberal ruling coalition," also significantly contributed to the durability of the weakened government.⁵² One can also add their incapability to mobilize and combine the opposition forces. Instead, the party politics discrepancies between the major opposition parties HZDS and Smer and the personal animosity between their leaders Mečiar and Fico

⁵⁰ Mesežnikov, Grigorij. *Another Episode of the Referendum Series*. [Ďalší diel referendového seriálu.] Bratislava: Institute for public Affairs (IVO), Jan. 2004: 2.

⁵¹ Mesežnikov, Grigorij: "Parties Learn Lessons." *Institute for Public Affairs (IVO) on the Web* Jan. 2005. 17 April 2007 <http://www.ivo.sk/buxus/docs/publicistika/subor/produkt_2274.pdf>.

⁵² Mesežnikov (2005)

fragmented and weakened the opposition considerably. The same reasons - namely the inability of the opposition to offer attractive alternatives to the acute issues that Slovakia faced in and following the year 1998 (when Mečiar's government came to an end) and their fragmentation - contributed to the Dzurinda's government success in passing all such crucial reforms as is the tax reform, social welfare reform, health care reform, pension system reforms and labor code reform. Though again, what should not be underestimated either is the strong mobilization and dedication of the coalition members in the process of adopting radical reforms⁵³ that aimed at putting an irretrievable end to the Slovak lagging behind in the reform process that has been substantially slowed down during the period of Mečiar's government. The coalition's strategy since the elections 2002 was to pass the necessary reforms as fast as possible and most crucially before the accession to the EU because this would make many of the radical reforms impossible. In the case of tax reform, the process from the flat taxation proposal to its approval was very short⁵⁴ and as a result there was only limited space for open debate. The following quote by Richard Sulík, the author of the idea of introducing flat taxation in Slovakia and the former advisor to Finance Minister Ivan Mikloš, describes the situation in 2003 when the flat tax reform was approved:

“There has not been much time for persuading the voters. From the inception of the idea to its ratification passed less than one year...the political configuration at that time and the exceptional influence of Ivan Mikloš in the economic circles helped the adoption of flat taxation without facing lengthy debates. Based on what we can witness today, it is good it has been like that. In the Czech Republic, the debates started much sooner than in our case and the Czechs debate over it until today. We were lucky to introduce the flat tax so quickly.”⁵⁵

⁵³ In the case of flat taxation it was the dedication of the Minister of Finance Ivan Mikloš.

⁵⁴ The first ‘Tripartite’ talks on the tax reform proposal were held on April 25, 2003, the government approved it in June 2003 and the Parliament passed the reform first on October 29, 2003 and then again on December 5, 2003 after the President Rudolf Schuster's veto.

⁵⁵ Pardubský, Lukáš: “Politicians want to play Gods.” [Politici sa chcú hrať na Bohov]. *Hospodárske Noviny on the Web* 26 March 2007. 18 April 2007 < http://hnonline.sk/c3-20750630-k00000_detail-richard-sulik-politici-sa-chcu-hrat-na-bohov >.

Although many democratization scholars might object that the absence of public debate over such consequential issues as is the tax reform was a major infringement on the democratic process, Richard Sulík views the swiftness of that time tax reform implementation as an advantage and claims that the government did not do anything that would go against the principles of democracy: “The elite received its mandate in the elections of 2002 and the adoption of flat rate taxation was in compliance with this mandate,”⁵⁶ says Sulík.

The most recent example that also suggests the absence of institutionalized political parties and their ideological principles is the composition of the Slovak government after the parliamentary elections in 2006. The government of Prime Minister Róbert Fico was formed by three former opposition parties Smer, HZDS and SNS and that despite their contrary party programs and deep hostilities between their leaders in the past. Grigorij Mesežnikov is critical of the formation of a coalition between social democrats and radical nationalists that has only been possible at the expense of their substantial party program change. According to him, “in societies with established and crystallized political parties such problems occur only rarely.”⁵⁷ Mesežnikov calls for reforms within the party politics stressing the generation switch of the political party elites and calling for politics where such flushing between two immensely distinct concepts and substantial situational modification of the party program would not be possible.⁵⁸ This leads us back to O’Dwyer’s main observation of the absence of political parties linked to clearly defined socio-economic constituencies.⁵⁹ The quote by the Czech President Václav Klaus clearly highlights the opacity of the Slovak political parties

⁵⁶ Pardubský, Lukáš: “Politicians want to play Gods.” 26 March 2007.

⁵⁷ Szabad Újság. “Reform within Party Politics.” [Reformu stránickej politiky]. *Institute for Public Affairs on the Web* 12 Dec. 2005. 17 April 2007 < http://www.ivo.sk/buxus/docs/publicistika/subor/produkt_2310.pdf >.

⁵⁸ Szabad Újság (2005).

⁵⁹ O’Dwyer (2006): 17.

system by comparing it to the party systems of the Czech Republic, as well as of the WE countries:

“the distribution of the political powers is not clear and easy to comprehend. On the Czech political scene you have perceptible political structure and you can classify them [parties] from left to right. You can be absolutely sure to say who is who ... and it is not because of lack of interest or attention on my part. It is clear to me how to define the Austrian political scene or the German one.”⁶⁰

The author Kevin Deegan Krause⁶¹ also deals with the question of party system and opposition institutionalization in the two East European country cases studied here. What he finds is similar to what Conor O'Dwyer claims in his paper - that the party system and opposition institutionalization is weaker in the case of Slovakia than the Czech Republic. The author identifies two main sources of the particularly sharp divisions within the opposition in Slovakia: first, the religious factor and second, the specific questions related to Slovakia's Hungarian minority. The author concludes that “because of such conflicts, opposition parties missed key opportunities to cooperate and check the power of the coalition.”⁶² At the same time, he observes that the differences of opinion that impeded effective cooperation within the opposition left (interestingly) the coalition intact. On the contrary, “the coalitions formed after 1994 show greater coherence than the oppositions on all factors.”⁶³ In contrast, in the Czech Republic there were no such serious aspects of politics that would cause significant fragmentation within the opposition: “the Czech opposition, while not particularly effective in its own attempts at cooperation, at least did not suffer from this additional handicap.”⁶⁴ In line with this observation, the following quote by Václav Klaus expresses his perception of the Slovak tax reform: “It is extremely unlikely

⁶⁰ Palata, Ľuboš. “Klaus: Slovakia is not crucial.” [Klaus: Slovensko nie je kľúčové]. *Pravda on the Web* 19 March 2003. 13 May 2007 < <http://www.czsk.net/svet/clanky/sr/klausrozhovor.html> >.

⁶¹ Krause, Kevin Deegan. “Public Opinion and Party Choice in Slovakia and the Czech Republic.” *Party Politics*, Vol. 6, No. 1 (2000): 23-46.

⁶² Krause (2000): 40.

⁶³ Krause (2000): 40.

⁶⁴ Krause (2000): 41.

that such reforms could be undertaken in Germany, France, Italy or the Czech Republic in such a pace without tough debates in society.”⁶⁵ Although seemingly hitting the nail on the head, further elaboration is needed, whether the Czech political party system can be rightfully grouped into the same category with Germany and other West European states.⁶⁶

In sum, this section has shown that since the formation of the Slovak state the political party system was marked by high volatility of the political parties. On the one hand, there were parties that surprisingly quickly disappeared from the political scene (SDE, ZRS – Union of the Workers of Slovakia) and on the other hand, several new parties were formed or grouped together (SDK, SOP, ANO, SMER, SF). Apart from the weakly institutionalized multi-party system, this section emphasizes the distribution of political power among the decision-making actors as another factor decisive for the flat-tax implementation. The determination and cohesiveness of the centre-right (coalition) parties on the one hand, and the disintegrated opposition on the other, largely contributed to the feasibility of the new flat-tax reform and other radical social welfare, pension and health-care reforms in Slovakia. However, to make a comprehensive picture of the conditions under which the flat-tax reform became feasible in Slovakia, we have to address shortly the position of social actors, specifically the labor unions, in the policy-making process.

