

CENTRAL AND EASTERN EUROPE IS FLATTENING

A COMPARATIVE STUDY ON FLAT TAX

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Submitted to
Central European University
Department of International Relations and European Studies

In partial fulfilment of the requirements for the degree of Master of Arts

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Budapest, Hungary
2008

Word count: 17 199

Abstract

The present thesis analyzes the current spread of the flat tax among the Central and Eastern European countries from a political-economic perspective. The combination of the economic and political aspects provides a comprehensive framework for understanding why governments implement such radical liberal reforms. The central hypothesis of the thesis is that the embeddedness of the state in the society defines the factors which determine the feasibility of the flat tax. Based on the hypothesis a model is established that describes the feasibility of the flat tax in weakly and strongly embedded countries upon the cost-benefit calculations of the governments. Through the comparative analysis of the eight most developed post-communist countries, the hypothesis is tested. I find that in weakly embedded countries the macroeconomic circumstances and the government's preferences define the type of the new tax system, while in embedded countries the decision is influenced by the voters' and interest groups' preferences as well.

Acknowledgements

Foremost, I would like to express my gratitude to my supervisor, Professor Robert C. Hancké, whose assistance, helpful advices and guidance were substantial in writing the thesis. The long-lasting thesis seminars offered a significant support to my work. I would also like to thank for the encouragement of Professor Béla Greskovits, whose exciting classes inspired me to evaluate the topic. My gratitude is also to Professor Péter Gedeon, who helped me in finding the most relevant literature on the topic. Finally, I cannot end without thanking to my family, from whom I got the greatest support during my work.

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“The Art of Taxation consists of so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing.”¹

Jean-Baptiste Colbert

1. Introduction

Out of the ten new post-communist EU Member States seven have introduced the flat tax system in the past decades, and Poland has already declared to implement it in 2010. The spread of the flat tax is the most puzzling second generation reform among-communist Central and Eastern European countries. (CEE) The introduction of the flat tax poses the question why in countries in different macroeconomic situation, with different institutional settings, facing with different challenges similar reforms could be implemented.

Although, flat tax is seen as a general medicine for all the challenges in the post-communist countries tax structure- like high tax avoidance, an overcomplicated system that results high inefficiency- no detailed research has succeeded in proving that flat tax is more efficient than any other tax reforms.² In addition, the argument that the intensive tax competition makes countries implement similar tax structures in order to raise their competitiveness provides only a partial explanation.³ Thus it remains an open question, why the countries facing different economic challenges implement the flat tax.

The thesis sets the goal to explain the current spread of the flat tax by a politico-economical framework. Many studies have revealed either the economic or the political aspect of the flat tax, I seek to move beyond the one-sided explanations and combine the two approaches. The combination of the economic and political aspects provides a comprehensive framework for understanding why

¹ Jean- Baptiste Colbert ([cited 03/03/2008]; available from <http://www.evene.fr/celebre/biographie/jean-baptiste-colbert-3654.php>).

² Pablo Saavedra, "Flat Income Tax Reforms," in *Fiscal Policy and Economic Growth in Europe and Central Asia*, ed. Cheryl Gray, Tracey Lane, and Aristomene Varoudakis (World Bank, 2007). 2.

³ Erzsébet Viszt, "Competitiveness and Tax Rates" (paper presented at the Conference on the Hungarian Competitiveness, Budapest, 2007).

governments implement such radical liberal reforms. The focal question of the thesis is which variables and how determines the final decision of the governments on the tax reform.

In the first section of the thesis I describe the background of the flat tax and give an overview about the most relevant literatures. The final aim of this section is to fill gap between the political and economic type of explanations by establishing a hypothesis. In my hypothesis I argue that the variables determining the feasibility of the flat tax depend on the embeddedness of the state, and upon the level of embeddedness different cost-benefit equations could be established. The governments' compare the outcomes of the cost-benefit equations in the case of different tax systems, and choose the most beneficial one.

At this stage the notion of embeddedness of the state should be clarified. Although the embeddedness can be defined differently upon the approaches; in the thesis a simplified definition of the embeddedness is used. While Granovetter⁴ and Evans⁵ mean a broad network of the micro-, macro-level internal and external interactions when talking about the embeddedness of the state, the thesis focuses on the interactions between the levels. I define the embeddedness of the state in light of the strength of linkages between the state and the relevant stakeholders (citizens, interest groups, economic actors). Thus in my simplistic definition I classify every state embedded where the linkages between the state and the stakeholders are strong.

Drawing on this framework, I then elaborate, through case studies, the two variant of countries, the embedded and the non embedded countries. The empirical researches aims to highlight how the governmental policies are formed in the eight most developed post-communist countries, the eight that joined the European Union first. The first part of the second chapter deals with the non-embedded Baltic States. In the case of the non-embedded countries, upon our hypothesis the macroeconomic circumstances and the government's position, the institutional settings determined the feasibility of the

⁴ Mark Granovetter, "The Strengths of Weak Ties," *American Journal of Sociology* 78 (1973).

⁵ Peter Evans, "The State as a Problem and Solution: Predation, Embedded Autonomy, and Structural Change," in *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State*, ed. Stephan Haggard and Robert R. Kaufman (Princeton: Princeton University Press, 1992).

flat tax. Hence the combination of these factors is analyzed in light of the reforms. The second part of this chapter illustrates the case of the embedded countries, where the cost-benefit equation reflects the stakeholders' preferences as well. The analysis first observes the case of Slovenia, where the embeddedness of the state is accompanied by high support for the notion of social protectionism.⁶ Hence, Slovenia is a perfect example to reflect that the introduction of the flat tax relies on a complex cost-benefit calculation. The third group of the countries to be analyzed consist the four Visegrád states, where the level of embeddedness of the state varies. Through the description of the four countries we have a better overview about how the different variables in the cost-benefit equation determine the states' decision on the reforms.

The final part of the thesis sets the goal to- upon the experiences on the empirical studies- explain the implication of the model. I demonstrate that the hypothesis and the established cost-benefit equation provide a comprehensive framework for analyzing and forecasting the governments' choices over the tax reforms.

⁶ Dorothee Bohle and Béla Greskovits, "Neoliberalism, Embedded Neoliberalism, and Neocorporatism: Paths Towards Transnational Capitalism in Central-Eastern Europe" (paper presented at the Comparative Politics Workshop, Post-Communist Political Economy and Democratic Politics, Duke University, 2006).

2. Background and Literature Review

2.1. *The Economic Background of the Flat Tax*

Before analyzing the extensive literature on the flat tax, the economic background should be clarified. There are three types of tax systems; progressive, proportional and regressive. In the progressive tax the effective tax rate increases as the amount to which the rate is applied increases. In other words the tax rate increases proportionally with the tax base. Theoretically the more progressive the tax is, the more equality it brings, therefore the state's intervention in the redistribution is higher. The above described reason led to the widespread application of the progressive taxes in the welfare states. However, the progressivity also brings complexity, thereof the administrative costs are higher and the tax avoidance is more likely in a progressive system. The opposite of a progressive tax is the regressive tax, where the tax rate decreases as the tax bases increase. The third system is the proportional, where the tax rate remains equal independently from the tax bases. The proportional system is widely used in the indirect taxation (e.g. value added tax). Generally the tax systems are composed of proportional and progressive elements. Typically the income based taxes are progressive and the consumption based taxes are proportional.⁷ The flat tax system is a form of proportional tax.

The flat tax systems are differing from each other in their compositions and their structures. The first Robert Hall and Alvin Rabushka⁸ proposed flat tax is similar to the value added tax.⁹ As Pablo Saavedra describes the flat tax rate simplifies the tax systems, increases the transparency and decreases not only the administrative costs, but also the tax evasion rate. Usually, the tax burdens are also decreased by the system, which is a motivator for the investors.¹⁰ The flat tax contrary to the progressive rates focuses on the fairness function instead of the equality function. In the case of flat tax the contribution of the citizens is equal, only the extent is differing. In flat tax systems the

⁷ Tamás Bánfi and Sulyok-Pap Márta, *Pénzügytan (Finance)* (Budapest: Tanszék Kft., 2002). 229-246.

⁸ Robert Ernest Hall and Alvin Rabushka, *The Flat Tax* (Stanford: Hoover Press, 1995).

⁹ Joel Slemrod, "My Beautiful Tax Reform," *Ross School of Business Paper* No. 1027 (2005). 5.

¹⁰ Saavedra, "Flat Income Tax Reforms." 2.

governments are not influencing the societal structure significantly through taxes, but through other measures. In this respect the flat tax system is a liberal economic idea, the system minimizes the state's role to maintain the fairness function and to promote the competition.

Many scientists and political actors however question the optimality of the flat tax systems by highlighting the missed equalizer role. As illustrated above it is a political question whether the tax system is focusing more on the justice or the fairness principle. The tax system together with other subsystems influences the social structure of a country. A government can highly intervene to the social structure on the distribution side even in a flat tax country.

2.2. Literature Review

The introduction of flat tax in post-communist EU Member States raises the question why countries with different political and institutional structures implement similar tax systems. During the second part of the last century a widespread debate was launched about the divergence of the tax systems. Economists aimed to answer the puzzle why developed democracies have different tax systems. According to Steinmo, three groups of explanations evolved in the debate.¹¹ The first explanations rooted in the interest groups theory. The interest group based explanations suggest that the distribution of the taxes reflects the interests of specific groups in the society.¹² The second type of explanation, by acknowledging the weakness of the interest theory, does not rely on the assumption that the interests groups have similar preferences in every country, and states only that citizens define the role of the governments in different countries differently. This value based explanation suggests that citizens' different value system creates different public policies.¹³ The third explanation widens the first and the second theory by putting the emphasis on the role of the states. This approach

¹¹ Sven Steinmo, *Taxation and Democracy : Swedish, British, and American Approaches to Financing the Modern State* (New Haven Yale University Press, 1993).

¹² James E. Alt, "The Evolution of Tax Structures " *Public Choice* 41 (1983).

¹³ Louis Hartz, *The Liberal Tradition in America* (US: Harcourt, Brace, 1955).

suggests that the state as a relatively individual actor has the most decisive role in determining the public policy.¹⁴

The fourth explanation is devoted to Steinmo, who claims that none of the three approaches fully explains the divergences within the public policies, they fail to explain how certain preferences are formed and what kind of impact they have on policies. According to him the analysis of the institutions creates a link between individual preferences and the policy making strategies. In addition the constitutional settings define the political arena for the governments in which they have certain autonomic latitude. Steinmo underlines, that the different decision-making models create different policies, which are highly observable in the tax structures of the given countries¹⁵ The Steinmonian framework provides a relevant starting point when observing the current trend of flat tax reforms.

The spread of flat tax reforms raises the question, why different countries have introduced similar reforms. The neo-institutional approach suggests that countries with different institutional settings would implement different tax reforms; however, this is not the case in Central and Eastern Europe. Although the eight most developed CEE have a common historical background, their institutional settings vary highly.¹⁶ Thus it is an interesting question why countries with different institutional settings, different level of political institutionalization and with different interests groups implement similar tax reforms.

While an extensive literature concentrates on the economic background of the flat tax, hardly any current literature provides a broader analysis of how the above described differences are depicted in the current spread of flat tax. One of the most relevant writings that provide a coherent explanation for

¹⁴ Peter Evans, Dietrich Rueschmeyer, and Theda Skocpol, "On the Road to a More Adequate Understanding of the State," in *Bringing the State Back In*, ed. Peter Evans, Dietrich Rueschmeyer, and Theda Skocpol (Cambridge Cambridge University Press, 1985).

¹⁵ Steinmo, *Taxation and Democracy : Swedish, British, and American Approaches to Financing the Modern State*. 7-13.

¹⁶ Bohle and Greskovits, "Neoliberalism, Embedded Neoliberalism, and Neocorporatism: Paths Towards Transnational Capitalism in Central-Eastern Europe".

the reforms is the article of O'Dwyer and Kovalčík.¹⁷ As they argue, the second generation reforms are usually painful for the society, and therefore governments, are likely to face significant political and societal pressures. Thereupon, the reforms are likely to be implemented in weakly consolidated democracies, where because of the lack of the societal linkages the voters are less likely to resist. This model explains the radical reforms in weakly institutionalized countries; however, the framework does not give an adequate answer to how in embedded countries radical reforms can be implemented.¹⁸ Although O'Dwyer and Kovalčík only partially explain the spread of the flat tax and their framework can be criticized in the case of embedded countries, their argument on differentiating between the lowly and highly embedded countries seems to be decisive in the feasibility of the flat tax.

