**Political consensus and sustainability of major social and economic reforms
in postcommunist countries**

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Abstract:

During the last 15 years, postcommunist countries have undergone dramatic changes in their economic and social policies. Major policy reforms have been sometimes enacted with apparent consensus, but were frequently highly controversial. In this paper, we examine whether the degree of consensus and controversy at the time of the reform passage influences future sustainability of the reforms. For this purpose, we selected two types of reforms that were emblematic of liberal economic policies and have major fiscal impact. These are introduction of the flat tax and introduction of the so-called „2nd pension pillar“ - a compulsory, funded element of the pension system. We examine a sample of EU member states which have implemented flat tax and/or 2nd pension pillars. For these countries, we examine level of consensus/controversy about the need for and shape of these reforms at the time of their passage and how the consensus/controversy influenced sustainability of the reforms, defined as abolition or major changes in the reforms. Our conclusion is that the level of consensus was not relevant for sustainability and the reforms created their own „lock-in“ effect though of a very different nature for each of them.

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Section 1: Introduction

During the last 15 years, postcommunist countries have undergone dramatic changes in their economic and social policies. Major policy reforms have been sometimes enacted with apparent consensus, but were frequently highly controversial. In this paper, we examine whether the degree of consensus and controversy at the time of the reform passage influences future sustainability of the reforms.

For this purpose, we selected two types of reforms that were emblematic of liberal economic policies and have major fiscal impact. These are introduction of the flat tax and introduction of the so-called „2nd pension pillar“, a compulsory, funded element of the pension system. These reforms were selected not only because they are “standard bearers” for liberal economic policies, but also because they were significant – fiscally and politically. Therefore, any conclusions drawn from them are likely to have wider relevance.

We examine a sample of EU member states which have implemented flat tax and/or 2nd pension pillars.

At Table 1 shows, 2nd pillar and/or flat income tax reforms have been introduced in majority of the postcommunist EU member states (though not all), but they have not been introduced (with the exception of very small 2nd pillars) in any of the „old“ member states. Therefore, the issue of why were they introduced and how have they been able to survive politically is of major interest.

Table 1: Presence of the 2nd pillar and flat income tax reforms in EU postcommunist member states

Country	2nd pillar	Flat income tax
Bulgaria	YES	YES
Czech Republic	NO	YES
Estonia	YES	YES
Hungary	YES	NO
Latvia	YES	YES
Lithuania	YES	YES
Poland	YES	NO
Romania	YES	YES
Slovakia	YES	YES
Slovenia	NO	NO

Source: authors

The paper focuses on the issue of why do big changes in social and economic policy happen in these countries and what makes them sustainable? We proceed in the following steps. First of all, we look at the 2nd pillar reforms, describing them briefly and their introduction. In the same section, we analyze their level of controversy and

impact on sustainability. In the next section, we do the same for the flat income tax reforms. Finally, we draw the conclusions together.

Section 2: Second pillar pension reforms

As is well known, the 2nd pillar reforms consist of introduction of a compulsory funded part into the pension system. As such, the 2nd pillar reforms are a partial privatisation of the public pension system and thus are an important element of liberal changes to economic and social policy. However, the size of pillar can differ dramatically and the introduction of the pillar can have both regressive or progressive consequences depending on the balance between the 2nd pillar and the publicly provided pension pay-as-you-go system (the 1st pillar) and particularly on the 1st pillar pension formula.