2.1.2. Labor Unions’ Institutionalization

From what has been suggested previously we can expect to find weakly institutionalized labor unions in Slovakia in contrast to those in the West. This section will first provide us with an empirical evidence of the labor weakness and outline the possible

⁶⁵ O’Dwyer (2006): 2.

⁶⁶ Section 2.2.1. of the thesis elaborates on this issue in more detail.

reasons hiding behind the labor's underinstitutionalization. In addition, this section also reveals the second Dzurinda's government perception of the labor unions role in the reform process, as well as the labor unions' perception of the radical reforms, including the flat-tax, undertaken by the centre-right coalition beginning 2003.

One can identify three major factors largely accounting for the overall labor's weakness in Slovakia, as well as its inability to effectively temper the radical socio-economic changes of the reform process. First, there is the aspect of historical legacy of the communist regime, which largely discredited the role and the function of labor unions in the post-communist society. Further, the role of the unions was considerably weakened in the course of the transition period, when the Mečiar's government pushed the labor unions aside. As a result, the unions joined the opposition and anti-Mečiar movement and practically helped the first Dzurinda government to come to power in 1998. Although Dzurinda's first government improved the position of the labor unions in Slovakia, this has been largely due to the pressure of the leftist coalition member SDĽ that insisted on the legal establishment of the tripartite social dialogue and other socially pleasing changes. However, the role of the labor unions has been diminished again during the second centre-right government when the Tripartite Law of 1999 was repealed. Finally, the "large-scale privatization and the rise of startup firms including green-field investments where owners often opposed the establishment of trade unions"⁶⁷ have certainly not helped to strengthen the Slovak labor unions.

Secondly, what one has to acknowledge, is that labor unions were undoubtedly active during the term of the second Dzurinda government, however their efforts proved futile and

⁶⁷ Jurajda, Štěpán and Katarína Mathernová. "How to Overhaul the Labor Market: Political Economy of Recent Czech and Slovak Reforms." Background Paper prepared for the World Development Report 2005. 25 March 2004: 16.

ineffective (the unions have initiated the referendum to recall the current government or called for general strike – rather radical actions both of which failed). Their tireless and often radical activity stemmed from the absence of a viable left-oriented political party that would represent the unions' interests at the political level. The absence of a political partner with representatives in the decision-making bodies (Parliament) also made it hard for the labor unions to push through their suggestions at the high level politics. This situation has certainly contributed to the difficult position and overall weakness of labor unions.⁶⁸ The only left party represented in the Parliament was the Slovak Communist Party, however cooperation with which was unacceptable for the labor unions. Only later on, before the parliamentary elections of 2006, have the labor unions and the Smer party of Róbert Fico come together to sign an agreement as a guarantee of their post-election cooperation.

Finally, what Emil Machyna, the president of OZ KOVO, a labor union organizing predominantly workers of the metal, machinery, metallurgical and electrotechnical industries, considers another (third) possible reason for the labor's weakness its internal fragmentation.⁶⁹ The Confederation of Trade Unions of the Slovak Republic (KOZ SR) is an umbrella organization for 35 labor unions representing workers of diverse job backgrounds. Machyna admits that this number of labor unions makes it often difficult to reach an agreement between them. To elaborate more on his point, Machyna contrasts the KOZ SR to labor organization in Germany where the overarching labor union Deutscher Gewerkschaftsbund (DGW) groups together eight trade unions only, which is certainly a

⁶⁸ Vašečka, Michal. "Social tension is increasing but a general strike would be a surprise." [Sociálne napätie sa zvyšuje, ale generálny štrajk by bol prekvapením]. *Institute for Public Affairs on the Web* 20 Feb. 2003. 24 May 2007 < http://www.ivo.sk/buxus/docs/publicistika/subor/produkt_2187.pdf>.

⁶⁹ Sudor, Karol. "Interview with Emil Machyna, the President of the labor union OZ KOVO." [Rozhovor s Emilom Machynom, predsedom OZ KOVO.] *SME on the Web* 5 June 2006. 23 May 2007 < <http://sudor.blog.sme.sk/c/50646/Rozhovor-s-Emilom-Machynom-predsedom-OZ-KOVO.html>>.

paradoxical situation given the size and the overall production of Slovakia to that of Germany.⁷⁰

That the labor unions displayed their dissatisfaction with the socio-economic reforms undertaken by the centre-right coalition is comprehensible as the new legislation largely liberalized the employment and cut on the social benefits. Also, as already suggested, the coalition abolished the Law on Economic and Social Partnership in December 2004, by which the influence of the labor unions and other lobbyist groups was dramatically reduced. The unions and business interest groups could from that point on evolve pressure through the Council for Economic and Social Concertation (Rada hospodárskej a sociálnej dohody - RHSD) which, however, only held an advisory function to the government with strictly defined competences and responsibilities.⁷¹ These events can be rightfully understood as actions by which the government dismissed the unions as a partner in the reform process.⁷² The statement by Minister of Justice Daniel Lipšic clearly depicts the government's position towards labor unions: "I do not see a reason for the existence of a corporatist model in which the privileged lobbying position is guaranteed to labor unions and employers at the expense of other interest groups and that particularly in a situation when the labor unions actively and openly make politics."⁷³ With respect to the flat-tax reform, it seems that the president of KOZ SR Ivan Saktor recognized the boundaries limiting the possible negotiations between the labor unions and the government: "we are persuaded that presumably we will not be able to change the government's mind on the issues declared by it

⁷⁰ Machyna also mentions the most recent developments in Austria where 5 labor unions got incorporated into one labor union in order to better push through their interests.

⁷¹ The Slovak Republic Government Office. Council for Economic and Social Concertation. 23 May 2007 <<http://www-8.vlada.gov.sk/index.php?ID=1145>>.

⁷² O'Dwyer (2006): 19-20.

⁷³ Národná Obroda. "Lipšic wants the abolishment of the Tripartite Law." [Lipšic chce zrušenie zákona o tripartite]. *Národná Obroda on the Web* 22 Dec. 2003. 15 May 2007 <<http://www.obroda.sk/clanok/1976/Lipšic-chce-zrusenie-zakona-o-tripartite/>>.

in the program proclamation before the elections, meaning that the tax reform is directed towards the flat-tax adoption.”⁷⁴ Interestingly, although taking a negative stance towards the flat-tax implementation and having strong reservations especially about the increased VAT, the labor unions – under the circumstances they found themselves in - had to accept the adoption of flat-tax and more or less take it as a given.

2.2. The Czech Republic: the Flat-Tax Puzzle

The study of the Czech Republic is crucial for our understanding of what factors play the most decisive role in the flat-tax (un-)feasibility. The recently started flat-tax debate heated up the political parties across the political spectrum. However, for the time being it remains a big puzzle whether the Czech Republic will join the East European flat-tax tide or not. In fact, the end-results of the flat-tax debate in the Czech Republic will help us uncover and identify which of the considered factors plays the most important role in the flat-tax feasibility. Still, based on the study of the three variables (identified previously) and comparing them to the observations in Slovakia and Germany, we should be able to make predictions about the decisive variables for the flat-tax implementation. This, however, will be the subject of the third comparative chapter. This section, following the same pattern as the previous one, explores the political party system, as well as the labor unions entrenchment in the Czech Republic. The aim is to point to the variations within the East.