Evans and Aligica aim to provide a wider framework when analyzing the spread of the flat tax in twenty post-communist countries.¹⁹ Based on six conditions: tax evasion and budget pressure, the capital flight, the membership of international community, the civil society, the presence of a policy champion and finally the precedent cases, they establish a general equation about the probability of the implementation of the flat tax. According to them, "internal budget pressures, external capital flight pressures, and precedent will lead to the adoption of the flat tax."²⁰ In addition, in the countries where the flat tax was implemented, the low level of political institutionalization is accompanied by the lack of the civil society. Evans and Aligica acknowledge that the framework fails to explain the tendencies among the Visegrád countries. They argue that „our understanding isn't satisfied, but we've adequately dealt with one of the competing theories: if ideas do matter we need a more refined concept.”²¹

¹⁷ Conor O'Dwyer and Branislav Kovalčík, "Party System Institutionalization and Second-Generation Economic Reform in the New EU Member-States: The Advantages of Underdevelopment?" (paper presented at the European Union Studies Association's Ninth Biennial International Conference, Austin, March 31-April 2, 2005).

¹⁸ Livia Antalova, "Contemporary Flat-Tax Reforms in Eastern Europe: Causes of Diverse Approaches a Comparison of Slovakia, Czech Republic and Germany" (Central European University, 2007).

¹⁹ Anthony J Evans and Paul Dragos Aligica, "The Spread of the Flat Tax in Eastern Europe," *Eastern European Economics* 46 (2008).

²⁰ Ibid. 64.

²¹ Ibid. 65.

A concept that explains better the differences between the politically highly and lowly institutionalized countries was created by a former CEU student, Livia Antalova. In her thesis, she identifies three decisive factors that influence the feasibility of the flat tax: the party system institutionalization, cohesiveness of the political arena (opposition and coalition forming patterns) and finally the role of a specific interest group, the labor unions.²² Although Antalova provides the most comprehensive approach, she misses to connect the economic and political factors.

In sum, the presented approaches fail to explain how flat tax could be introduced in countries with different level of embeddedness and in countries facing different challenges. The aim of the thesis is thus, to provide a comprehensive framework that fill the gap between the political and economic type of explanations and give a better overview about the ongoing reforms. In my opinion the reviewed literatures provide an adequate starting point for the analysis. O'Dwyer is right when defining the embeddedness of the state as the most decisive element of the development. Evans and Aglica's attempt to describe the spread of flat tax processes by equation also provides an interesting framework. Thus, the combination of these approaches could provide a reliable framework for the analysis.

2.3. The Model

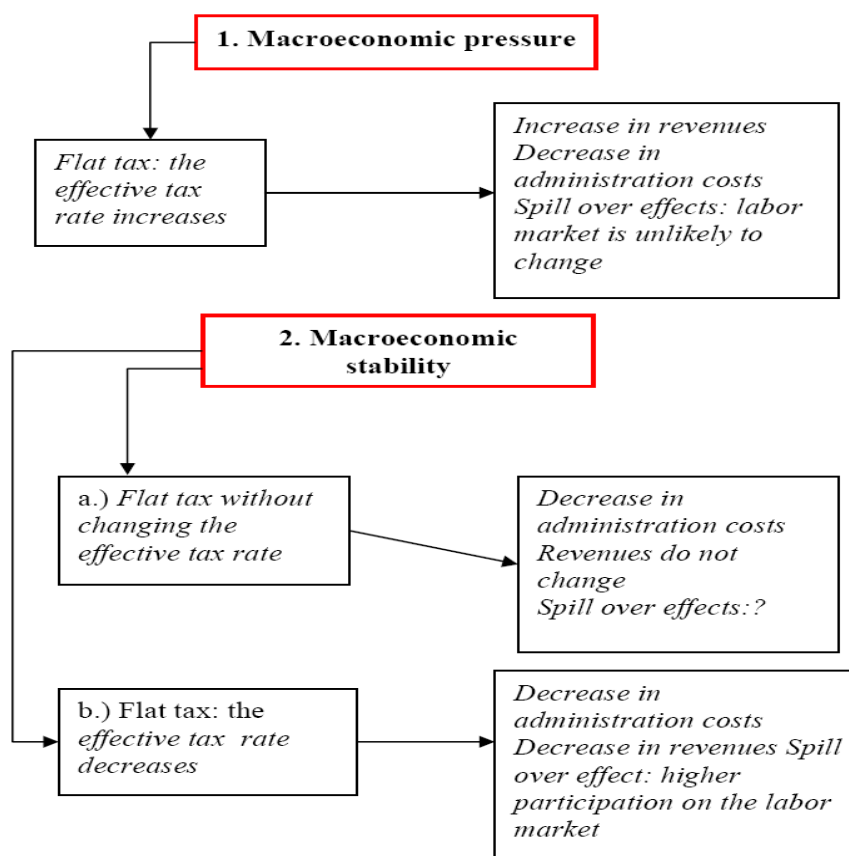
My hypothesis is that the embeddedness of the state in the society defines the factors which determine the feasibility of the flat tax. Therefore, different factors are decisive in lowly embedded countries, than where the state is embedded. In all the two cases cost-benefit equation can be established about determining variables. Thus, in lowly or not embedded societies the tax reform is based on the macroeconomic circumstances and the government's preferences which can be depicted through the following cost-benefit equation:

$$\text{Administration costs} + / - \text{higher/lower tax revenues} + \text{benefits from positive spill over effects} - \text{actual costs of the reform}$$

²² Antalova, "Contemporary Flat-Tax Reforms in Eastern Europe: Causes of Diverse Approaches a Comparison of Slovakia, Czech Republic and Germany".

In the model the decrease in the administration costs depends on the type and efficiency of the reform. The tax revenues are based primarily on the macroeconomic situation, but the institutional settings have a minor influential role as well.²³ The benefits of spill over effects (such as the higher participation on the labor market, higher competitiveness) are as important for the governments as the two other variables, however unlike the first two variables, these effects could be estimated only subjectively. The last variable is the actual cost of the reform, which only has a decisive role in a shorter run calculation.²⁴ In changing macroeconomic situation, as Figure 1. illustrates, the government's decision could vary highly.

Figure 1: The feasibility of the flat tax in non embedded countries in changing macroeconomic circumstances



²³ In neoliberal countries the governments are less likely to increase the revenues in order to maximize the governments role, while in neocorporatist state a tax cut, to secure the notion of minimal state, is unlikely.

²⁴ The last variable can be seen as part of the administrative cost, but as it is a fixed and single cost it should be separated from the general administrative costs.

In the case of weakly embedded societies, the governments' position and the macroeconomic situation determines whether the flat tax is to be introduced. Under macroeconomic pressure the governments are likely to increase the taxes; hence the introduction of the flat tax not only results in higher taxes revenues, but also lowers the expenses spent on the tax system. In macroeconomic stability the governments can implement the flat tax without modifying the effective tax rate, which results in a more efficient tax system with lower administrative cost and equal revenues.

This change is the less likely, because the reform itself has high costs, thus when the spill over effects cannot be estimated clearly the government implements only the flat tax if the decrease in the administration costs is significantly higher than the costs of the reform. Finally, when the government aims to motivate the labor market and the economic circumstances allow it, the effective tax rate can be decreased through the tax reform.

In embedded societies we can assume that the governments' cost benefit equation reflects not only the macroeconomic situation, but also the voters' and the interest groups' preferences.

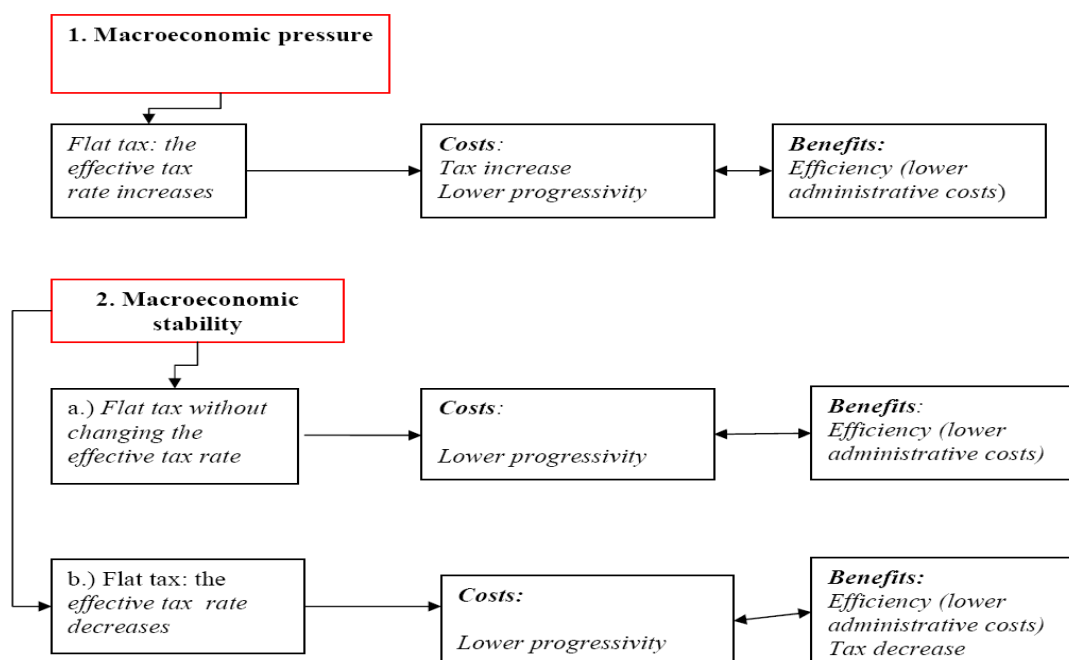
Administration costs +/- higher/lower tax revenues + benefits of spill over effects - actual costs of the reform - costs of convincing the voters and interest groups

In my opinion, the new variable seems to be the most decisive element of the equation. As far as the governments' legitimacy depends on the voters and the interest groups in the embedded societies, every policy should reflect at some level their preferences. Thus, the estimation of the costs of convincing the voters and interest groups is crucial. The estimation is based on how much the voters and the interest groups support a policy in question, which can be described by the voters' and interest' groups cost-benefit function:

Decrease in administration costs +/- the cost of higher/lower tax +/- individual estimated costs of a less progressive tax system

The simplification of the tax system not only decreases the government's administration costs, but also those of the voters. The second factor is based on the macroeconomic situation²⁵ and this variable can be influenced by the governments' preferences. The individually estimated costs appear in the case when governments would like to decrease the progressivity of the tax system. As Roberts et al. showed that voters perceive a positive correlation between the progressivity and social protectionism, because they believe that the more progressive a system is, the more equality it brings.²⁶ Thus the estimation is based on how much voters prefer a tax system that upon their estimation reduces the social inequalities. In any tax system proposal the two variables are likely to change are the administration costs and the individually estimated cost. It should be added that the more embedded a society is, the higher the influence of the voters and the interest groups. As Figure 2. illustrates, in changing macroeconomic situations the voters' and interest groups' cost-benefit calculations differ highly.

Figure 2. The feasibility of the flat tax in embedded countries in changing macroeconomic circumstances



²⁵ The governments have a minor influence on the tax rates. In light of the macroeconomic situation and the long run estimations, the governments could increase and decrease the taxes upon the political arena. Thus, in embedded countries the political arena seems to be more decisive than the institutional settings.

²⁶ Michael L. Roberts, Peggy A. Hite, and Cassie F. Bradley, "Understanding Attitudes toward Progressive Taxation," *The Public Opinion Quarterly* 58 (1994).

If two variables –the estimated costs of a lower progressivity and the benefits gained from the lower administrative costs- are kept fixed, the tax rate decides the feasibility of the tax reform. The model thus suggests that in any embedded society where the preferences of the voters and the interest groups are fixed, the feasibility of the flat tax depends on the tax rate. Based on the above described model it can be argued that governments are likely to implement the flat tax in countries where the cost-benefit equation of the flat tax is more preferential than that of any other tax systems.