Table 2: Data on 2nd pillar introduction and their political economy

Country	Introduction of the 2nd pillar	Size of the contributions (% of wage)	Controversy of 2nd pillar introduction	Date when 2nd pillar opponents entered government and the consequences
Bulgaria	January 1, 2001	2 % (increasing to 5 % by 2005)	Medium	-
Estonia	July 1, 2002	6%	Low	-
Latvia	July 1, 2001	2% (increasing to 10 % by 2010)	Low	-
Lithuania	January 1, 2004	2.5 % (increasing to 5.5 % by 2007)	Low	-
Hungary	January 1, 1998	6 % (increasing to 8 % by 2002)	High	1998 (Fidesz), freezing increases in the size of contributions
Poland	January 1, 1999	7.20%	Low	-
Romania	January 1, 2008	2 % (increasing to 6 % by 2016)	Medium	-
Slovakia	January 1, 2005	9%	High	2006 (Smer-SD), increase in minimum savings period, allowing temporary opt-out

Source: authors

As we can see, the controversy of the 2nd pillar was of low to medium level (with the exception of Hungary and Slovakia). The level of controversy was measured based on a combination of publicly available information about the position of the public and the political parties towards the reform during the reform and in the run-up to the subsequent elections.

The reasons for the relatively high level of acceptance were primarily the low trust of the younger part of the electorate in the ability of state to provide for old age at the level they expect. These expectations have been based primarily on the experience due to combination of transition recession and low revenue yield of the social security

contribution system. This was coupled with the belief of political elites they are locking in responsible fiscal policy for the future (by making implicit debt explicit).

It should also be emphasized that the size of the reform and its cost can also be calibrated towards domestic political and fiscal realities. As we can see from Table 1, the size of the 2nd pillar differed dramatically between individual countries even though they share similar demographic realities.

The 2nd pillar reforms **were** controversial though not as much as the flat tax reforms. This was particularly the case in four countries where the political opposition was strongly opposed: Bulgaria, Hungary, Romania and Slovakia. However, in all these four countries, the reform has not been abolished (it should be noted though that the introduction in Romania was very recent, so the reform has not yet withstood an election test).

Therefore, it would seem that the level of controversy had no effect on the sustainability of the 2nd pillar reforms. The reasons can be traced to the concept of path dependency and resilience of the welfare state (Gosta-Esping (1990), Pierson (1994, 1995)) where choices made at a critical juncture can have difficult-to-reverse effects because massive constituencies coalesce around the new systems as any future changes would entail significant costs for them.

Empirically, organizing paradigms of welfare regimes applied in individual countries tend to be very sticky, which makes the issue of how the original paradigm was selected extremely important. At the same time, welfare states in industrialized countries of Western Europe and North America have undergone significant changes during 1980s and 1990s, frequently labelled as “welfare state retrenchment”, (Pierson (1994)) even though it should be noted that the scholarly evaluation of the extent of these changes is that the rhetoric exceed actual change (ibid.). (Hacker (2004) presents a counterargument, but it is more in terms of lack of new policy initiatives than dismantling existing policies.) Castles’ analysis (2004) confirms the hypothesis that the welfare state is not losing its position and that the welfare regimes are still keeping their specific profiles (‘steady state welfare state’) although there are some signs of convergence.

The case of the 2nd pillar shows that this path dependency logic can be applied also to the liberal, privatising reforms when they create a politically important constituency – in this case, millions of voters who have entered the second pillar. Of course, this sustainability is predicated on the initial enthusiasm of these voters for the 2nd pillar based on the argument set forth above.

It should however be noted that the controversy had some influence on later changes, but these were minor. In the two countries, where the controversy was high, opponents of the reform, when they entered the government, made some changes to the 2nd pillar.

In Hungary, the Fidesz party froze future increases in the size of contribution. In Slovakia, the government of the Smer-SD party increased the minimum savings period and allowed temporary opt-out.

Section 3: Flat income tax reforms

Table 3 shows basic information on the introduction of the flat income tax. As we can see, the precise shape of the flat tax can be very different under the same label. The tax rate can be same or different for the corporate and personal income taxes. The reform can consist of a fundamental tax reform or just unifying rates within the existing framework of the tax system. Very importantly, the rate itself can vary – in our sample of countries, it has been in the range of 10% to 33%. As a result, the flat tax can also be calibrated to achieve a variety of policy goals and can even be more progressive than „progressive“ income tax (e.g. in Slovakia – see World Bank (2005)).