⁷⁴ Government of the Slovak Republic. “Record from the briefing after the working meeting between the Prime Minister Mikuláš Dzurinda, President of Confederation of Trade Unions (KOZ SR) Ivan Saktor and the President of the Federation of Employers’ Associations of the Slovak Republic (AZZZ SR) Michal Lach. 19 Sept. 2003. 20 May 2007 < www.government.gov.sk/infoservis/audiogaleria/20030919.rtf>.

2.2.1. The Party System Institutionalization and the Coalition Cohesion

The debate on the urging necessity of comprehensive reforms of tax, social welfare, pension and health care system has been present in the Czech Republic for a long time. The debate has even intensified recently due to the continuously rising government debt and budget deficit which is expected to reach the level of 4.3% of GDP in 2007.⁷⁵ What is, however, even more alarming than the actual current budget deficit rate is the pace of its growth that might cause serious troubles to the Czech economy once no reform steps are done to stop the trend. In fact, since the collapse of the communist regime the Czech tax system has not undergone a serious reform. The numerous amendments that have taken place were only partial and made the system more complicated and less transparent (according to the data there were 80 amendments of personal income tax law by 2006). The necessity of implementing sound tax system as a precondition for sustainable economic growth can be hardly disputed. In late 2006 a new centre-right government⁷⁶ of the Prime Minister and leader of the Civic Democratic Party (ODS) Mirek Topolánek was formed in coalition with the Christian Democratic Union-Czechoslovak People's Party (KDÚ-ČSL) and the Green Party, though has only a fragile majority in the lower chamber of the Parliament.

Already in April 2007 the government disclosed a new and relatively revolutionary (in terms of Czech conditions) proposal of reforms for the tax and social welfare system. The basis of the tax reform proposal is the introduction of flat (however, not single rate) taxation for personal incomes (PIT) at the rate of 15% and the corporate incomes (CIT) at 19% (by the year 2010). What concerns the the lower rate VAT, that is to be increased from

⁷⁵ Ministry of Finance of the Czech Republic. "Fiscal outlook." [Fiskální výhled]. April 2007. May 18, 2007 <http://www.mfcr.cz/cps/rde/xbcr/mfcr/FiskalVyhled_2007Q1_komplet_pdf.pdf>.

⁷⁶ The Parliamentary Election was held already in June 2006 but because of the tight results it was not until late of the year that the government was formed.

5% to 9%, though the headline rate of 19% should remain unchanged. When compared to the Slovak flat tax system, the variance between the two systems is evident: first, the Slovak tax reform introduced single rate for all personal and corporate income taxes, as well as for the VAT. Secondly, the rate was set at 19% which is seemingly higher than the one proposed in the Czech Republic. In reality, however, the Czech 15% personal income tax is “charged on gross income, which includes the employers’ social security and health care contributions”⁷⁷ and under the Slovak conditions this would correspond to a rate of 23%, which is above the Slovak 19% rate. Also, like it was in the Slovak case, the Czech tax reform should be simultaneously accompanied by the reform of social welfare system, however with the significant difference that the intervention into the current system is substantially less radical and more socially acceptable (but not sufficiently as seen by the left oriented opposition parties). After identifying the differences, what the Czech reform proposal and the Slovak reform have in common, is that they sought to abolish the numerous exemptions in the current tax system.⁷⁸

The comparison of the Czech proposal of 2007 with the Slovak tax reform of 2004 is necessary, to point to the variance in the flat tax reforms/proposals in CEE. From these two, the Slovak tax reform has been significantly more radical when compared to both, the Czech proposal on the one hand and the level of taxation in Slovakia prior to the tax reform on the other. However, what might be even more interesting is contrasting the government tax proposal with the pre-election concepts of the three coalition parties. The Civic

⁷⁷ Lomas, Ulrika: “Czech Government Announces Bold Tax Plans.” *Tax-News.com* 5 April 2007. 8 April 2007 <http://www.taxnews.com/asp/story/Czech_Government_Announces_Bold_Tax_Reform_Plans_xxxx26885.html>.

⁷⁸ For example, the Slovak tax system, prior to the flat-tax reform of 2004, recognized 21 various tax rates (of which 5 were personal income rates) and distinguished 443 income categories. Source: Pravda. “The Parliament approved the 19% flat-tax.” [Parlament schválil rovnú daň vo výške 19%]. *Pravda on the Web*, 29 October 2003. 5 May 2007 <http://tvojepeňiaze.pravda.sk/sk_pspravy.asp?r=sk_pspravy&c=A031028_175049_sk_ekonomika_p04>.

Democratic Party ran in the elections with the proposal of introducing a 15% flat and single rate tax on PIT, CIT and VAT. Christian Democrats wished to introduce flat tax on PIT and CIT only and the Greens were actually against the flat tax whatsoever, though wished to lower the direct income taxation and increase the indirect taxes especially on electricity, coal and gas (so called ecological tax reform). The proposed version of the tax reform seems to be a balanced compromise of the party programs of the three coalition partners.⁷⁹ The negotiation process between the coalition partners alone largely mitigated the original and relatively radical concept suggested by ODS and resulted in a moderate version of flat-tax reform proposal.⁸⁰ In fact, some analysts even hesitate to call it a reform implying that the label “reform” is for the cosmetic changes in the public finance a somewhat strong term. They rather propose to call it “fine-tuning.”⁸¹

What will happen to the tax reform next and whether it will be pushed through the Parliament, where the centre-right coalition has only a fragile majority, remains to be seen in the parliamentary summer session. The final voting will, however, decide not only about the reform’s future, but also about the prospects of Topolánek’s government, who has officially tied the potential failure of the reform package (that also includes the social welfare reform) with his post. Because of the cuts in welfare spending, such as unemployment benefits and healthcare, the parliamentary opposition formed by the Czech Social Democratic Party (ČSSD) and Communist Party (KSČM) has already refused to support the government’s

⁷⁹ Though the Civic Democrats (ODS) were the ones to make the most concessions from their pre-election tax reform plan.

⁸⁰ Vašek, Petr. “ODS exchanged the reform for big concessions.” [ODS vyměnila reformu za velké ústupky]. *Hospodářské Noviny on the Web* 25 May 2007. 25 May 2007 < http://www.ihned.cz/c3-21221020-000000_d-ods-vymenila-reformu-za-velke-ustupky >.

⁸¹ Schwarz, Jiří. “Slovak reform and Czech fine-tuning.” [Slovenská reforma a České doladování]. *Liberální Institut* 6 Sept. 2004. 20 May 2007 < <http://www.libinst.cz/clanky.php?id=81> >.

reform package, proclaiming it for unsocial and radically intruding into the current social security system.

The political powers in the Czech Republic are currently balanced between the left and the right. In fact, it has been early in the transition period when the two major parties on both sides of the political spectrum have been established and form a substantial part of the Czech political party system until present. Except for the Greens, who made it to the Parliament after the elections of 2006 for the first time in Czech history, the Christian Democrats and the Communists are highly established political parties in the Czech political system and have been continuously represented in the Parliament since the very inceptions of the Czech Republic. In contrast to a rather volatile political party system of Slovakia, the Czech party system shows signs of high institutionalization. With regard to the flat-tax reform, judging from the current position of the main opposition party and from the influence of social actors (especially labor unions), it really remains puzzling whether Topolánek will be able to push through his reform despite the majority (although fragile) that his government disposes of in the Parliament. At least to pass it in the pure form, as suggested by the coalition without making certain concessions to the opposition Social Democrats.⁸² In sum, what concerns the political party institutionalization and the coalition cohesion, the Czech starting position for the flat-tax implementation appears to be rather different from that of Slovakia. The next section looks more closely on the role of the labor unions in the Czech society.