In order to test how this framework works in the reality, an empirical analysis will be conducted on the feasibility of the flat tax. The empirical research concentrates on the most developed post-communist countries; on the first eight post-communist countries joining to the European Union as far as among these countries is the highest the number of the embedded states where the introduction of the flat tax was in question. The first part of the analysis will depict the government's decision in politically less institutionalized countries, while the second part of the research describes politically embedded countries. The third part will analyze the four Visegrád countries, that have seemingly homogenous institutional settings, but where the level of embeddedness of the state varies highly.

3. The Feasibility of Flat Tax: A Comparative Study

The aim of this chapter is to describe the political and economic framework of the flat tax upon the analysis of the eight most developed post-communist countries. The established hypothesis states that the embeddedness of the countries determines the cost-benefit functions of the governments that determine the policy choices. In order to testify the hypothesis the policy choices will be analyzed upon the governments' cost-benefit equations. Thus, first the embeddedness of the state should be in focus, which is determined by the transition process. As Kitschelt et al. showed the transition period identifies the linkages between the voters, interest groups and the state. According to their research linkage formation is defined by several mutually important factors, the institutions, the legacies, the political economy and finally the political alignments. These factors together are crucial in the linkage formation.²⁷ Thus the measurement of the embeddedness includes the description of these factors, which influences the further analysis. Based on the level of embeddedness the cost-benefit equation of the countries will differ. Thus, in weakly embedded countries the economic situation together with the institutional settings should be taken into account. Finally based on the government's estimation about the spill over effects, the equation can be established. To understand how these effects were decisive, the tax reform itself should be taken into account.

In embedded societies the cost-benefit equation differs from the second stage. The second aspect which is crucial in understanding the policies is the economic situation in which tax reform was decided. In embedded countries the state preferences are determined by the voters and the interest groups. Hence, the preferences of these groups are depicted through their own cost-benefit equation that is finally integrated to the state's equation. In the case of the interest groups their influence and their position is measured through official statements and researches. In the case of voters' the median voters' preferences will be depicted through public opinion surveys. Finally, the established general

²⁷ Herbert Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation* (Cambridge: Cambridge University Press, 1999). 60.

equation will give us a clarified and comprehensive framework to describe the feasibility of the flat tax, and also allow making forecast about the further implementations.

3.1. *The Baltic States*

The first group of countries to be analyzed is the Baltic States. The Baltic States form a relatively homogenous subgroup, with not only a historically common institutional structure, but also common responses given to the challenges of economic and political changes. The Baltic States, right after the fall of the Soviet Union, faced three relatively connected dilemmas: the question of independence, economic depression and political instability. According to Bohle and Greskovits, these countries first aimed to secure the independence and followed a so-called identity politics.²⁸ The aim of this identity-based politics was to respond to the questions of nation-building and economic struggle in the meantime. All three countries highly depended on the international markets, and therefore, the maintenance of their independence almost automatically resulted in opening their economies. The Baltic pathway, hence, was the result of the three-fold pressure of economic instability, securing the independence and the political instability, which enforced the countries to follow a radical reformist strategy. In the next section thus the focal question would be how this pathway influenced the embeddedness of the state.

3.1.1. *The Embeddedness of the States: the Voice of Voters and Interest Groups*

The first dimension which is substantial to understand the aims and the feasibility of the flat tax reforms is the embeddedness of the state. In the case of the Baltic States the identity-driven politics determined not only the structure of the society, but also the linkages. The political challenges of the identity formation brought about a difficult political situation, where the participation of the Russian

²⁸ Dorothee Bohle and Béla Greskovits, "Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe," *West European Politics* 30 (2007). 451.

minority was not desirable; this exclusion automatically decreased the linkages between the voters and the political parties. In addition, in the unstable and underdeveloped party system no linkages evolved between the voters and the parties.²⁹ The high number of parties and the different coalitions resulted in a low level of political institutionalization.³⁰ Because of the high fluctuation of parties and policies, the voters could not link either the negative or the positive measures to parties. More importantly, due to the weak linkages, their pressure on the governments was partial. The low level of institutionalization allowed the governments to implement measures that do not depict the voters' preferences.

Besides the voters, the interests groups had hardly any influence on the decision-making. In the identity-based politics the interest groups were dismissed because the governments, instead of strengthening the linkages, aimed to stabilize the countries' external reputation. The consequence of this tendency was the low organization of the labor movements and the civil society. In general, the Baltic States have a low number of union members with a typically small wage bargaining power. Thus the social dialogue between the state and the employees was reduced to minimal.³¹ For example, Feldmann and Sally argue that in Estonia because of the instability and the lack of linkages, the interest groups had practically no voice during the reforms.³²

The governments of the Baltic States thus had wide latitude to respond the economic challenges, and the political arena seemed to be partial in the given responses. Interestingly in the Baltic countries neither the voters nor the interests groups could influence the political decision-making, but the external and internal economic pressure did. Thus the cost-benefit equation on the tax reform was based on the following variables:

$$\text{Decrease the administration costs} \pm \text{higher/lower tax revenues} - \text{the cost of the reform} + \text{benefits from spill over effects}$$

²⁹ Vera Stojarová et al., "Political Parties in Central and Eastern Europe in Search of Consolidation," (Stockholm: IDEA, 2007).

³⁰ Marina Popescu and Martin Hannavy, "Project on Political Transformation and the Electoral Process in Post-Communist Europe," (Essex University).

³¹ Magnus Feldmann, "Emerging Varieties of Capitalism in Transition Countries: Industrial Relations and Wage Bargaining in Estonia and Slovenia," *Comparative Political Studies* 39 (2006).

³² Magnus Feldmann and Razeen Sally, "From the Soviet Union to the European Union: The Political Economy of Estonian Trade Policy Reforms, 1991-2000," *Bank of Finland, Institute for Economics in Transition* 1 (2001).

3.1.2. *The Macroeconomic Situation*

The most radical reformers among the new EU Member States were the Baltic countries. Because of the late starting of the transition, the three countries implemented the first and the second generation reforms almost at the same time. Hence, the economic depression- caused by the first generation reforms- lasted only for few years, which was ceased by the second generation reforms.

The Baltic countries went over the shortest transition period compared to other post-communist countries.³³ Among the Baltic States there were only small differences in the economic transition, as they almost faced similar challenges, to which they gave similar answers.³⁴ The first country to implement the second generation reforms was Estonia, where a high inflation rate was accompanied by a high unemployment rate, resulting in economic depression.³⁵ The two other countries, Latvia and Lithuania one year later implemented the same reforms as Estonia had in 1994.³⁶ The Baltic countries' economic development followed a very specific way. The second generation reforms were implemented without stabilizing the macroeconomic situation, thus the external and internal macroeconomic pressure was the most decisive elements of the reforms.³⁷

To conclude, the Baltic States faced a significant macroeconomic instability when they decided to implement the second generation reforms. Thus the aim of the reforms was to provide a more stable macroeconomic position.

³³ Feldmann, "Emerging Varieties of Capitalism in Transition Countries: Industrial Relations and Wage Bargaining in Estonia and Slovenia."

³⁴ Estonia was always the forerunner of the group, while the other two countries exercised a follow-up strategy. Thus, while before the Estonian second generation reforms the state had only unclear estimations about the spillover effects, in the case of the two other countries upon the Estonian precedent, the spillover effects could be better calculated.

³⁵ Paul Belien, "Walking on Water: How to Do It," review of Reviewed Item, *Brussels Journal*, no. (25. August 2005), <http://www.brusselsjournal.com/node/202>.

³⁶ *Policy Insights from a Decade of Baltic Transition* (OECD, 2000 [cited 01/04/2008]; available from <http://www.oecd.org/dataoecd/35/1/1864879.pdf>).

³⁷ Evans and Aligica, "The Spread of the Flat Tax in Eastern Europe."

*Decrease in the administration costs + **higher tax revenues** - the cost of the reform + benefits from positive spill over effects*

Hence, we would expect that the tax reforms therefore would result in higher effective tax rates than the original one. In order to understand how a tax increase together with the flattening of the system could be implemented, the state's latitude and preferences should be analyzed.

3.1.3. *The Governmental Decision on the Flat Tax*

As far as the interest groups were less dominant in the policy forming, the governments' own preferences and the institutional settings determined the reforms. The small country size accompanied by macroeconomic pressure encouraged the governments to implement more liberal policies than in other post-communist countries.³⁸ The Baltic States, hence, due to the economic and political reforms became neoliberal states, where the level of political institutionalization remained weak.

To conclude in the Baltic States the macroeconomic pressure together with the institutional settings defined the economic policies, thus the tax policy as well. It could be assumed that because of the macroeconomic pressure the governments were likely to increase taxes. The increase in taxes was unlikely to influence the political arena, thus the governments could implement a more radical reform, which was in harmony with the neoliberal institutional settings. To understand the role of the influencing factors, the reforms itself should be analyzed.

3.1.4. *The Implementation of the Flat tax in the Baltic States*

The newly independent states went over two tax reforms in five years. Right after the political changes they introduced a new progressive tax system, which in Estonia was replaced by a flat tax

³⁸ Seija Lainela, "Baltic Accession to the European Union," *Lithuanian Quarterly Journal Of Arts And Sciences* 46 (2000).

system in 1994 and in the two other countries in 1995. While in Estonia (16-33%) and in Lithuania (18-33%) the original personal income tax rates' ranges were similar, in Latvia the ranges varied between 10 and 25%. In Estonia the flat tax rate was set to 26%, in the other two countries it was set to the highest rates.³⁹ The flat tax system, because of the high rates, meant an increase in the overall tax rates in all the three countries, which was also demonstrated in the overall increase of revenues.⁴⁰ The tax reforms, therefore, were to stabilize the countries' macroeconomic positions rather than to stimulate the economies. The introduction of the flat tax hence, served a major economic goal, the maintenance of the economic stability and independence of the countries. In addition, the low level embeddedness allowed the government to implement a tax policy that was unfavorable for the majority of the citizens, but was in harmony with state's preferences.

The structure and the form of the tax reforms support our hypothesis that under macroeconomic pressure neoliberal countries are likely to introduce the flat tax with a higher effective tax rate. The new flat tax systems were designed upon the liberal fairness principle and aimed to increase the revenues. Because of the hyperinflation and the high unemployment rate, the revenues needed to be increased. The governments responded to this challenge in a liberal way. They did not simply increase the tax ranges but also made the progressive tax system proportional. In addition, the flat tax was not only a tax increase, but it immediately eliminated the equalizer function of the tax system. The state's cost-benefit equation therefore could be described as the following:

$$\text{Decrease in the administration costs} + \text{higher tax revenues} - \text{the cost of the reform} + \\ \text{benefits from the spill over effects (lower in Estonia, higher in Latvia and Lithuania)}$$

In the case of Estonia, according to the equation, we could assume that the introduction of the flat tax was uniquely the result of the low administration cost, and therefore, any other type of tax reform could have been implemented that would cut back on the administration costs more radically. In Latvia and in Lithuania, besides the administration costs the spill over effects also played an important

³⁹ Michael Keen, Yitae Kim, and Ricardo Varsano, "The "Flat Tax(Es)": Principles and Evidence," (IMF, 2006).

⁴⁰ Ibid. 6.

role in the governments' decision. While in the case of Estonia the spill over effects were hardly estimated, because the lack of experiences, but for the other two states Estonia provided a precedent. The Estonian flat tax fostered a significant growth in the labour market and in the economy, which was expected in the two other countries.

To conclude, the implementation of the flat tax depended on the low level of embeddedness, which allowed the governments to relatively freely decide on the tax reform. The governments' main constraint was the macroeconomic stability, which forced the political decision-makers to increase taxes. The governments by comparing the different tax systems finally agreed on the flat tax because of the low administration costs and positive spill over effects.⁴¹

In order to understand how the cost-benefit equation of the governments changes in societies where the level of embeddedness is different from the Baltic States the other five countries should be analyzed. Firstly another outlier country, Slovenia is analyzed where the flat tax was refused in 2006.