Table 3: Basic information on the introduction of the flat income tax

Country	Date of reform adoption	Tax rates before reform		Tax rates after reform	
		CIT	PIT	CIT	PIT
Estonia	1.1.1994	above 26%	16%-33%	26%	26%
Lithuania	1.1.1995	29%	18%-33%	29%	33%
Latvia	1.1.1997	25%	10% and 25%	25%	25%
Slovakia	1.1.2004	25%	10%-38%	19%	19%
Romania	1.1.2005	25%	18%-40%	16%	16%
Bulgaria	CIT 1.1.2007, PIT 1.1.2008	15%	10%-24%	10%	10%
Czech Republic	1.1.2008	24%	12%-32%	22%	15%

Source: authors

Note: CIT = corporate income tax, PIT = personal income tax; the rates after reform are rates immediately after the reform and many have changed since

Looking at why it was possible to introduce and sustain flat income taxes, it is important to note that the flat tax was usually introduced at a point and in a way which did not have significant fiscal consequences. This is shown in Table 4. By the time of the introduction of the flat tax, the revenue from the taxes of income and wealth ranged from 6 to 9% of GDP, compared to more than 13% for the old member states. Even in Estonia, which introduced the flat taxes at a much higher level and with much higher revenue, the flat tax was introduced in a fiscally neutral way.

Table 4: Current taxes on income, wealth, etc. - (% of GDP)

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Estonia	10.9	9.5	9.6	10.5	10.1	7.8	7.3	7.6	8.1	8.0	7.0	7.1
Lithuania	8.7	8.2	8.9	9.0	9.2	8.5	7.8	7.5	8.0	8.7	9.1	9.7
Latvia	7.1	7.0	7.5	8.0	7.7	7.3	7.6	7.7	7.5	7.9	7.9	8.4
Slovakia	10.7	9.6	9.1	8.9	8.9	7.3	7.3	6.9	7.1	6.1	6.0	6.0
Romania				8.1	6.5	6.6	6.1	5.7	5.7	6.3	5.3	6.1
Bulgaria	11.8	12.8	11.2	9.9	9.8	9.4	8.1	6.8	6.8	6.3	6.0	6.5
Czech Republic	9.6	8.3	8.8	8.3	8.5	8.3	8.8	9.1	9.6	9.6	9.2	8.8
EU 15	12.3	12.7	13.0	13.5	13.8	14.1	13.7	13.1	12.7	12.7	13.1	13.6

Source: Eurostat

Note: The red square indicated a year after the introduction of the flat tax. In Estonia, the flat tax was introduced in 1994, in Bulgaria and in the Czech Republic in 2008, so they are outside the scope of the data

Therefore, the new member states could generally “afford” the flat tax in a way which would be difficult to sustain for the old member states. At the same time, the very different level of revenue between individual states indicates that it is false to interpret the introduction of the flat tax as a way of generating “at least some revenue” with fiscally weak states.

Affordability is a necessary, but not sufficient condition for reform introduction and sustainability. Additional reasons are the following:

- Low ability of the key anti-interest groups to mobilise (only trade unions and they were generally weak)
- Primacy of FDI attraction as a policy goal, for which the flat tax serves as a powerful signalling device of the government pro-business and pro-investment climate
- Ability of the flat tax to also serve as a domestic symbol of policy change
- As already mentioned, versatility of the flat tax concept to adjust to specific policy goals

In other words, flat tax did not cost much, it could serve as a powerful symbol domestically and internationally and, at the same time, its real shape could serve to achieve a variety of policy goals.

Despite that, the flat tax was generally controversial and, in many countries, even highly unpopular at the time of its introduction. Table 5 shows the detailed data.