⁸² The centre-right government, especially ODS and KDÚ-ČSL, considers the Communist Party as politically unacceptable and therefore would do no concessions to its ideas.

2.2.2. Labor Unions' Institutionalization

The Czech sociologist Zdeňka Mansfeldová and her colleague Petra Rakušanová acknowledge in their paper⁸³ the institutionalized position of the interest groups in the Czech society. They argue that the social groups, in addition to political parties, played an important role during the transfer to the market economy and claim that their importance has even increased as a result of the accession of the Czech Republic to the EU.⁸⁴ According to the authors, from “among the large number of interest organizations and civic associations active in the Czech Republic, there are some that, because of their influence and prominent position, have permanent access to political decision-makers and that to a great extent influence the public policies.”⁸⁵ To the group of particularly influential social actors they assign both the representatives of labor (trade unions) and capital (employers and business organizations), though some authors⁸⁶ would certainly object that the tripartite relationship is hardly reaching the level of the neocorporatist model of Slovenia or of unions in Germany, as the next chapter will show.

There is a number of possible interpretations that can help us understand today's strength of the Czech labor unions. In contrast to Slovakia, the Czech labor unions did not experience the marginalization the Slovak unions have tasted during the Mečiar's period and therefore could develop and establish themselves in society. In fact, some authors argue that the fact that the Czech labor unions had to operate under the centre-right government until 1997 was positive in the way that they learned how to organize and negotiate about the

⁸³ Mansfeldová, Zdeňka and Petra Rakušanová. *The Role of Organised Interests in the Czech Republic in the Context of the Association to the European Union*. Prague: Institute of Sociology, Academy of Science of the Czech Republic (April 2006): 2.

⁸⁴ Thanks to the EU principle of Social Dialogue.

⁸⁵ Mansfeldová and Rakušanová (2006): 2.

⁸⁶ See Bohle and Greskovits (2007).

reforms proposed by the government.⁸⁷ Though the real political power the unions seem to have gained only under the social democratic governments in the period between the years 1997/8 and 2006. The social dialogue “has been extended and institutionalized beyond the tripartite meetings” under the social democrats what has facilitated that “the influence of the trade unions shows in several policy and institutional dimensions.”⁸⁸

Another aspect that significantly sets apart the Czech unions from the Slovak ones (that are missing a political partner) is the interrelationship between them and the leading left party ČSSD. This close proximity is best embodied in the person of Milan Štěch who, being the President of the Czech-Moravian Confederation of Trade Unions (ČMOKS) – the umbrella organization of the Czech unions, also holds the position of Senator for social democrats in the upper chamber of the Czech Parliament. More similar cases of (former) union representatives holding a post in the government could be found suggesting the labor unions’ influence on the policy-making. At least this has certainly been the case during the social-democratic governments. With the political turnaround after the elections of 2006 that has brought to power the centre-right forces, one should be cautious about the effect this change could have possibly had on the position of labor unions in the Czech society and their influence on the policy-making. Although the close proximity of the labor unions and the social democrats persists, meaning that the position of the unions is represented in the political decision making, they are not anymore in the position to directly influence the actual process of policy-making.

That the centre-right government does not seem to take much into consideration the opinion of the labor unions has been recently demonstrated with respect to the reform of public finance. The tripartite partners were invited to the round table only after the coalition

⁸⁷ Jurajda and Mathernová (2004): 33.

⁸⁸ Jurajda and Mathernová (2004): 26.

has already agreed on the complete reform package and on the introduction of flat-tax. As the position of the Czech business groups has been, with few and less substantial remarks, rather positive, the government's indifference has become particularly disturbing to the labor unions. The unions leader's embitterment from the tripartite talks is expressed in the following quote by Milan Štěch: "We sat over something that has been already approved by the government. The commentary procedure was utterly formal and in fact nobody took notice of our reservations."⁸⁹ The Czech unions are particularly critical of the abolishment of the progressive taxation and its replacement by the flat-tax, as well as of the cuts in the corporate tax rates. They argue that this step relieves the rich and businesses and puts additional burden on the middle- and low-income groups, a traditional argument heard from the labor unions on the part of flat-tax also elsewhere. In sum, it appears that the labor unions may have been loosing on their political influence with the rise of the centre-right in the Czech Republic, though they still remain an institutionalized and influential social actor that together with the social democrats forms a coherent block of anti-flat-tax resentments.

As the analysis shows, the institutionalization of political parties and of the labor unions in the Czech Republic is certainly deeper than in Slovakia, what might lead to lengthy political and public debates over the Czech tax reform, and result either in the adoption of the flat-tax or its rejection, depending on the current combined strength of the political parties and social groups in favor of the flat-tax. When trying to compare the two East European cases a question arises whether it is the economic lagging behind its neighbors that made Slovakia launch a major economic reform, while it was enough for the Czech Republic

⁸⁹ Mladá Fronta Dnes. "The reform gave off sparks during the tripartite talks." [Reforma jiskřila na jednání tripartity.] *Mladá Fronta Dnes on the Web*, 2 May 2007. 27 May 2007
<http://ekonomika.idnes.cz/tiskni.asp?r=ekonomika&c=A070502_143854_ekonomika_spi>.

to make only few cosmetic changes. Jiří Schwarz from the Czech Liberální Institut (Liberal Institute) negates this approach and maintains that the differences in the economic indicators of both countries were not of such fundamental character, as to claim that there was no other option left for Slovakia than to undergo a radical economic and social reform. He rather sees the difference between the Slovak reforms and the Czech “fine-tuning” in the politics, suggesting that every economic reform is a matter of political feasibility, which rests on a reliable parliamentary majority.⁹⁰ This is an observation that from the three factors studied here gives credit especially to the factor of coalition cohesiveness.

⁹⁰ Schwarz (2004).

3. Flat-Tax Approaches in the West

After the analysis of the two East European cases, what follows is the reflection of the West. As already indicated, the flat- and low-tax tide in EE provoked numerous discussions in the West – including Germany. The reactions of the West were at first mixed: right away, France did not sympathize with such measures, while Germany acted more cautiously at first, but later on moved closer towards the French position. Conspicuously, none of the West European countries have chosen this system of taxation and although there is an urgent need for new sound tax reforms among them as well, their perception of flat taxation is so skeptical that any attempts at change in that direction would likely prove futile. The perception of flat taxation in the West can be aptly described as “fine in theory, just not practical in the real world.”⁹¹ The reasons behind this pattern constitute the main subject for discussion in this chapter. In addition, this section will also use the example of Germany to point out the fact that the critical voices in the West became loud particularly once such tax reforms proved politically unfeasible. Employing Germany as the crucial case here is compelling for several reasons: first, in Germany the flat-tax debate not only reached the highest level of political decision making, but it was also considered by the leading political party as a potential cure-all for the complex and arguably inefficient German tax system. Second, Germany is an excellent example of a dramatic turnaround from attempts at implementing flat-tax to direct refusal of such measures. As such, it represents a good case on which the (perceived) unfeasibility of the flat-tax can be studied. This chapter follows a pattern similar to the previous one and approaches the study of flat-tax (un-)feasibility through the perspective of the domestic political situation and the strength of the political

⁹¹ The Economist. “The flat tax revolution.” *The Economist*, Vol. 375, Issue 8422 (16 April 2005): 11.

and social actors, as well as through the perspective of the distribution of the pro- and anti-flat-tax forces in the society.