3.2. Slovenia

Since the beginning of the transition period Slovenia has always been the odd one out country in the region. Among the new EU Member States Slovenia was not the only country where the political changes resulted in an armed conflict, but it was the first to recover, and becoming the forerunner of the group. The Slovenian path was similar to those countries that gained independence only after the fall of the Berlin wall as the political changes were connected with the independence question such like in the Baltic States. Therefore, the first years of transition were an identity-driven path search. As Bohle and Greskovits describe, Slovenia together with Hungary and Poland traditionally belonged to

⁴¹ Belien, "Walking on Water: How to Do It," review of Reviewed Item, no.

the most developed and capitalized countries,⁴² where even during the communist area some reforms had already started, which fostered further economic and political development after the political changes. In addition, Slovenia, as one of the smallest countries in the region, faced high dependence on the international markets.⁴³ The Slovenian pathway thus was unique because the identity-based politics was accompanied by a relatively developed and reformed economic and political structure.

Slovenia, for above mentioned reasons, started the transition period as a rather developed country, where gradual reforms could be implemented. Seemingly two aspects determined the Slovenian development. On one hand, the transition from a reform communist system to a capitalist one was less radical, while on the other hand Slovenia could easily integrate to the Western type of economic system. These two aspects led to a less radical type of reform.⁴⁴

3.2.1. The Embeddedness of the State: the Voice of Voters and Interest Groups

The Slovenian transition period and the reform communism resulted in a highly embedded society. Unlike the Baltic countries, the Slovenian state can be classified as an embedded democracy, where the linkages between the parties, the economy and the voters were built up during the transition period. The significant influencing power of the labor unions automatically created strong and rather homogenous interest groups that not only had clear preferences, but were not afraid to declare them. The strong linkages and the embedded subgroups created protectionist institutional settings, devoting a strong role to the government.

The interest group formation and their political power became evident first when the privatization started. An intensive public debate was launched about the form of privatization, but the two oppositional sides could not reach an agreement, hence the government had to resign. The intensive

⁴² Bohle and Greskovits, "Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe." 446.

⁴³ Feldmann, "Emerging Varieties of Capitalism in Transition Countries: Industrial Relations and Wage Bargaining in Estonia and Slovenia."

⁴⁴ Ibid. 846.

political debate clearly showed that the government needed public support to accomplish the reforms.⁴⁵ The highly embedded society suggests that the Slovenian government is likely to reflect in every political decision the preferences of the voters and the interest groups. Thus the state's cost-benefit calculation relies on the following variables:

Administration costs-lower/higher tax revenues +benefits from spill over effects -actual costs of the reform- cost of convincing the voters and interest groups

3.2.2. *The Macroeconomic Situation*

The gradual reforms resulted in that the government remained one of the key engines of the transition, hence not only pure market solutions drove the economic changes. As Feldman describes, although Slovenia adopted a rather liberal foreign trade policy, the presence of the state remained important in all fields of the economy. For example, the macroeconomic stabilization was a key challenge in both the Baltic States and in Slovenia. The hyperinflation pushed the governments toward a more flexible monetary policy; however they gave different answers to the same challenges. While the Baltic States, in order to stabilize their macroeconomic situation almost immediately, introduced a currency board, the Slovenian financial decision-makers chose a managed floating of the currency.⁴⁶ These differences in the monetary policy highlight how the different government replied to the same challenges differently.

The gradual reforms resulted in a never seen economic success in Slovenia. Due to the liberal foreign policy and the active state participation, the Slovenian economy was the first to meet the European convergence criteria and could introduce the Euro in 2007. The macroeconomic stability allowed the government to implement the second generation reforms carefully to foster further

⁴⁵ Olivier Jean Blanchard, Kenneth A. Froot, and Jeffrey D. Sachs, *The Transition in Eastern Europe* (Chicago: The University of Chicago Press, 1994).

⁴⁶ Feldmann, "Emerging Varieties of Capitalism in Transition Countries: Industrial Relations and Wage Bargaining in Estonia and Slovenia." 848-849.

development. Thus the goal of the Slovenian tax reform was to raise the efficiency of the system and to serve the voters.

Upon the macroeconomic situation we can estimate that the state would reduce taxes, and due to the stable economic circumstances any tax reform would slightly influence the labor market, thus the expected spill over effects would not be significant:

Decrease in administration costs - lower tax revenues + benefits from spill over effects
(low⁴⁷) - actual costs of the reform - cost of convincing the voters and interest groups

3.2.3. The voter's and interest groups' preferences on the social protection

As discussed above, the voters and the interest groups have significant influence on the government's choice, and therefore these stakeholders' cost-benefit equitation influences highly the policy outcome. The equation can be used in describing both the voters and the interest group preferences:

Decrease in administration costs + lower/unchanged taxes +/- individual estimated cost
of a less progressive tax system

In the case of the flat tax, the decrease in the administration costs is the highest among the tax systems. The total amount of tax cuts is also fixed, however it varies highly in the case of different tax systems. In progressive tax systems a proportional and equal tax cut would result a more advantageous situation for all the tax payers, while in the case of the flat tax, the rate is the most decisive. In general it can be argued, that for the median voter the flat tax is more preferential only if the rate is set low enough. However the official Slovenia proposal supported a 20% tax rate that would not modify the

⁴⁷ The spill over effects can be estimated through the precedent examples and on detailed researches. See for example Gonzalo C. Capriolo, "Proportional ("Flat") Personal Income Tax Rate and Competitiveness in Slovenia: Towards Understanding the Policy Issues and Policy Implications" (paper presented at the International Forum on Flat Tax Rate, Ljubljana, 2006).

position of the median voter.⁴⁸ Thus the flat tax in these conditions would be advantageous for the median voters only if they prefer the notion of equity to justice. Therefore, the question is how Slovenian interest groups and voters support the social equalizer role of the tax system.

Slovenia, after Sweden and Denmark, is the most equal country in Europe upon its Gini coefficient⁴⁹. In addition voters accept the cost of the broader social protection. As the Public Opinion Surveys⁵⁰ show, almost 80% of the voters believe that one of the most important roles of the government is to decrease income differences, while more than two thirds of the respondents thought that the differences in income had to be further reduced. Interestingly, when voters had to choose between the tax reductions or increasing the social spending, the majority of the voters could not decide, and the rest supported the two options equally.⁵¹ The voters' preferences are independent from their political position, the surveys highlight that Slovenian voters highly support any measures that increase the level of social protection. Therefore, tax reforms where the progressivity of the system is increased are likely to be supported only if through the social expenses the governments compensate for the caused inequalities more. However, the modification of the compensation system is extremely complex, and therefore only smaller modification and simplifications are likely.

The second policy forming group is the interest groups. To simplify the model, the labor and trade unions' position is depicted. The labor unions – compared to other post-communist countries- have a significant voice in wage bargaining. The bargaining process hence is the most institutionalized among one the post communist countries. The coverage rates of collective agreements reaches 100 percent, which suggest that the labor unions' position is significant. The labor unions supported the equalizer role of the tax system; therefore they preferred a more equal system with decreased tax rates. In

⁴⁸ Mitja Čok, "Flat Tax Reform in Slovenia" (paper presented at the International Forum on Flat Tax Rate, Ljubljana, 2006).

⁴⁹ Márton Medgyesi and Péter Hegedüs, "Inequality and Poverty in Eu-Silc Countries, According to Oecd Methodology," (Budapest: Társi, 2007).

⁵⁰ Sample size 14349

⁵¹ *Public Opinion Survey 1990-1998 (Slovenia)* (ZACAT, 2006 [cited 21/04/2008]; available from <http://zacat.gesis.org/webview/index.jsp>).

addition, they have declared from time to time that the preservation of the welfare functions is substantial.⁵²

To conclude, in Slovenia the interest groups' and the voters' preferences have significant influences on the reforms. As they prefer highly a progressive tax system the state cost-benefit equation is the following:

$$\text{Administration costs} - \text{lower tax revenues} + \text{benefits from spill over effects (low)} - \text{actual costs of the reform} - \text{cost of convincing the voters and interest groups (high)}$$

The extremely high cost to convince the voters is unlikely to be compensated by the lower administration costs. Upon our estimation, because of the societal resistance the flat tax could not be implemented in Slovenia. To depict the governmental decision the debate over the flat tax should be analyzed.

3.2.4. Governmental Decision on the Tax Reform

In Slovenian neocorporatist state, tax policy is clearly one of the most important influencing factors in decreasing inequalities.⁵³ In a highly embedded society any tax reform should gain the support of the majority of the voters and that the interest groups. In addition, as the Worldbank report on government expenditures shows, the relatively high social protection rate is accompanied by a rather conservative fiscal policy, which required a high level of income taxes.⁵⁴

The Slovenian tax burden on personal incomes was among the highest and most progressive taxes in the European Union.⁵⁵ The government has gradually decreased the number of tax brackets since the 1990's: while in 2004 there were six brackets, after last years' tax simplification there are currently

⁵² Ibid.

⁵³ Steinmo, *Taxation and Democracy : Swedish, British, and American Approaches to Financing the Modern State*.

⁵⁴ Thanos Catsambas, "Government Expenditures as a Citizens' Evaluation of Public Output," (Worldbank, 1993).

⁵⁵ Philippe Egoume-Bossogo and Anita Tuladhar, "Tax, Welfare, and Pension Reforms in Slovenia: Implications for Work Incentives and Labor Participation," in *IMF Working Paper* (IMF, 2006).

only three. Before the latest reforms, the Slovenian government realized that the progressive tax system with extremely high rates is not efficient; however, no significant tax cuts were realistic, either. On the one hand, the government clearly relied on the tax incomes and the strong social protection was sponsored from the incomes, while on the other hand, both the population and the government saw the tax system as a social equalizer. It should also be noted that in Slovenia the reform of the tax system is seen as a rather late element of the second generation reforms. Unlike the Baltic States, Slovenia became the forerunner among the Central European countries, which was partly the result of high governmental incomes.⁵⁶ While in the Baltic countries the tax reform was needed in order to increase the governmental incomes, the Slovenian tax system fulfilled this criterion without any modification. The tax reform in Slovenia in this respect became a question at a very late stage of the transition, when the country was already in a stable macroeconomic situation.

The aim of the new tax system was to broaden the participation rate in the labor market, and to decrease tax evasion, which required the lowering of the average tax rates and the simplification of the system. The flat tax could offer a solution for these challenges; however, it would cease the equalizer function of the tax system. In 2005 the government proposed a widespread reform aiming to implement a 20% flat tax and cutting on the social spending in the meantime.⁵⁷ At the time of the declaration of the reforms a widespread political and social debate was launched. The zenith of the debate was the largest demonstration in the country's history that was organized by all labor unions and NGOs⁵⁸. The latitude of the government- because of the institutionalized linkages- was reduced to minimal in the tax reform.

In a country where the social equalizer function of the tax system is essential, and governmental spending is based on the tax incomes, the voters are not likely to support a flat tax system unless the social spending is increased. In Slovenia the refusal of the flat tax relied on the interest groups' and

⁵⁶ Lorenz Jarass and Gustav M. Obermair, "Structures of the Tax Systems in Estonia, Poland, Hungary, the Czech Republic and Slovenia," (Wiesbaden: European Commission, 2000).

⁵⁷ Stefan Skledar, *Unions Protest against Government's Reform Programme* (2006 [cited 23/05/2008]; available from <http://www.eurofound.europa.eu/eiro/2006/01/feature/si0601303f.htm>).

⁵⁸ There was also an important debate organized by Center of Excellence and the IMF in February 2006 with the participation of international and national experts on the flat tax.

voters' resistance. The notion of the social protection was stronger than the estimated gains offered by the new tax system. The interest groups encouraged the neocorporatist government to sustain the wide social protection system, which was mainly sponsored by the tax incomes. The Slovenian example shows that the feasibility of the flat tax in a highly embedded society where both the voters and the interest groups support highly the social equalizer role of the tax system is possible only, if the social spending is increased.