Table 5: Political opposition towards the flat tax

Country	Opposition arguments against reform	Ideology of government implemented that the reform	Change of government	New government ideology	Opposition policy towards the reform
Estonia	increase in poverty	Center-right	1995	center-left	against-no change
	budgetary losses		1999	center-liberal	for-small changes
	increase in bankruptcy of companies		2003	center-liberal	for-small changes
	injustice high/low income groups		2007	left-center-liberal	for-small changes
Latvia	injustice high/low income groups	Center-right	1998	nationalist-center-right	for-medium changes
	budgetary losses		2002	nationalist-populist-conservative-liberal	for-small changes
	increase in poverty		2004	left-wing	for-medium changes
			2006	nationalist-liberal-left-center	for-small changes
Lithuania	increase in poverty	center-left	1996	conservative-liberal	against-medium changes
	huge tax burden on citizens		2000	liberal +left later	for-big changes
	no discussion with opposition		2004	center-left-liberal	for-big changes

Slovakia	Burden on middle classes	Center-right+minority	2006	nationalist-center-left	against-small changes
	injust to low-wage classes				
	deepening of social imbalances				
	increase in living costs				
	decrease in real income				
Romania	overheating of economy	Center-right+minority	no	no	
	budgetary losses				
	rising of inflation				
	decrease in real income				
Bulgaria	increased tax burden	Social-liberal	no	no	
	increased social inequalities				
	budgetary losses				
Czech Republic	decreased living standards of middle-classes	Center-right+greens	no	no	

Source: authors

However, despite the significant level of controversy, the flat tax has not been rescinded so far in any of the countries that have introduced it though it should be noted that elections since its introduction have taken place only in 4 out of 7 countries that have introduced it. The shape of the tax has not changed significantly in any of the countries – indeed, in Baltic countries, the rates have been lowered over the last decade.

The reasons for its sustainability follow from the reasons for its introduction - change to a more progressive system would not yield much revenue, but, like a reversal of another highly symbolic economic policy - independent central banking, it would send a powerful signal that the government is going to deviate from a pro-investment and pro-business economic policy. While such a signal might be welcome by parts of the electorate, the political gain would be probably dwarfed by the political losses resulting from the worsening of the perceived business and investment climate.

Section 4: Conclusion

In this paper, we examined whether the degree of consensus and controversy at the time of the reform passage influences future sustainability of the reforms. To do this, we looked at introduction of two major economic and social reforms - the flat income tax and introduction of the so-called „2nd pension pillar“. We based our work on the sample of postcommunist EU member states which have implemented flat tax and/or 2nd pension pillars.

We examined the level of consensus/controversy about the need for and shape of these reforms at the time of their passage and how the consensus/controversy influenced sustainability of the reforms, defined as abolition or major changes in the reforms.

We found the same headline result, but underpinned by different political and social mechanisms. The headline result is that the both types of reforms have shown great resilience even in countries where they have been highly controversial.

The different underlying mechanisms are:

- strong pro-2nd pillar constituency among the general population created by its successful introduction and high membership, which nullifies short-term high cost of the 2nd pillar reforms
- very strong signalling role of the flat tax to the business and investment community coupled with its fiscal affordability
- what both reforms share is that they are versatile enough to be shaped towards a variety of policy goals, allowing their introduction and retention in a variety of economic and social circumstances

The results of this research makes it likely that the 2nd pillar and the flat tax will survive in countries where they have not yet been tested by an election result (Bulgaria and the Czech Republic in the case of the flat tax, Romania for both reforms). For these reasons, we also see a significant probability for introduction of flat tax in the remaining new member states (Hungary, Poland though not in Slovenia) as a symbol of change policy, particularly in a time of crisis. We see much less probability of introduction of the 2nd pillar in the remaining new member states (Czech Republic, Slovenia) due to the already high affluence and consequent trust in the ability of state to provide. Also, we do not see much of a chance for either to happen in the „old“ member states – the reasons do not apply.

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