3.1 Germany: Unfeasibility

Three major categories of foreign reactions to Slovak tax reform depending on the aims and interests pursued by these groups can be identified. First, it is the experts' viewpoint, which is based on the evaluation of the reform from the perspective of economic efficiency and social sustainability endorsed organizations like the OECD, IMF, World Bank or the European Commission. This group generally assesses the reform positively. The second type of response is the already mentioned private sector, represented primarily by businesses leaders and foreign investors, who evaluate the reform using their preferred criteria of the openness and quality of the business environment. As the Slovak reform resulted also in a decrease in corporate tax, apart from being flat, their reaction was also positive. Finally, but crucially for the purposes of this thesis, we find the views of political leaders in the West, evaluating the reform, "while pursuing their political aims. They express opinions on foreign reforms that are in line with the intentions of their domestic political agenda."⁹² This is the moment where the reactions of Angela Merkel (CDU), the current German Chancellor, can be aptly fitted in.

Before the *Bundestag* elections in September 2005 the Christian Democratic Union (CDU) introduced in its election campaign the idea of flat-tax as one of the crucial solutions to the German economic problems and tax complexities. At this time, Merkel had praised the Slovak tax reform, as the outcomes that it had produced in this small East-European

⁹² Krajčír, Zdenko and Ľudovít Ódor. "First Year of the Tax Reform, or 19 Percent at Work." *Financial Policy Institute*, Economic Analysis No. 8 (Sept. 2005): 78. 15 Dec. 2006 <www.finance.gov.sk/ifp>.

economy were in line with Merkel's political aims. However, soon after the Slovak-inspired proposal entered the German political arena, it encountered strong domestic opposition. The strategic political actors she is, Merkel backed out and switched positions in what the experts on German politics explain as her defense of German national interests.⁹³ As a result, the political course of the new German government in the tax policy was accompanied with a revised position towards Slovak tax reform, as the previous position did not correspond with the home-grown political agenda. At the same time, it is important to recognize the fact that in the neo-liberal circles in Germany the flat-tax captured great interest as it would provide solution to the current complicated tax system. However, the reality showed that the idea proved politically unfeasible in German society.

Merkel's turnaround and the later resentment of the Slovak reform can be understood only in the context of the domestic situation and flat-tax discourse in Germany. The peculiarity of the situation indicates that there were significant domestic pressures opposing the idea of flat-tax. However, that Germany needs a new, sound, and most importantly transparent tax reform is beyond dispute. And why should not a tax system that helps EE countries, which surely were in a more troublesome situation than Germany, to overcome their problems inherited from the past work in Germany? What conditions made the system of flat- and low-rate taxes unfeasible here? – that is the conundrum I hope to be addressing in the following sections.

⁹³ EurActiv. "Slovakia "surprised" by Merkel's stance on taxes." *EurActiv on the Web* 28 Nov. 2005. 28 Nov. 2006 <<http://www.euractiv.com/en/agenda2004/slovakia-surprised-merkel-stance-taxes/article-150068>>.

3.1.1. Political Parties' Institutionalization and Coalition Incoherence

In trying to solve the puzzle of the flat-tax unfeasibility in Germany, one should start by addressing the issue from the perspective of the political parties involved in the policy- and decision-making process. The political party system in Germany is based on two major “cross-class parties with a record and reputation of support for the country’s welfare state”⁹⁴ - CDU, SPD. What needs to be emphasized here is particularly the aspect of social inclusiveness that both parties are committed to. This often implies preserving the status quo and refusing any radical reforms changing the institutional and socio-economic character of the German environment. In fact, any major party that dared to touch them or promised to do so, was doomed to failure in the next election.⁹⁵ Some authors suggest that this has also been the case in the election of 2005 when the preferences for the flat-tax initiating party (CDU) sharply declined, once their tax proposal was made public.⁹⁶

As mentioned previously, the flat-tax was proposed, as in the previous two country cases, by the centre-right party CDU, or more specifically by Paul Kirchhof⁹⁷, and brought about extensive debates across the political spectrum. Both SPD and the Green Party resolutely refused the flat-tax implementation as a substitute for the existing progressive taxation. In fact, the only party that was ready to support the flat-tax proposal was the FDP (Free German Party), the traditional coalition partner of CDU in the past. Though, as the following analysis will show, the approaches of even the flat-tax proponents have not been

⁹⁴ Kitschelt, Herbert and Wolfgang Streeck. “From Stability to Stagnation: Germany at the Beginning of the Twenty-First Century.” *West European Politics*, Vol. 26, Issue 4 (2003): 26.

⁹⁵ Kitschelt and Streeck (2003): 26.

⁹⁶ Tagesspiegel Online. “Black-Yellow dissociates itself from Kirchhof.” [Schwarz-Gelb geht auf Distanz zu Kirchhof]. *Tagesspiegel Online* 11 Sept. 2005. 28 May 2007
<<http://www.tagesspiegel.de/politik/archiv/11.09.2005/2047406.asp>>.

⁹⁷ Professor Paul Kirchhof was the initiator of the flat-tax idea in CDU and for that matter also in Germany, setting the flat-tax rate at the level of 25 % for all PIT, CIT and VAT. In fact, he was nominated by Angela Merkel as the prospective Minister of Finance, in case CDU wins the elections.

unequivocal (CDU) or have changed over time (FDP) and largely contributed to the ultimate failure of the flat-tax.

One of the crucial aspects that has certainly had a negative effect on the outcome of the flat-tax debate in Germany was the split on the flat-tax issue within the Merkel's CDU party itself. Actually, it is not a recent problem that the party has been divided in the left and the right wing balancing between the two concepts. The social element in German politics had already been introduced in the time of Konrad Adenauer through Ludwig Erhard's social market economy, which has in fact been accepted by all main German political parties ever since and has become deeply embedded in German society. Therefore, it is not surprising that a critique of flat taxation comes from CDU's own (left-wing) ranks as well. Norbert Blüm was a Minister of Work and Social Affairs (1982-1998) in the cabinet of Helmut Kohl and in his contribution to *Süddeutsche Zeitung* he regrets that the Union "got infected with the neoliberal epidemic."⁹⁸ He complains that the flat-tax contradicts the basic concept of the Christian-social theory which is the concept of justice. Several other examples of such defections in thoughts can be observed also at the chairmanship level of the CDU and CSU, as well as in the ranks of the *Länderministerpräsidenten* (from CDU/CSU). In fact, this is not a rare incident and has been previously identified by the scholars: "ambitious state governors belonging to a party represented in the national cabinet may act on interests different from those of their national leadership."⁹⁹

Apart from the resistance to flat taxation within the CDU party itself, there is one other aspect that has contributed to the failure of the flat-tax implementation in Germany and can equally be attributed to the Christian Democrats, specifically to their wrong strategy.

⁹⁸ Blüm, Norbert. "Critic from the own Ranks – CDU is infected with neoliberal Epidemy." [Kritik aus den eigenen Reihen - Die CDU ist von der neoliberalen Epidemie infiziert]. *Süddeutsche Zeitung on the Web*, 25 Sept. 2005. 15 Dec. 2006 <<http://www.sueddeutsche.de/deutschland/artikel/421/61360/>>.

⁹⁹ Kitschelt and Streeck (2003): 7.