3.3. Slovakia

Slovakia and the Czech Republic faced similar challenges in the beginning of the transition period as the Baltic States and as Slovenia, the need for an identity based policy. The most significant difference in the case of Czechoslovakia was that the transition period started before the self-identification period; therefore the economic challenges were separated from the self-identification. Within the federal Czechoslovakia the Slovak part always belonged to the less developed regions, with a lower level of industrialization.⁵⁹ In the first years of transitions this developmental gap widened, as Slovakia, apart from Bulgaria, had the lowest GDP growth among the post-communist CEE countries.⁶⁰ When gaining independence in 1993, the lower level of development with the self-identification problems pushed Slovakia towards a political radicalization. The 1990's, because of the political radicalization and low level of economic liberalization, brought recession for the country: as Madeleine Albright put it, Slovakia became "the black hole of Europe."⁶¹

3.3.1. The embeddedness of the state: voters' and interest groups' voice

⁵⁹ Vladimír Baláz, "Regional Development During Economic Transition: A Case Study of the Slovak Republic," *European Urban and Regional Studies* 2 (1995).

⁶⁰ Grzegorz W. Kolodko, "Ten Years of Postsocialist Transition: The Lessons for Policy Reforms," (Washington,,: World bank, 1999). 21.

⁶¹ Tim Houghton and Darina Malova, *Forming Preferences on European Integration: The Case of Slovakia* (World Bank, [cited 2/05/2008]; available from <http://web.worldbank.org/WBSITE/EXTERNAL/NEWSLETTERS/EXTTRANSITION/EXTDECBEYTRANEWLET/0,,contentMDK:21385085~isCURL:Y~menuPK:1544633~pagePK:64168445~piPK:64168309~theSitePK:1542353,00.html>).

The embeddedness of the state in Slovakia is closer to the Baltic States than to the three other Visegrád countries. More importantly the linkages between the voters and the political arena - that secures the accountability of the policy makers - are weak.⁶² The political arena in the first years of transition was characterized by highly instable party system. Only the major parties (Direction–Social Democracy (SMER–SD), Slovak Democratic and Christian Union (SDKÚ–DS) had a relatively stable voting base, but the voting patterns were fluctuating highly.⁶³ The instable party system resulted lower level linkages between the political parties and the voters, which remained decisive in the further stages of the development. The weak linkages between the political arena and the voters had a negative overlapping effect on the interest groups.⁶⁴ The linkages between the citizens and the state remained weak, such like the linkages between the voters and the political arena.

The interest groups are also weakly institutionalized, as Antalova argues the most important interest group, the labor unions became the tools of the political parties. First they were put aside by the radical nationalist government, because the anti-Meciarist stances. When the Dzurinda government came into force the role of the unions strengthened their positions due to encouragements from the new government.⁶⁵ In this respect the institutionalization of the labor unions highly depended on the governments aims, and thus their preferences were unlikely to form the government positions. The labor unions, such like other stakeholders were simply dismissed in the reforms. Since 1989 the system of tripartite reconciliation was officially ceased, and the involvement of any stakeholders in the decision making process depended uniquely on the governments' positions.⁶⁶ As Bohle-Greskovits argue the embeddedness of the Slovak state is more relevant in the economic sector, the linkages between the economic stakeholders and the government are relatively strong.⁶⁷

⁶² O'Dwyer and Kovalčík, "Party System Institutionalization and Second-Generation Economic Reform in the New Eu Member-States: The Advantages of Underdevelopment?"

⁶³ Stojarová et al., "Political Parties in Central and Eastern Europe in Search of Consolidation." 73.

⁶⁴ O'Dwyer and Kovalčík, "Party System Institutionalization and Second-Generation Economic Reform in the New Eu Member-States: The Advantages of Underdevelopment?"

⁶⁵ Antalova, "Contemporary Flat-Tax Reforms in Eastern Europe: Causes of Diverse Approaches a Comparison of Slovakia, Czech Republic and Germany". 29-30

⁶⁶ O'Dwyer and Kovalčík, "Party System Institutionalization and Second-Generation Economic Reform in the New Eu Member-States: The Advantages of Underdevelopment?" 20.

⁶⁷ Bohle and Greskovits, "Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe." 30.

To conclude, the Slovak example is a mixture of the weakly and strongly embedded states, where the government involved the labor unions and the voters when it was favorable, but dismissed them when they were unlikely to support its politics. As far as the voters and the interest groups had a secondary role in the policy forming, the introduction of any reform depended more on the economic factors and the government's preferences. Thus, the cost-benefit equation of the state consists only the preferences of the economic stakeholders:

$$\text{Decrease in administration costs} + \text{lower/higher tax revenues} + \text{benefits from spill over effects} - \text{actual costs of the reform} - \text{cost of convincing the economic actors (low)}$$

The economic stakeholders' preferences are based on the lower costs and higher efficiency, thus they are likely to support any measures that foster development. In this respect the governmental preferences and the macroeconomic situation determines the reforms.

3.3.2. *The Macroeconomic Situation*

In Slovakia when the government decided to implement second generation reforms the economy suffered from the overdue first generation reforms. During the first years of transition the poor governance and the radical nationalist ideology was reflected in the economic policy. Unlike in the neighboring countries, in Slovakia the government opposed to launch deep reforms, which resulted in a great macroeconomic instability coupled with a low level of foreign direct investments. Economic stabilization started only in 1998, when the new non-radical government launched deep reforms: restructured the banking system, implemented a more transparent fiscal and monetary policy, and restructured the pension system.⁶⁸

Slovakia followed a Baltic type of developmental path, with a laggard implementation of first wave reforms, but early and radical implementation of second generation ones. When the question of

⁶⁸ *Country Brief - Slovakia* (World Bank, 2008 [cited 15/05/2008]; available from <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/SLOVAKIAEXTN/0,,contentMDK:20630686~menuPK:305124~pagePK:141137~piPK:141127~theSitePK:305117,00.html>).

the tax reform came into focus, Slovakia was the most laggard Visegrád country, with a highly indebted budget, inefficient investments, and with fragile monetary system.⁶⁹ Thus the aim of the second generation reforms was to stabilize the country's economy and foster development. Thus, the restructuring of the tax system was accompanied by high expected positive spill over effects.

Decrease in administration costs+higher/unchanged tax revenues +benefits from spill over effects(high) -actual costs of the reform- cost of convincing the economic actors (low)

3.3.3. *The Governmental Decision on the Flat Tax*

As the voter' and the interest groups' preferences were less decisive in the decision-making, the governments' own preferences and the institutional settings determined the reforms. Slovakia had the less stable institutional settings out of the eight post-communist countries. The first years of transition that was marked with economic depression and radicalization of the political system eventuated in a temporary transitional path. The first period of transition can be characterized as a hybrid neoliberal-neopatrimonial developmental phase.⁷⁰ In the further phases of development the neoliberal stances became more influential, which can be depicted through the social spending. State intervention and social protection was the lowest among the Visegrád countries in Slovakia.⁷¹ According to the EUROSTAT surveys the Slovak expenditures on social protection remains under 17% of the total GDP that reaches the level of the Baltic States⁷²

Interestingly, in Slovakia because of the lack of stable institutional settings the governments could highly form the institutions. In this respect the second generation reforms were uniquely the product of the government's decisions and the macroeconomic situation. Thus the government had broad latitude

⁶⁹ Ibid.

⁷⁰ Iván Szelényi, "Lecture on Varieties of Post-Communist Capitalism," (Erlangen-Nürnberg: Erlangen-Nürnberg, 2003).

⁷¹ Bohle and Greskovits, "Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe," 446.

⁷² Alexandra Petrásová, "Social Protection in the European Union," (EUROSTAT, 2008). 7.

to implement a new tax system, and the flat tax seemed to be adequate, because of the low administration costs, the high estimated benefits from the spill over effects.

3.3.4. *The Implementation of the Flat tax in Slovakia*

Slovakia was the first Central European country introducing the flat tax rate as part of an overall economic reform program, which started after the elections in 2002. Slovakia was facing severe economic difficulties at the time, and the government's aim was to stimulate the economy, to raise the budget incomes and to create an investment friendly atmosphere.⁷³ Unlike the Baltic States, the main objective of the Slovak reforms was not to increase the revenues, but to restructure them⁷⁴. Slovakia, as a laggard country aimed to make the tax system competitive by lowering the average tax rates, reducing the administration cost and making it more transparent by simplifying the system, and finally raise the tax morale.⁷⁵

The original Slovak tax system consisted of five tax burdens on the personal incomes: 10%, 20%, 28%, 35% and 38%. The relatively progressive tax system was changed by a flat tax system consisting of two brackets; a tax free bracket and a 19% bracket. The tax reform included the lowering of the corporate taxes to 19%, the unification of the 20% and 14% VAT to 19% and the deleting of the minor taxes. The declared aim of the tax reform was not to increase the revenues, but to provide neutral and sustainable fiscal policy that reduces the distortions of the tax systems.⁷⁶ The tax reform in this respect was unfavorable for the average tax payers, according to Peter Golias and Robert Kičina, the tax reforms had immediate negative effects on the tax payers with a monthly income between 10,000 SKK and 23,000 SKK. As the average Slovak salary in 2004 was 15,825 SKK, the majority of the population fell into the losers' category.⁷⁷

⁷³ Csaba Árendás et al., "Tax Reform in Slovakia in 2004- the Year of 19%," *Forum Institute* (2006).

⁷⁵ Peter Golias and Robert Kičina, "Slovak Tax Reform: One Year After," *INEKO Working Paper* (2005).

⁷⁶ Árendás et al., "Tax Reform in Slovakia in 2004- the Year of 19%."

⁷⁷ Golias and Kičina, "Slovak Tax Reform: One Year After." 10.

The tax reform in this respect was unfavorable for most of the population, which justifies our hypothesis that in lowly embedded societies the government can implement measures that does not necessarily reflect the preferences of the voters and the interest groups. It should be also noted that the economic success of the reform relied on the economic stakeholders' preferences; they supported a more transparent system and cut backs on the expenses. Their preferences were also reflected in the decrease of the corporate taxes.

To conclude, in Slovakia because of the low level of linkages between the voters, the trade unions and the state, the government could implement radical reforms. The implementation of the flat tax served the interests of the economic stakeholders and was in harmony with other second generation reforms. The government choice to implement the flat tax relied on the positive experiences of the Baltic States and on the expected significant decreases in the administration costs. As far as the other three Visegrád countries seem to be closer in the level of embeddedness to Slovenia, the question is how in these countries the voters and the interest groups influence the final decision of the governments.

3.4. *The Czech Republic*

The Czech Republic always belonged to the most developed group of countries in the Central European region. Unlike Slovakia, the Czech Republic became the forerunner of the transition countries right after gaining its independence. Until 1996 the Czech Republic was the most successful post-communist country with no significant transitional depression period. The first period of transition resulted in an unprecedented success in the country, the fast liberalization of prizes and wages and other structural reforms fostered the development of a strong private sector. Although the macroeconomic stability seemed to be secured by the implemented reforms due to several speculative attacks against the national currency a backsliding period started. The macroeconomic situation was

stabilized only in 2000, when thanks to financial reforms the amount of FDI increased. The FDI driven economic development resulted in a more than six percent growth in the GDP.⁷⁸

The Czech developmental pathway was in this respect stable, where the government in cohesion with the interest groups and the voters made decisions. The embeddedness of the state was higher than in Slovakia since the beginning of the transition period.

3.4.1. *The Embeddedness of the State: Voters' and Interest Groups' voice*

The Czech transition period was a more radical rupture with the old regime than in Hungary and in Poland, which can be explained through the less reformist type of communism in Czechoslovakia. This deep and impulsive transition was depicted in the level of embeddedness. The depersonalization of the electoral contest was strong which encouraged the formation of new interest groups and linkages. It should be also noted, that even in this type of radical transition some linkages between the new state and the old elite remained decisive.⁷⁹

The political cleavages that were formed upon the stakeholders' demand were also path dependent. Kitschelt highlights that the political cleavages were formed upon the type of regime. According to them while the bureaucratic–authoritarian type of communism promote one-dimensional competition based on the economic divides, the transition from national-accommodative communism to capitalism reinforce a two dimensional competitions upon the socio-cultural and economic issues.⁸⁰ In the Czech Republic, as being a former bureaucratic-authoritarian type of communist system, the most decisive party forming force was the economic position. The role of the economic cleavage was created upon the voters' demand, and voters favored a more liberal economic policy than in Poland and in Hungary. The transition path created new linkages between the voters and the political arena while the interest groups were also under formation.

⁷⁸ *Country Brief - Czech Republic* (World Bank, 2007 [cited 08/05/2008]; available from <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/CZECHEXTN/0,,contentMDK:20629025~menuPK:304641~pagePK:141137~piPK:141127~theSitePK:304634,00.html#Economy>).

⁷⁹ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*. 61.

⁸⁰ Ibid. 60.

The embeddedness of the interest groups was also path dependent. The interest groups, unlike in Slovakia, gained significant role in the decision makings. Not only the labor unions, but also civil organizations highly influenced the government's decision making patterns.⁸¹ Thus the cost-benefit calculation of the state is likely to depict the voters' and interest groups' preferences:

Decrease in administration costs+/-higher/lower tax revenues +benefits from spill over effects -actual costs of the reform- cost of convincing the voters and interest groups

3.4.2. The Macroeconomic Situation

The implementation of the second generation reforms in the Czech Republic started in stable macroeconomic circumstances. The Czech economy, as one of the most developed in the region, had not faced as significant challenges as the Slovakia did. The aim of the second generation reforms thus, was not to escape the country from a laggard position, but to make the state more efficient. The reforms because of the stable macroeconomic reforms were gradual, and because of the high embeddedness of the state every stakeholders were involved in the policy making process.⁸² The government upon the macroeconomic circumstances therefore, had broad latitude to cut back on taxes. The flat tax in the tax decrease provided an option to the government to cut back significantly on the administration costs. In addition, the Slovak example highlighted that the flat tax motivates the tax payers and raises the efficiency of the system in a relatively short term, thus, the expected benefits from the spill over effects were high:

Decrease in administration costs-lower tax revenues +benefits from spill over effects (high) -actual costs of the reform- cost of convincing the voters and interest groups

⁸¹ O'Dwyer and Kovalčík, "Party System Institutionalization and Second-Generation Economic Reform in the New Eu Member-States: The Advantages of Underdevelopment?" 29.

⁸² Ibid. 30.

3.4.3. *The Preferences of the Voters and the Interest Groups on the Social Protection*

As in the Czech Republic the linkages between the state and the stakeholders are strong, the cost-benefit function of the state is influenced highly by the voters' and the interest groups' preferences. In the Czech Republic the political cleavages are based uniquely on the economic dimension. In the one-dimensional left-right (social protectionist-liberal) scale, more than four-third of the Czech voters placed themselves on the center-right of the scale, which shows the highest support of the rightist parties in the region.⁸³ The Czech voters assign less protectionist role to the government by favoring a smaller and less intervening state. As the surveys of the Institute for Public Opinion Research⁸⁴, made on a sample size of 11000 respondents, underlines the Czech voters in most of the questions about the social protection support liberal stances. Especially, in the case of redistribution and income differences, unlike the Hungarian and the Poles, the Czechs are refusing the high level of state interventions. The International Social Survey Programme on Social Inequalities also highlights that Czech voters support more liberal distribution to social protectionism.⁸⁵

Other policy forming stakeholders, such as the labor unions attributes a great significance to the notion of social protectionism. In every political and economic platform the labor unions expressed their rejection to a less progressive tax system.⁸⁶ According to them, the state should provide security for all the citizens, thus higher level of social protectionism is needed. On the other hand the economic actors encouraged the government to implement reforms, to cut back on taxes and on social spending.

To conclude, the Czech voters and interest groups were taking significantly different positions on the question of social protectionism. As the voters are the most decisive in the elections, it is assumable that the governmental decisions are influenced the most by the voters' preferences. The Czech median voter was likely to support any tax reforms that make the system more efficient, and

⁸³ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*. 285.

⁸⁴ *Party Preferences Czech Republic* (ZACAT, 2007 [cited 15/05/2008]; available from <http://zacat.gesis.org/webview/index.jsp>.

⁸⁵ "The International Social Survey Programme 1999: Social Inequality Iii.," (ZACAT, 1999).

⁸⁶ "Thousands of Czech Labor Union Members Protest Proposed Tax Reform, Cuts in Welfare Spending," *International Herald Tribune* (23/07/2007).

which attribute to the government a less decisive role. Thus, the Czech states' cost-benefit equation was the following:

*Decrease in administration costs-lower tax revenues +benefits from spill over effects
(high)-actual costs of the reform- **cost of convincing the voters (low) and interest groups**
(medium)*

As the equation illustrates the implementation of the flat tax depended more on the tax rates. In case of low tax rates both the voters and the economic stakeholders seem to be convincible easily.

3.4.4. Governmental Decision on the Tax Reform

The Czech government implemented two tax reforms in the past five years, a moderated one that kept the progressivity of the system and a radical one that introduced the flat tax. Before the reforms the Czech tax system was similar to the Western European ones with a relatively high level of progressivity. The four bracket progressive tax system (12%; 19%; 25%; 32%); with a low average effective tax rate was based on a lower level of redistribution, than in any of the neighboring countries.⁸⁷ Neither the Czech participation in the labor market, nor the unemployment rate differed from the EU average; hence, the tax reform was not substantially needed in the country.

.The tax reform in this respect was more a political issue in the country than an economic choice. The Czech government finally decided in 2007 to introduce the flat tax rate fully by 2010 after a widespread political debate. The gradual implementation of the flat tax together with a low, 15 % rate also depicts the political message of the tax reform. While in Slovakia the effective tax rate was set higher than before the reform, in the Czech Republic the effective tax rate is significantly lower than original rate. The tax reform thus, was advantageous not only for the richest and poorest, but also for

⁸⁷ Jarass and Obermair, "Structures of the Tax Systems in Estonia, Poland, Hungary, the Czech Republic and Slovenia."

the majority of the middle-class.⁸⁸ In addition the introduction of the flat tax was the result of a widespread societal debate, which illustrates how the embeddedness of the society forms the decision-making patterns.

Unlike in the Slovak case, the Czech reform was favorable for the median voter, because they gained from the tax cuts and they supported slightly liberal reforms.⁸⁹ In highly embedded country, like in the Czech Republic the government could not implement any radical reforms without the support of the majority of the voters. The Czech government hence was to translate the economic reforms to the political arena. The flat tax reform with a low rate, in this respect, depicts the median voters' political affiliation.⁹⁰

The low tax rate seems to be a political message rather than an economic one, because the Czech tax system even originally was favorable for the foreign investors. The Czechs started from the most balanced situation among the countries introducing the flat tax. One could argue thus, that upon the economic rationality a higher tax would be still favorable for the country. The flat tax rate was clearly set to a lower rate than what the economic situation of the country would have required, which provided a political tool for the government to raise its support. The political message could be also seen that the gradual reform touches the latest the investors, while the flat tax was introduced on the personal incomes in 2008, on the corporate incomes it will be only in 2010.⁹¹

To conclude, the Czech example reflects how in a society where the linkages between the voters and the interest groups are strong a liberal tax reform can be translated into votes. The Czech median voters' rightist affiliation gave relative broad latitude for the government to implement a less just, but fairer tax system. The government in order to translate the economic measures to the political arena decided to set lower the effective tax rate. The lower tax rate resulted in tax decrease not only for the

⁸⁸ Thomas Dalsgaard, "Tax and Welfare Reforms in the Czech Republic—Structural Implications and Challenges," in *IMF Working Paper* (IMF, 2008).

⁸⁹ *Party Preferences Czech Republic*.

⁹⁰ Dalsgaard, "Tax and Welfare Reforms in the Czech Republic—Structural Implications and Challenges."

⁹¹ *Ibid.*

richest and the poorest, but also for the average tax payers. The Czech approval of the flat tax was the result of a broad discussion between the stakeholders that gave possibility to the government to estimate how much the flat tax is supported by the voters and the interest groups. Seemingly the most important decision forming group was the voters, the huge manifestations against the tax reforms that reflected the resistance of the labor unions were not crucial in the decision.⁹² Thus, in highly embedded countries the feasibility of the flat tax is possible, if it is favorable for the median voter; the lower rates, higher efficiency and lower costs can compensate the losses caused by the lower level of the progressivity.

3.5. *Poland*

Poland, like Hungary, belonged to the reform communist countries. According to Kitschelt, this reform type of communism was a national-accommodative system, where due to reforms some elements of the market economy appeared. The reform type of communism led to a milder transition than in the bureaucratic-authoritarian type of communism.⁹³ Thus, the Polish transition started in a medium authoritarian regime, where the opposition launched negotiations with the communist elite. The political transition in this respect was less impulsive than in the Czech Republic, which resulted in a moderated institutional transition. The depersonalization of the electoral contest was mild, which provided broader latitude to the old interest groups to keep certain linkages with the state apparatus.

3.5.1. *The Embeddedness of the State: Voters' and Interest groups' Voice*

According to McDermott, the Polish negotiating transition pathway immediately created linkages between the state and the stakeholders. As during the economic and the political changes all the

⁹² "Thousands of Czech Labor Union Members Protest Proposed Tax Reform, Cuts in Welfare Spending."

⁹³ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*. 36.

stakeholders were involved, the mediation resulted in a highly embedded society.⁹⁴ Although during the first moments of the transition the linkages between the political decision makers and the voters were under formation and a shock therapy type of reform could be implemented. According to Orenstein,⁹⁵ the Polish political leaders followed a start-stop-start type of reforms, when the political linkages were stabilized; the interest groups' resistance pushed the government to slow down the reforms.

The political embeddedness was also based on the transition pathway, as Kitschelt et al. highlight, the voters and the interest groups formed the political arena. The division of the political arena depicted this tendency by a medium strong economic-distributive divide and a strong socio-cultural divide.⁹⁶ Interestingly, the Polish political division differs significantly from the Czech example. While in the Czech Republic the economic division became the strongest party-forming force, in Poland the positions on socio-cultural issues were more important.

The political arena, because of the integrated linkages, was highly connected to the interest groups. It was not by coincidence, that the most influential interest group, the Solidarity became a political actor as the biggest labor union of the country.⁹⁷ The Solidarity's involvement in the political arena also weakened the position of other labor unions, which were not directly involved in politics.

To conclude, the transition path determined the level of embeddedness in Poland. As far as the Polish state is embedded in the society, in the decision-making process a high variety of stakeholders are involved. Hence, the state's cost-benefit equation includes the preferences of the stakeholders:

$$\text{Decrease in administration costs-lower/higher tax revenues} + \text{benefits from spill over} \\ \text{effects-actual costs of the reform-} \textbf{cost of convincing the voters and interest group}$$

⁹⁴ Gerald A. McDermott, "Institutional Change and Firm Creation in East-Central Europe: An Embedded Politics Approach" (paper presented at the Comparative Politics Seminar and Comparative Economics Luncheon Seminar, Davis Center for Russian Studies, Harvard University, 2002).

⁹⁵ Mitchell A. Orenstein, *Out of the Red: Building Capitalism and Democracy in Postcommunist Europe* (Ann Arbor: University of Michigan Press, 2001).

⁹⁶ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*. 78.

⁹⁷ Michael Bernhard, *The Polish Opposition and the Technology of Resistance* ([cited 23/04/2008]; available from <http://test.scripts.psu.edu/users/m/h/mhb5/Solid3.pdf>).

3.5.2. *The Macroeconomic Situation*

Although the political transition in Poland was less impulsive than in the Czech Republic, the economic changes were more radical. Poland in the beginning of the 1990's faced significant macroeconomic challenges. The shock therapy type of reforms consisted of the liberalization of the market, making convertible the national currency and a relatively fast privatization of the inefficient public companies.⁹⁸ The reforms fostered a never seen economic development in the country, but the growth slowed down in early 2000. According to the World Bank, currently the Polish economy, despite the high growth, faces significant inflation pressures and a robust account deficit.⁹⁹ In order to stabilize the economy, further second generation reforms are expected. Hence, the government is likely to restructure the expenses, cut back on public expenses, and reduce the public deficit. Because of the developments and the radical reforms, a slight tax decrease is foreseen. In addition the country highly relies on the Czech and Slovak experiences, the government expects high spill over effects if the flat tax is introduced that can be depicted in the cost-benefit equation:

Decrease in administration costs - lower tax revenues + benefits from spill over effects

(high) - actual costs of the reform - cost of convincing the voters and interest group

3.5.3. *The Preferences of the Voter and the Interest Groups on the Social Protection*

As discussed above, the Polish voters' preferences are depicted in the two-dimensional political arena. Research shows that the average Polish voter prefers the golden mean in both dimensions.¹⁰⁰ While on the socio-cultural dimension the voters tended to support the center, in economic questions

⁹⁸ *Country Brief - Poland* (World Bank, 2008 [cited 16/05/2008]; available from <http://www.worldbank.org.pl/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/POLANDEXTN/0,,contentMDK:20630617~menuPK:304802~pagePK:141137~piPK:141127~theSitePK:304795,00.html>).