The last minute introduction of such a radical change in a crucial area as is the tax policy before elections partly resulted in the loss of credibility of CDU. Two concepts – the official one of the party keeping the tax rates between 12 and 39% on the one hand and the one of Kirchhof on the other – created confusion among the voters. Also Merkel's personal change in attitude from support for one concept to the other contributed to even greater turmoil. Even the only allied partner on the tax issue - FDP - showed signs of hesitation with regard to flat-tax implementation after its unacceptability to so many groups became obvious. The CDU leader Merkel tried once to play with liberalism but it proved unsuccessful and so she got back on the track of the social tradition of the Union.¹⁰⁰ The described situation is an excellent example of the phenomenon characteristic of the German post-war politics that the “entrepreneurialism, political or otherwise, is not highly rewarded.”¹⁰¹ It appears that the German soil was not ready for the flat-tax idea of the “visionary” – as Kirchhof was sometimes called. This is what Herbert Kitschelt calls a ‘German disease’ and gives a precise description of the whole situation: “Cases like this, in which an experimental search for new solutions at the ground level is narrowly circumscribed or altogether outlawed in the name of equality and social protection, abound in the German system.”¹⁰²

With regard to the dissenting position of the major political rival party (SPD), the major objections of the left relied on the arguments of the flat-tax being unjust, unsocial and financially unsustainable. Interestingly, the German translation of the term flat tax - the *Einheitssteuer* - does not give the impression of the Anglo-Saxon modernity that the English term might suggest. On the contrary, it actually implies a superficially egalitarian policy in

¹⁰⁰ Germis, Carsten. “Merkel's short Flirtation with Market Economy.” [Merkels kurzer Flirt mit der Marktwirtschaft]. *FAZ on the Web*, 23 Nov. 2006. 12 May 2007
 <<http://www.faz.net/s/RubEC1ACFE1EE274C81BCD3621EF555C83C/Doc~EA5B777A5075D4F94B79CCD6EE3C9BBEB~ATpl~Ecommon~Scontent.html>>.

¹⁰¹ Kitschelt and Streeck (2003): 4.

¹⁰² Kitschelt and Streeck (2003): 29.

which all citizens pay the same amount of money not reflecting the level of personal incomes. This perception, suggests that people with higher incomes pay the same taxes as those with lower incomes sounding largely unfair especially to people with lower incomes. This apprehension proved to be one of the sources of discontent among the people, as well as fertile soil for political argumentation of the SPD, the Greens, and the labor unions. Some SPD politicians even did not hesitate to call the flat-taxation a *Primitivsteuermodell* (primitive tax model).¹⁰³

Following the identification of possible explanations of the flat-tax failure within the scope of the political party system in Germany, this paragraph will look more closely on the distribution of the political power between these political parties. The parliamentary election of 2005 has brought with itself very unusual results with several coalition options open. Due to lengthy negotiations, the government coalition was formed only several weeks after the election by the two largest parties CDU and SPD. The formation of Grand Coalition emphasizes the peculiarity of the election results, as this has been only the second time in German history that the two major parties got together to form the government. Due to the lack of cohesiveness and permanent resistance of the SPD towards the introduction of flat-tax (especially of the new Minister of Finance Peer Steinbrück from SPD), as well as its stronger bargaining position, the coalition finally abandoned the idea of *Einheitssteuer*. In fact, the protest against it happened to be an official declaration of the big coalition and was demonstrated also in the coalition agreement.¹⁰⁴ There are two possible explanations of the bargaining strength of SPD: first, the Christian Democrats paid a high price for securing the

¹⁰³ Hamburger Abendblatt. "Kirchhof Wants the Enforcement of Flat-tax in 2007." [Kirchhof will Einheitssteuer 2007 umsetzen]. *Hamburger Abendblatt on the Web*, 24 Aug. 2005. 28 May 2007 <<http://www.abendblatt.de/daten/2005/08/24/474420.html>>.

¹⁰⁴ *Koalitionsvertrag zwischen CDU, CSU und SPD*. Section 'Steuerpolitik in Europa', 11 Nov. 2005: 73. 28 Dec.2006 <http://www.bundesregierung.de/nsc_true/Content/DE/___Anlagen/koalitionsvertrag,templateId=raw,property=publicationFile.pdf/koalitionsvertrag>.

chancellorship and secondly, based on the election outcome the Social Democrats had more coalition alternatives open and could easily form even a minority government.¹⁰⁵ Contrary to the low cohesion of the coalition, the political, as well as social opposition was primarily negative towards and relatively united on the issue of flat-tax.

At last, let me refer to the lecture delivered by Professor Kurt Biedenkopf, the former governor of the Free State of Saxony (1990-2002), on the issue of the modern welfare state and its promises and failures.¹⁰⁶ When asked the question where he would see the roots of such a turnaround on the part of the CDU towards flat-tax adoption, he identified similar factors to those presented here. The first point Biedenkopf presented is the 2005 election outcome that has led to the formation of the Grand Coalition, in which the CDU's coalition partner SPD resolutely refused to abandon the progressive taxation. This point was addressed in more detail in the section above. Secondly, he asserted that the German taxation is a very complex system with numberless tax exemptions. Though, what Biedenkopf wanted to emphasize at this point, was the fact that behind each of the exemptions is a vast interest of different social actors and lobby groups and therefore the abolishment of which would be politically unfeasible. Finally, he perceives the quick and radical adoption of the flat-tax reform in Slovakia rather as a matter of "the fortune of the hour." Biedenkopf concluded saying that this would have been hardly possible in highly developed societies reminding us of the argument proposed and developed in more detail by Conor O'Dwyer. The next section will expand more particularly on the Biedenkopf's second point - the role of the interest groups in the flat-tax debate, specifically the labor unions'

¹⁰⁵ Proksch, Sven-Oliver and Jonathan B. Slapin. "Institutions and Coalition Formation: The German Election of 2005." *West European Politics*, Vol. 29, No. 3 (May 2006): 553-554.

¹⁰⁶ Biedenkopf, Kurt. Lecture by author. Central European University, Budapest, Hungary, 25 April 2007.

“contribution” to the flat-tax failure in Germany - and as a result, add more credit to his claim.

3.1.2. Labor Unions and Welfare-Identity Embedment

The flat-tax reform plan has become only one of many reform proposals - aimed at reshaping the German state to face the continuously changing external challenges - that were, however, doomed to a failure in the German socio-political environment. The resentment towards the reform in Germany has been the subject of interest to numerous studies in an attempt to identify the possible factors for the its ‘reform stagnation.’ For example, Kitschelt and Streeck (2003) see the main impediment to reforms in the German overcommitment to the institutions created in the past to secure the mutual recognition of interests of the political, corporate and social actors. The “unshakeable tripartite consensus with business and labor,”¹⁰⁷ the functioning welfare state and the disposition to compromise have always been something that the German politicians were proud of. Though, as Kitschelt and Streeck claim, “what used to be a virtue of stability may have turned into the vice of stagnation.”¹⁰⁸ A partial reform process has been initiated by the last Schröder government in the area of labor market and benefit system (Hartz IV). Although this has been an initiative in the right direction, a whole range of other reforms of tax system, health care, welfare system are needed to ensure the sustainability and competitiveness of German economy for the future. Currently, Germany is experiencing a cyclical recovery what according to the IMF experts should be utilized by Germany for adopting the necessary structural reforms and for reducing debt.¹⁰⁹ Notably, however, Kitschelt and Streeck are

¹⁰⁷ Kitschelt and Streeck (2003): 1.

¹⁰⁸ Kitschelt and Streeck (2003): 4.

¹⁰⁹ International Monetary Fund. “Germany: Recovering at last.” *IMF Survey*, Vol. 36, No. 3 (Feb. 12, 2007): 44-45.

rather skeptical about German ability to overcome the “high equilibrium trap”¹¹⁰ in the near future.