⁹⁹ Ibid.

¹⁰⁰ Anna Gwiazda, *The Parliamentary Election in Poland, October 2007* (16/05/2008 2008); available from http://www.sciencedirect.com/science?_ob=ArticleURL&_udi=B6V9P-4SHN081-1&_user=1634558&_coverDate=05%2F16%2F2008&_alid=741074749&_rdoc=1&_fmt=high&_orig=search&_cdi=5904&_sort=d&_docanchor=&view=c&_ct=1&_acct=C000054034&_version=1&_urlVersion=0&_userid=1634558&md5=ea95169093eb095544015b510c769142#sec4.

they preferred the center-left.¹⁰¹ The two-dimensional cleavages were clearly defined in the party competition due to the crystallization of the programs.

The Polish average median supports a centrist type of economy, i.e. neither a radical liberalist, nor radical corporatist type.¹⁰² The Poles consider the social protectionist function of the tax system important. According to the Polish National Election Studies, more than 80% of respondents supported the statement that the government should reduce the income difference.¹⁰³ In addition, in all the posed questions related to the social protectionism a stable majority of the respondents supported a more protectionist state. Interestingly, in other surveys, when the tax policy was in focus, the respondents were less coherent. According to the Polish Public Opinion Research Center's survey, since 1998 the Poles have been supporting the more the progressivity in the tax system. In 2008 more than 78% of the respondents agreed with the statement that people with higher revenues should pay a higher percentage of taxes.¹⁰⁴ Interestingly, the research also highlights that while the voters are refusing the notion of a less progressive tax system, under some conditions significant majority of the respondent would support the flat tax. These conditions include lower tax rates and tax relief for children.¹⁰⁵

When analyzing the interest groups' positions, it should be taking into account that the trade unions have a minor role in the decision making process in Poland. Thus, their rejection of the flat tax is not crucial in the government's position. In the meantime the other part of the stakeholders, the economic actors supported any tax reform that make the system more efficient.¹⁰⁶

To conclude, the cost of convincing the voters and the interest groups is substantial in Poland. The equation of the median voters' and the interest groups can be described as the following:

¹⁰¹ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*. 258-260.

¹⁰² "The International Social Survey Programme 1999: Social Inequality Iii.."

¹⁰³ *Polish National Election Study-2001* (ZACAT, 2001 [cited 03/04/2008]; available from <http://zacat.gesis.org/webview/index.jsp>.

¹⁰⁴ "Preferred Taxes in Poland," (Public Opinion Research Center, 2008).

¹⁰⁵ Ibid.

¹⁰⁶ Robert Anderson, Christopher Condon, and Vanessa Houlder, "Flat Tax Fans Point to 'Success' in Europe," *Financial Times* (29/03/2005).

*Decrease in administration costs + the benefits of a lower tax (**high tax cuts are expected**)*
*- individual estimated cost of a less progressive tax system (**medium for the voters, low for the economic stakeholder**)*

The equation clearly shows that the flat tax is likely to be supported by the voters if the tax rate is set low enough. Although most of the population insists on the progressive type of tax system, the median voter can be compensated with better income positions. Based on this estimation the government's decision on the tax reform should be analyzed.

3.5.4. The Governmental Decision on the Tax Reform

Poland, together with Hungary was the first country to adopt a general income tax system. The adopted tax system, with smaller modifications, prevails till today. The progressive tax system with three tax brackets (19%, 30% and 40%) was reformed last in 2004.¹⁰⁷ The relatively high tax burden and the high social contribution rate results in relatively high allowances and high redistribution rate.

The reform on the personal income taxation came into focus at the end of the 1990's, when due to the high taxes and social contribution the cost of the compensation became higher than the benefits. In addition, the high rates touched the question of competitiveness. While many researches urged for lowering the rates, basically no changes occurred till today.¹⁰⁸ In addition, the high taxes do not result in high incomes, the Polish taxes on incomes and profits as percentage of GDP is much lower than the European average.¹⁰⁹ The procrastination of the reforms is not sustainable in long-term due to the low participation rate in the labor market, which is combined with the highest unemployment rate in the region.¹¹⁰ Thus, unlike in the Czech Republic, the reform of the Polish tax system is essential to enliven the labor market.

¹⁰⁷ "Tax Administration and Tax System in Poland," (Ministry of Finance, Poland, 2004).

¹⁰⁸ Carlos B. Cavalcanti and Zhicheng Li, "Reforming Tax Expenditure Tax Expenditure Programs in Poland " (World Bank, 2000).

¹⁰⁹ *Revenue Statistics 1965-2004*, (OECD Publishing, 2005).

¹¹⁰ Dalsgaard, "Tax and Welfare Reforms in the Czech Republic—Structural Implications and Challenges."

Based on the median voter's preferences we can estimate that the type of reform exclusively depends on the governments preferences, whether it estimates the cost of a lower effective rate higher than the benefits of the simplified system. As far as the estimation can be a political forming power, it could become a focal question during the election campaign in 2007.

In the campaign the two major parties' different visions about the tax reforms were in focus.¹¹¹ The Justice and Law Party is positioned to the right on cultural issues and to the left in economic issues. The social-conservative party supports the notion of a strong intervening state by underlining the importance of social norms and principles.¹¹² The adversary party, the Civic Platform is a liberal-conservative party meaning a rightist position in both the socio-cultural and the economic dimensions. In tax policies both parties have realized that urgent reforms were needed in the last year's election campaign. The governmental party campaigned even in 2005 with tax reduction. According to their plan, the tax system would have preserved the justice function with increasing the rebate related to the number of children. The program of the social-conservative party was therefore to reform the tax system with a politically popular way, to preserve the equalizer role and to decrease the rates in the meantime. The liberal-conservative Civic Platform campaigned with a 15% flat tax on the personal incomes, corporate incomes and VAT. The main difference between the two parties' tax policies could be found in the definition of the functions.

As the Civic Platform won the elections, they immediately proposed the flat tax, which is likely to be implemented with a higher 17% rate by 2010. The reform will be gradual, in 2009 the number of tax brackets will be reduced to two, and upon the experiences the government will determine the final rate.¹¹³

¹¹¹ The two political parties took similar positions in several questions, thus in the last elections, in 2005 it was planned to form coalition together. Due to the main differences in economic policies, power-sharing the idea of the coalition seemed to be unrealistic.

¹¹² Gwiazda, *The Parliamentary Election in Poland, October 2007*.

¹¹³ "Egykulcsos Adót Terveznek a Lengyelek (the Poles Are Planning a Flat Tax System)," *Portfolio* 2008.

To conclude, the Polish example shows that a country where the level of the embeddedness of the state is high, where the parties are competing equally in the socio-cultural and the economic dimension, and finally where the voters are likely to support a centrist/leftist economic policy, the flat tax could be introduced if the stakeholders are compensated. Thus the introduction of the flat tax highly depends on the economic circumstances; whether the government can cut back enough on the tax to compensate the median voter. In addition the Polish elections showed that the implementation of the flat tax is also highly depends on the political choices.

The costs of the implementation of the flat tax were estimated differently by the two largest parties. The Law and Justice Party attributed higher cost than benefits to the flat tax, while the Civic Platform higher benefits to the flat tax.¹¹⁴ The Law and Justice Party calculation was the following:

*Decrease in Administration costs-lower tax revenues +benefits of spill over effects
(medium/low)-actual costs of the reform- cost of convincing the voters and interest group
(high)*

The party estimated that the flat tax is less advantageous for the country than other taxes, while the Civic Platform had a different position:

*Decrease in administration costs-lower tax revenues +benefits of spill over effects (high)-
actual costs of the reform- cost of convincing the voters and interest group (medium)*

The Polish elections show how the political factor influences the outcomes of the cost-benefit equation. Thus, because of the subjective variables in most of the cases the government's political stances are decisive in the implementation of the flat tax.

3.6. Hungary

Hungary in several respects is one of the most interesting countries among the Visegrád states regarding flat tax. In Hungary, due to the extremely high tax rates the idea of a wider tax reform came into focus at a relatively early stage of the development; however, besides smaller modifications, the

¹¹⁴ Gwiazda, *The Parliamentary Election in Poland, October 2007*. 3.

tax system has remained unreformed. Thus, the idea of the implementation of the flat tax is a daily topic. In this reformist environment the established model could be used in Hungary as forecast on the feasibility of the flat tax.

3.6.1. The Embeddedness of the State: the Voice of the Voters and Interest Groups

As in the case of the other Visegrád countries, the transition period determined the embeddedness of the state in Hungary as well. Hungarian communism resembled the Polish one in being a national-accommodative regime, where the transition was the result of a political negotiation between the Socialist Party and the opposition forces. The less radical political changes and the early transition period resulted in a less radical type of transitional process, where the interest groups were highly involved in the formation of the new state. In this respect the linkages evolved at a very early stage of the transition.

In Hungary due to a moderated and gradual transition period, the political arena remained relatively stable and the linkages between the political parties and the citizens also became strong right after the political changes. The political arena thus depicted the voters' preferences, which were stabilized after the first years of transition. As Kitschelt shows, the self-identification of the voters was almost exclusively based on the voters' position in the socio-cultural dimension, which could be explained through the deep economic depression after the first generation reforms in the early 1990's.¹¹⁵

In the meantime, the interest groups gained influential role during the negotiation type of transition, such like in Poland. The level of organization of trade unions, such as those of the civil society is stronger than in any of the three Visegrád countries. Although the labor unions' density is not the highest in Hungary among the Visegrád countries, their participation in the political decision-

¹¹⁵ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*.

making is the most significant; the days spent with strikes is the highest in Hungary¹¹⁶, the referendums issued by NGOs or unions is also the highest. Therefore, the state's cost-benefit function consists the costs of convincing the interest groups and the voters:

Decrease in administration costs-/+lower/higher tax revenues +benefits of spill over effects-actual costs of the reform- cost of convincing the voters -cost of convincing the interest groups and voters

3.6.2. The Macroeconomic Situation

Hungary always belonged to the frontrunner of the economic and political changes; together with Poland it was the country where the economic changes started before the political changes, which resulted in a more gradual type of transition period. These gradual reforms were successful in the shorter term; however, by the mid 1990's the country faced a significant depression period accompanied by low macroeconomic performance, and highly indebt budget.¹¹⁷ To manage the unsustainable economic situation, Hungary implemented a shock therapy type of reform package, including structural reforms aiming to stabilize the fiscal and monetary situation of the country.¹¹⁸ The radical reform resulted in growth that lasted till the beginning of the 21st century, when due to a less strict fiscal policy the macroeconomic stability became fragile. The latest convergence program for the period of 2007-2011 aims to stabilize the macroeconomic situation by implementing several restricting measures.¹¹⁹ In the current macroeconomic situation just a smaller tax cut is possible. According to the prime minister's calculations, not more than 200-300 billion forint could be spent on the tax cuts,

¹¹⁶ Mark Knell and Martin Srholec, "Diverging Pathways in Central and Eastern Europe," in *Varieties of Capitalism in Post-Communist Countries*, ed. David Lane and Martin Myrant (London: Palgrave, 2007). 52-53.

¹¹⁷ László Antal, "Mi Változott És Mi Nem? Reformhullámok És Stagnáló Szakaszok Váltakozása Magyarországon (What Changed and What Not? Reforms and Stagnation in Hungary)," in *Fecseg a Felszín És Hallgat a Mély (the Surface Is Babbling, but Deep Down Its Utter Silence)*, ed. Muraközy László (Budapest: Akadémiai Kiadó, 2007).

¹¹⁸ *Country Brief- Hungary* (World Bank, 2007 [cited 15/05/2008]; available from <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/HUNGARYEXTN/0,,contentMDK:20629263~menuPK:302088~pagePK:141137~piPK:141127~theSitePK:302081,00.html>).