The previous section on the political parties institutionalization in Germany has documented the commitment of the two leading political parties SPD and CDU (though more the former than the latter) to the traditional concepts of German politics, such as corporatism, welfare state and the social market economy. Therefore, following the Kitschelt and Streeck’s argument, the political parties can be identified as the first group of actors making the old German institutions alive to this day. Into the second group of actors committed to the old institutions, resistant towards novelties and as a result, impeding the adoption of necessary reforms, I would place the German labor unions (though not the social actors as a whole, as the representatives of business seem to be more biased towards change and reform process, especially in the economic and labor market sphere). According to Cox (2001) the German labor unions have often used the idea of security in their argumentation, “depicting reforms as promoting insecurity” and as a “way to undermine their viability.”¹¹¹ In his paper, the author poses a similar question to that of mine and seeks to find the most viable explanation for why Germany failed to emulate the adoption of radical welfare reform of its neighbors Denmark and the Netherlands in the 1980s. Cox expectantly points to the important role of the social partners, especially labor unions and their welfare-identity. The organization of German labor is multi-layered,¹¹² though united under the umbrella Confederation of German Trade Unions (DGB), currently led by Michael Sommer. The lack of their support weakened the coalition for reform and prevented

¹¹⁰ In Kitschelt and Streeck (2003): 1-2.

¹¹¹ Cox, Robert Henry. “The social construction of an imperative. Why welfare reform happened in Denmark and the Netherlands but not in Germany.” *World Politics*, Vol. 53 (April 2001): 495.

¹¹² Kitschelt and Streeck (2003): 4.

the government to pass the welfare reform, despite the strong parliamentary support.¹¹³ What followed, was an adoption of numerous piecemeal changes and Germany could in fact easily compete with its neighbors when measuring the reform in terms of quantity, but could hardly reach their decisiveness and, by implication, quality. The case explored by Cox is an analogical situation to the German attempts of flat-tax implementation. As Angela Merkel did more recently, in the 1980s Helmut Kohl “quickly abandoned the idea of turnabout” when faced with vigorous opposition.¹¹⁴

The industrial relations in Germany are very well established and the labor unions well institutionalized with a strong bargaining position. The Chancellor Merkel herself acknowledges their role in the policy-making process and has “interest in strong labor unions.”¹¹⁵ On the other hand, the government also acknowledges the need for structural reforms. What according to Cox is necessary in this seemingly stalemate-like situation, is the creation of “social construction of an imperative,” which means that in order to make the reform process politically feasible in Germany, the reform-minded government has to first overcome the skepticism towards reform process and novelties in general, as well as persuade the societal actors, including labor unions, of the importance of reform.¹¹⁶ As Cox aptly concludes: “the welfare reform is more a struggle over the identity of a society than over size of the budget.”¹¹⁷

In sum, the objectives of this chapter were 1.) to focus on the example of Germany on the political party system and its institutionalization, 2.) to examine the nature political

¹¹³ Cox (2001): 496.

¹¹⁴ Cox (2001): 490.

¹¹⁵ Frese, Alfons. “A new colleague.” [Ein neuer Kollege]. *Tagesspiegel on the Web*, 7 Sept. 2005. 27 May 2007 <<http://www.tagesspiegel.de/fragen-des-tages/archiv/07.09.2005/2036372.asp>>.

¹¹⁶ Cox (2001): 475.

¹¹⁷ Cox (2001): 498.

divisions among the main parties and their ability to build coalition/opposition for/against the flat-tax adoption and finally, 3.) to look at the the labor unions' position on flat-tax and their role in German society. From the above analysis of the German case we can conclude that the country has strongly institutionalized political parties, with CDU and SPD being the most dominant ones. With regard to the flat-tax issue, the government coalition was rather split and weak, at last completely abandoning the idea. On the contrary, the opposition cohesiveness against the flat-tax has proven to be rather high. What concerns the labor unions, but the social partners in general, they traditionally enjoy influence in affecting policy (including tax policy) change. This has largely been possible by the welfare-identity embedment in German society.

4. Comparison of Slovakia, the Czech Republic and Germany

This chapter is crucial due to its comparative analysis integrating the collected findings. In the examination above I proposed three key variables as decisive for the flat-tax implementation and the *Table 1* summarizes the findings of the feasibility variables for each country case. An attempt was made to develop a typology that would clearly structure the country conclusions. This chapter is organized as follows: 1./ it sums up the findings by the feasibility variables - not by country variable at this point – in order to emphasize the variety, as well as different significance of each of the factors in the countries. At the same time, it allows for an easier comparison of each variable's influence on the political system. Then 2./ the chapter uses the method of country paired comparisons and determines which of the studied factors play the most decisive role in the flat-tax adoption process.

Table 1: Flat-tax feasibility factors – three country typology.

	Political Parties' Institutionalization	Labor Unions' Institutionaliz.	Coalition/Opposition Cohesion	Flat-Tax
Slovakia	Low	Low	High/Low	Yes
Czech Rep.	High	Medium	Medium high/ Medium high	Yes/No
Germany	High	High	Low/High	No

Note: state of the variables during the time of flat-tax adoption in the case of Slovakia/proposal in the case of the Czech Republic/ refusal in the case of Germany

Starting with the political party institutionalization variable, there seems to be a high degree of variation between the countries. Slovakia, from the three country cases has the least established party system. It is marked by high volatility in terms of frequent emergence and disappearing of the parties and by the absence of the linkage to clearly defined socio-

economic constituencies (i.e. programmatic discrepancies not being an obstacle in the inter-party cooperation). On the other hand, the other EE country case, the Czech Republic, shows signs of high institutionalization with two major political parties on both centre-right and centre-left (ODS and ČSSD respectively). On this factor, the Czech Republic is rather congruent with political party system of Germany, where the two major cross-class parties (CDU, SPD) are an integral part of the German political scene ever since the WWII. However, there is one important aspect differentiating these parties from the Czech quasi two-party system, namely the commitment of both German parties to a welfare-identity.

In contrast to the party system institutionalization, Slovakia ranks first with regard to coalition cohesion during the time of flat-tax reform approval. At the same time, the coalition encountered only a fragmented and highly incoherent opposition – a combination of factors that to a large extent contributed to the political feasibility of flat-tax in Slovakia. On the other hand, the Czech Republic boasted only a somewhat coherent governing coalition. Although the coalition could agree on the flat-tax reform proposal, its partial incoherence and the slightly different programmatic goals of its members mitigated the radical character of the proposal (a coalition compromise). With respect to opposition cohesiveness, the two EE countries show rather divergence. The Czech Social Democrats represent a relatively strong opposition force against flat-tax with an additional support of labor unions. Though, the opposition is hardly reaching the German level of resentments. In Germany the low programmatic cohesion of the coalition after the elections (‘Grosse Koalition’) predisposed the flat-tax proposal as a joint government project to its failure. In addition to SPD’s resistance (which basically meant having an opposition within the coalition), the anti-flat-tax camp was supported by labor unions, the position of which is well embedded and widely accepted in German welfare society.

The study of Slovakia and the Czech Republic further confirms the notion of labor union weakness in Eastern Europe compared to the West European case of Germany. At the same time, the analysis shows variations within the EE region, leaving Slovakia with weakly organized, fragmented labor unions, lacking the capacity to evolve pressure on the decision-making bodies. On the other hand, the Czech labor unions find themselves in a better position partly because of the previous social democratic governments and their extension of the cooperation with labor unions beyond the tripartite meetings. Also, the interrelationship of the unions with a leading political party distinguishes the Czech labor unions from those in Slovakia. Still, one has to be aware that with the rise of the centre-right government the influence of labor unions might be decreased in a short-run, what might be crucial for the flat-tax implementation. Finally, Germany disposes of the most institutionalized labor unions with influence on the political decisions. One can claim that the welfare identity embedded in the German polity largely favors the position of labor unions.