¹¹⁹ "Magyarország Aktualizált Konvergencia Programja 2007-2011 (the Convergence Program of Hungary for the Period of 2007-2011)," (Hungarian Ministry of Finance, 2006).

while the opposition parties count with a 500 billion forint cut¹²⁰. Thus the equation of the governmental party differs from the opposition parties in the amount of the tax cuts:

Decrease in administration costs - lower tax revenues + benefits of spill over effects - actual costs of the reform - cost of convincing the voters and interest group

3.6.3. *The Preferences of the Voters and the Interest Groups on the Social Protection*

The most striking question in the feasibility of the flat tax is how the voters and the interest groups support the flat tax in Hungary. From 1989, the Hungarian political arena was marked by a strong socio-cultural divide, which remained the driving force of party competition till today.¹²¹ The left-right dimensions are based on these two factors; however, the socio-cultural dimension seems to be decisive in the self-identification of the voters. The left-right self-positioning of the voters thus tells little about their positioning in the economic dimension. However, it should be noted that Hungary is the only country among the Visegrád four, where the average voter is positioned slightly to the left.¹²² When taking the level of social protection into account, more than 70% of the voters support a high level of social protectionism. The political parties also favor a more protectionist system than in any other countries.¹²³ Among the Visegrád countries clearly in Hungary is the support for state interventionist in the question of social protectionism the highest.¹²⁴ In addition, as Csontos, Kornai et al. show, voters underestimate the expenses on the social spending and overestimate the paid taxes, thus they approve the hypothesis that any cuts on the social protection system is supported by the Hungarian voters if only they are compensated by much more than it would be expected.¹²⁵ Interestingly in Hungary no detailed survey was done about the acceptance of the flat tax. The most relevant is an unpublished survey made by the Median Research Center in 2007, which shows that

¹²⁰ András Keszthelyi, "Magyarország Jövője (the Future of Hungary)," (Budapest: Life, 2008).

¹²¹ Kitschelt et al., *Post-Communist Party System : Competition, Representation, and Inter-Party Cooperation*. 77-78.

¹²² Ibid. 81.

¹²³ Ibid. 311.

¹²⁴ "The International Social Survey Programme 1999: Social Inequality Iii.."

¹²⁵ László Csontos, János Kornai, and György Tóth István, *Adó tudatosság És Fiskális Illúziók (Tax Awareness and Fiscal Illusions)* (TÁRKI, 2006 [cited 03/04/2008]; available from <http://www.tarki.hu/adatbank-h/kutjel/pdf/00119.pdf>).

Hungarian voters prefer the progressive tax system, although the majority of the voters support tax cuts accompanied by a simpler tax system.¹²⁶

In the case of the interest groups, the trade unions have reacted the most negatively to the flat tax. They underlined that the lower progressivity results in a more unequal society, where the distribution of the incomes is not based on the notion of justice.¹²⁷ Thus, the interest groups took a similar position in the debate as the voters; they are supporting a less progressive system only if the compensations are significantly higher than the estimated costs.

Decrease in administration costs - the benefits of a lower tax (moderated tax cut is likely)

- individual estimated cost of a less progressive tax system (high)

Thus according to the equation the feasibility of the flat tax is unlikely in fragile macroeconomic circumstances.

3.6.4. The Governmental Decision on the Tax Reform

Hungary was the first communist country to introduce taxes on personal incomes in 1988. The first tax system was highly progressive with 11 tax brackets. This extreme progressivity was accompanied by high differences (0-60%)¹²⁸. Interestingly, the very early introduction of the tax system clearly distorted further development. On the one hand, the communist notion of social protectionism remained a significant goal in the tax system. On the other hand, the extreme progressivity made the system overcomplicated, which decreased the efficiency. Although after the political changes the number of tax brackets was decreased, the main pillars of the tax system remained unchanged.¹²⁹ The early starting of the reforms resulted in an overcomplicated system, which maintained the social protectionist function.

¹²⁶ "Adóreform Magyarországon (Tax Reforms in Hungary)," (Median, 2007).

¹²⁷ "Adóreform: Egyetértének a Dolgozók a Vállalkozókkal (Tax Reform: The Employees and the Entrepreneurs Agree)," *Figyelő* (17/01/2008).

¹²⁸ Jarass and Obermair, "Structures of the Tax Systems in Estonia, Poland, Hungary, the Czech Republic and Slovenia."

¹²⁹ *Információs Füzetek 2008 (Information Bulletin 2008)* (APEH, 2008 [cited 23/04/2008]; available from <http://www.apeh.hu/adoinfo/inf2008>).

A significant simplification of the tax system started in 1999, when a three-bracket system was introduced. The further simplification was made in 2005, when the number of brackets was reduced to two. Although the number of the brackets is low, the number of other minor taxes exceeds fifty- while in Poland the total number of taxes is eleven- that makes the Hungarian system highly progressive.¹³⁰

These characteristics are depicted in the citizens' tax paying attitudes: tax awareness in Hungary is extremely low, with a high rate of tax avoidance. In addition, the high tax rates discourage many workers from participating in the labor market, which harms the country's competitiveness. Currently 20% of the population participates in the labor market and pay taxes, which compared to other Central European countries, is extremely low.¹³¹

Interestingly, according to Peter Oszkó, the chief analyst of Deloitte Hungary, the Hungarian tax system, because of the generous rebates and allowances, supports the most the notion of solidarity among the European tax systems. Thus, the main aim of any reform should rely on cutting back on the rebates and subventions. In this respect the introduction of the flat tax would not increase the participation on the labour market more than any other tax system, but the expected spill over effects are the increase of tax awareness, the lowering of the level of tax evasion and whitening the grey economy, which will increase the overall tax revenues.¹³² Thus, the total cost-benefit calculation is the following:

Administration cost (significant decrease)-lower tax revenues +benefits of spill over effects (medium/high)-actual costs of the reform- cost of convincing the voters and interest group (high)

As the equation shows the implementation of the flat tax depends on the subjective variables. In Hungary the voters and interest groups fully support the social protectionist role of the state; in addition, the linkages between the voters and the political parties are strong. Hence, the government

¹³⁰ Ibid. and "Tax Administration and Tax System in Poland."

¹³¹ Ágota Scharle, "Munkaerőpiac És Versenyképesség (Labor Market and Competitiveness)," *PM Kutatási Füzetek* 4 (2003).

¹³² *The Flat Tax Debate* (Budapest: Klubrádió, 04/05/2008).

could introduce the flat tax only if three conditions are met at the same time. Firstly, the rate should be set low enough to offer benefits for the median voters. Secondly, the implementation of the flat tax should include compensating measures, such like increasing the social benefits. Thirdly, because the characteristics of the political arena and the tax system the government is not likely to gain votes from the implementation of the flat tax, thus it could be introduced only if there is a certain agreement between the parties.

Efforts to fulfill the last condition was done, when in the governmental crisis in April 2008, the smallest opposition party, the MDF proposed a tax package including the flat tax in order to establish an intraparty agreement among the five parliamentary parties.. The parliamentary parties are likely to agree on the flat tax or at least on a tax reform. The chief advisor of the Prime Minister, András Keszthelyi acknowledged that an agreement on the tax reform is very likely in the short term.¹³³

According to one of the most prestigious economic research companies, the GKI, in the current macroeconomic situation the government could introduce a 20 % flat tax rate¹³⁴. Lelkes and Benedek, by establishing a hypothetical framework with a microsimulation model on the 20% flat tax rate, found that the flat tax will benefit 15% of the households, while worsen the income situation of other 15%, and would not influence the income position of the others.¹³⁵ Based on the researches, the introduction of the flat tax would not modify the position of the median voter's position. Thus, because of the appearance of the fiscal illusion, the flat tax is likely to harm the median voter's preferences. Therefore, based on the microsimulation model we assume the following:

Administration cost (significant decrease)-lower tax revenues +benefits of spill over effects (medium/high)-actual costs of the reform- cost of convincing the voters and interest group (high)

¹³³ Keszthelyi, "Magyarország Jövője (the Future of Hungary)."

¹³⁴ " Adóreform Javaslat (Tax Reform Proposal)," (GKI Research Center, 2008).

¹³⁵ Orsolya Lelkes and Dora Benedek, "Assessment of Income Distribution and a Hypothetical Flat Tax Reform in Hungary," review of Reviewed Item, *Munich Personal RePEc Archive*, no. (2007), <http://mpira.ub.uni-muenchen.de/7304/>. 15.

The Hungarian cost-benefit equation shows that because of the high cost of convincing the voters and the interest groups the government would implement the flat tax in the current macroeconomic situation, only if there is a general political agreement on it.

4. Conclusion

The present thesis has analyzed the current spread of flat tax from a political-economic perspective. The thesis based on the empirical studies of eight post-communist countries highlighted that the feasibility of the flat tax can be modelled in light of the embeddedness of the state. The main hypothesis, that the embeddedness of the state defines the factors that determines the feasibility of the flat tax was justified through the case studies. The analysis revealed that in countries where the state is not embedded in the society, the state's cost-benefit calculation is based on the following variables:

Decrease/increase in the administration costs +/- higher/lower tax revenues - the cost of the reform + estimated spill over effects

In the Baltic States and in Slovakia, where the linkages between the state and the stakeholders are weak, the feasibility of the flat tax depended on the government's preferences and on the economic circumstances. The most laggard countries aimed to introduce the flat tax to increase the revenues with a simpler and more efficient system. The governments' decision relied on the economic and political rationality. Politically, because of the weak linkages between the voters, interest groups and the political arena, the governments could implement measures that harmed the interests of the voters or the interest groups. In these countries the reform resulted in higher tax rates and a less generous allowance system, and thus was clearly harming the interest of the median voters. In this respect the feasibility of the flat tax was a policy choice and depended on how the governments evaluated the costs and the benefits of the given tax system.

The feasibility of the flat tax in not-embedded countries is less puzzling. The cost-benefit equation is positive in lowly embedded countries; the expected benefits (the decrease in administration costs, higher revenues, and positive spill over effects) are almost always higher than the costs of the reforms. In addition, the simplicity of the system decrease immediately the administration costs and offers

incentives for the taxpayers at the same time. Thus, in lowly embedded countries the flat tax treated as the most efficient way to reform the tax system.

In countries where the state is embedded in the society, the feasibility of the flat tax depends on a complex combination of variables. In these countries the voters' and the interest groups' preferences are as decisive as other variables. The cost-benefit equation of the governments highly depends on the influencing potential of the stakeholders and their position, and thus it can be described as the following:

$$\text{Administration costs} \pm \text{lower/higher tax revenues} + \text{benefits of spill over effects} - \text{actual costs of the reform} - \text{cost of convincing the voters and interest group}$$

The equation was used to depict the feasibility of the flat tax in the embedded CEE countries. The empirical study of four countries, Slovenia, Czech Republic, Poland and Hungary have highlighted that while most of the variables could be estimated objectively, the estimation on the spill over effects and the voters', interest groups' preferences is highly subjective. In embedded countries the governments are likely to increase the taxes only under significant economic pressure and the least harmful way possible. Based on our estimation it is highly hypothetical that embedded countries would implement the flat tax in economic recession. The feasibility of the flat tax is more likely in stable or prosperous economic circumstances, where the voters can be compensated for a lower level of social protectionism.

As the example of four countries has shown, the extent of the compensation depends on the stakeholders' preferences. The case of Slovenia has highlighted that even in a country where the government is not facing with macroeconomic pressures the flat tax can be refused, if the interest groups and voters prefer a more protectionist tax system. In the Czech Republic, where the voters supported less protectionist and more liberal policies, the government could convince the median voters and the interest groups with lower taxes rates. In Poland, although the median voters valued highly the progressivity of the tax system, they could be compensated through lower taxes combined

by increasing the family type of allowances. The fourth country, Hungary is where the feasibility of the flat tax is part of the most recent debates. In Hungary both the voters and the interest groups support highly the notion of social protectionism, and because of the fragile macroeconomic situation the offered flat tax would not compensate the median voters adequately. Thus, the implementation of the flat tax is likely only as the result of a political compromise, or only when the macroeconomic circumstances are stabilized and allow a higher tax cut.

The empirical researches justified that the established model provides bases for analysing and forecasting the further spread of the flat tax in non-embedded and in embedded countries. Thus the model can be used to forecast the answer to one of the most focal question related to the topic, whether the wave of the flat tax would reach the Western European countries.

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