With regard to the labor unions, we must take note of the fact that labor leaders across the three countries studied here, jointly protest against the flat-tax implementation. Their line of reasoning most commonly rests on the argument that flat-tax brings inequality to the tax system and favors the wealthy, as well as the private business sector, while putting additional burden on low- and middle-income groups. An objective assessment of the losses and gains to these socio-economic classes, however, is largely country dependent. First, the trade-offs are determined by a country's initial tax situation, such as the original tax burden on the citizens (which was relatively high in the post-communist countries prior to reforms and was markedly lowered with the introduction of flat-tax), or the type of exemptions benefiting, or not, the lower income groups. Second, the question of what workers might

gain and loose by the flat-tax depends on the type of the flat-tax system, with option ranging between those applied broadly and exclusively, on PIT, CIT, VAT. The ultimate level of the tax rate is also key. Therefore, it is surprising that given the different initial (prior reform) country conditions, the argumentation was so similar, in fact if not the same. Having raised this interesting puzzle, however, it is beyond the scope of this paper to explore it in detail.

After summarizing the findings by the factors highlighting especially the variations between the countries (East vs. West, East vs. East), the next section uses the method of country paired comparisons to determine which of the studied factors plays the most decisive role in the flat-tax adoption process. For **Slovakia** and **Germany** all factors, including the outcome, are of opposite value and therefore, although this pair-comparison gives us an idea of what factors actually matter, the major shortcoming is that it does not tell us which of the three variables is the most decisive one.

On the other hand, the comparison of the **Czech Republic** and **Germany** is more telling. Under the condition that the flat-tax reform proposal will be passed in the Czech Republic, in that case the method of difference can be applied. The *political party institutionalization* is similarly high in both countries. What concerns the *coalition cohesion*, it is rather low in the two countries. Although it might appear that it is little higher in the Czech Republic than in Germany because of two reasons. First, in the Czech Republic the coalition could finally agree on the joint flat-tax proposal, although under the less radical conditions than originally planned and secondly, in Germany the flat-tax idea was totally unacceptable for the “big coalition” partner SPD. More specifically, when taken from the point of view of the voting procedure in the lower chamber of the Parliament, the Topolánek’s coalition will have to rely not only on all the MPs of the coalition parties (including MP Tlustý who refuses the reform in its current form), but also on the votes of two undecided MPs who

“defected” from the ČSSD opposition party, what clearly is not a sign of a coherent coalition. Still, I would not dismiss the coalition cohesion as an unimportant factor here. To be fair, if the Czech government succeeds in passing through the reform, as predicted above, the coalition then has to dispose of some effective, although limited, power. What seems to be decisive, however, is the level of *labor unions’ institutionalization*, although being higher in the Czech Republic than in Slovakia, it still remains far under the level of the workers’ organization in Germany. The high labor institutionalization in Germany, as well as the omnipresent welfare identity, seem to account for the unfeasibility of flat-tax in Germany. The lower level of labor institutionalization in the Czech Republic possibly for flat-tax implementation. When applying this finding to Slovakia, its low level of labor union institutionalization clearly supports the concept developed here. Therefore, what seems to account for the variation between the East and the West with regard to flat-tax issue, is the labor unions, understood as a key link to the welfare identity embedding the society.

When contrasting the three studied variables for **Slovakia** and the **Czech Republic**, what appears to be decisive here is the factor of coalition and opposition cohesion. In the case of *labor union institutionalization* the difference is obvious and the level lower in Slovakia than the Czech Republic. However, although the Czech labor unions seem stronger, their institutionalization is hardly reaching the German level in their capacity to dramatically influence the decisions of the governments. This holds particularly for the current centre-right government. With regard to *party system*, its institutionalization shows rather opposite values. Though I would question its decisive impact on the flat-tax feasibility. Of course, the political parties predispose and form the governments but the Czech political parties can equally come together (as they have proved recently) and agree on the flat-tax implementation like the less institutionalized parties in Slovakia. The more convincing

explanation seems to be that the *coalition and opposition cohesion* is the decisive factor in the two Eastern European cases.

Conclusion

The aim of this thesis has been to account for the different approaches that various European countries adopted towards the idea of a flat tax. More specifically it weighed several factors that make the feasibility of flat tax possible in some countries but not in others. Furthermore, it has attempted to elucidate, whether it is only one particular variable that accounts for most of flat-tax feasibility, or whether several variables are in the play simultaneously instead. Empirically, the thesis is based on detailed studies of Slovakia, the Czech Republic and Germany.

As the analysis has revealed, feasibility of the flat tax can largely be ascribed to political variables. Whether the flat-tax debate results in its adoption or its rejection, depends largely on the current combined strength of the political forces in favor of the flat-tax. Considering the puzzle of intra-regional variation in Eastern Europe in more detail, we have to conclude that it is the combination of numerous variables in each of the countries creating a context-specific political situation that is variously supportive of flat-tax reform. The three variables - 1./ party system institutionalization, 2./ coalition/opposition cohesiveness, 3./ labor unions' institutionalization - identified in the literature on the subject as factors most likely to affect flat-tax adoption, indeed seem to play an important role in flat-tax feasibility. One underlying variable, however its opposite values, seem to account for the political (un-)feasibility of the flat taxation in the East and the West. This conclusion confirms the widespread notion of the persistent East-West divide. In fact, it simultaneously confirms the social divide between the East and the West, in more particular.

In the case of Germany the study identified labor unions' influence and welfare identity for that matter, as the decisive variables for the flat-tax unfeasibility. The idea of

security and tripartite consensus underlie the political decision-making in Germany, making the country less (flat-tax) reform prone. The relative labor unions' weakness in both Slovakia and the Czech Republic (though weaker in the former than the latter) does not allow us to make similar conclusions for Eastern Europe. Here I claim that it is rather the factor of coalition and opposition cohesion that is decisive. Nevertheless, it is the absence of German type welfare identity in Eastern Europe that lets us make such conclusion. In fact, it is this absence of welfare identity that allows the Eastern European countries form more flat-tax prone coalitions. The presented country cases have confirmed our hypotheses set in the introduction that the higher the political parties' and labor unions' institutionalization, the less is the flat-tax politically feasible. This is interesting because even if some countries considered the adoption of flat-tax by virtue of its economic effects, it proves politically unfeasible. The German case also confirmed the expectation that lower coalition cohesion works against the flat-tax adoption. At last, to verify my conclusions, further paired comparisons of the non-flat-tax countries from Western Europe and both flat-tax and non-flat-tax countries from Eastern Europe are required.

Given the fact that the argumentation developed here is correct, an inquiring researcher is tempted to go even further in the analysis and apply it back to the empirical reality, seeking to extend the argument's contribution. What is of particular interest to me, is the case of the "flat-tax puzzle country" the Czech Republic and the question, whether it will adopt the flat-tax or not. I start out with the notion that the Slovak neighbor is more prone to flat-tax implementation than Germany. The reason for this I see mainly in the weaker position of labor unions and the absence of the German type welfare-identity – factors that could evolve strong negative pressure (taken from the flat-tax proponents' view) on the

decision-making process. In addition, the idea of flat-tax is not entirely new in the Czech environment and has been proposed by ODS for several years already. The “devotion” of the ODS party to the flat-tax idea is therefore obvious and the party also succeeded in making it the current coalition’s goal, although less radical than originally planned. What also needs to be pointed out is that in contrast to Germany, the reform stagnation of the last years is not conclusive as it was primarily the result of less reform oriented Social Democratic party. Therefore, I conclude that there is a reasonably good chance that the Czech Republic will introduce the flat-tax and join the East European “flat-tax tide.” This will possibly evolve even more tax competition¹¹⁸ pressure on the West (in particularly Germany) to rethink its welfare-identity based politics.

¹¹⁸ as the Czech flat-tax reform would be, as in the previous East European cases, accompanied by the lowering of tax rates.

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