Recent Economic Reform Experience from Central Europe: Inspirations and Suggestions for Ukraine

RECENT ECONOMIC REFORM EXPERIENCE FROM CENTRAL EUROPE:
INSPIRATIONS AND SUGGESTIONS FOR UKRAINE, KYIV, ICPS, 2005, 36 pages.

This publication was compiled by Andriy Blinov, Serhiy Seheda and Petro Udovenko.

Publication design by Ostap Stasiuk.

This publication consists of articles written by experts from Visegrad countries (Czech Republic, Hungary, Poland, and Slovakia) and features these countries' experience in economic reforms on their strategic paths to EU accession.

This publication was prepared as part of the "Transferring Slovak Economic Reform Know-How during Pre-Election and Post-Election Debates in Ukraine" project, a joint initiative of the Institute for Economic and Social Reforms INEKO (Bratislava, Slovakia) and the International Centre for Policy Studies (Kyiv, Ukraine). The main goal of this project is to promote further economic growth and alleviate poverty in Ukraine through improved economic reform policy design and implementation.

Printed in Ukraine by *Info-Print* Publishing House, vul. Tolstoho, 9.
Print-run: 1,200 copies.

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Social Security and Poverty Reduction Reforms in Slovakia and in the Rest of the Central Europe

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This paper summarizes, in an extremely brief fashion, experiences of Slovakia and other Central European countries (Czech Republic, Hungary and Poland) in reforming their social security systems, with focus on poverty reduction. The paper proceeds along the following logic. First of all, it examines preconditions for successful reduction of poverty – macroeconomic stability and sustainable growth. It then looks at definition of antipoverty objectives and selects ones appropriate to the Central European and Ukrainian situation. It then focuses on potential instruments to achieve these objectives in the area of employment and social inclusion.

The experience of Central European countries shows that macroeconomic stability is absolutely necessary, but not in itself sufficient to achieve a successful reduction of poverty. If fiscal and monetary policies are unsustainable or make the economy vulnerable to external and internal shocks, it is generally the poor and the vulnerable who pay a disproportionate part of the price. Fiscal deficit, high inflation, high interest rates and uncertain currency hurt the economy as a whole everywhere in the world, but they hurt the poor in transition countries more for two reasons. Transition countries usually lack markets where individuals and firms could protect themselves against macroeconomic instability (currency hedging, diversified investment portfolios) and where they exist, the poor and the less educated usually do not have the social capital and the skills to protect themselves. In other words, the poorer part of any society needs stability more than other groups.

There are two essential features of macroeconomic stability relevant to transition countries – sustainability of the public finance and adequately anti-inflationary monetary policy. Lack of either one sooner or later requires a massive policy correction and it is the experience of Hungary after the 1994 crisis, of the Czech Republic after the 1997 crisis, of Slovakia after the 1998 crisis and of Poland during the recession of 1999–2001 that delayed adjustment tends towards overshooting, exacerbating effects of any necessary fiscal restructuring, particularly on the poorer elements of the society.

The second precondition for a successful poverty reduction policy is a high level of sustainable growth, but such a topic is beyond the scope of this paper. Therefore, I would just point to one aspect of sustainable growth important for poverty reduction policies – diversification of the economy and attenuation of the economic cycle. Economies based on a small number of crops or industries which face a highly cyclical world market are bound to go through very sharp cycles of growth and decline in external de-mand. Slovakia was such an economy in mid-1990s, relying on its export of steel, chemical products and other intermediate manufactures. These disturbances have similar effects on the poor as overall macroeconomic instability.

Now let us turn the attention to actual aims of poverty reduction policies. While it can seem that defining objectives of poverty reduction is a straightforward exercise, it is the experience of Central European countries that both the public and the policy-makers emphasize inappropriate and misleading objectives within the context of middle-income economies such as Ukraine.

First of all, how should we define poverty? There are two schools of thought in economic and social policy. The first one focuses on relative poverty – for example, the European Commission looks, in some of its assessments, at what percentage of the population has income below 60% of the median income in the country. The second school bases its analysis on absolute poverty – setting a benchmark of subsistence (such as USD 2 per day) and then determining what percentage of population in individual countries is below the benchmark. While both yardsticks are of value, I would argue that it is the second one that makes sense for poorer and rapidly growing countries. Relative poverty measures look at equality within any society rather than at actual poverty of individual. Based on this yardstick, more people are poor in Britain than in Bulgaria or Romania. Also, inequality tends to rise in rapidly growing countries, which is not a cause for serious concern as long as fruits of growth are distributed across the whole population even if not absolutely equally.

Secondly, employment and unemployment tend to be key objectives of any antipoverty policy as risk of poverty is very closely correlated with unemployment in transition countries (of course, with the exception of the elderly). Most societies focus on the unemployment rate. While this, in theory, has the advantage of measuring the available labor force and concentrating the attention of policy-makers on those who want to work, but cannot find it, in

practice this is not so. What is truly important for the economy is how many people actually work as measured by the employment rate (for example the % of people between 15 and 64 who are in employment), because only these people actually produce goods, service and taxes. More importantly for the social policy, focus on formal unemployment rate creates incentive to promote economically and socially wasteful policies such as early retirement, easy access to the disability status etc. This is not a trivial issue. Slovakia and Hungary have the same employment rate of approximately 57%. However, Slovakia has a much higher unemployment – higher by 10% according to some measure. While this creates additional social pressure in Slovakia at the moment, this country will find it much easier to expand its labor force as the economy continues growing. For Hungary, it will be much more difficult to get people back into labor force from retirement or disability. At the same time, the Hungarian system is much more costly as the pensions are usually significantly higher than unemployment benefits.

Last but not least, poverty is easier to bear and its social costs are minimized if poverty tends to be of short-term nature, is not reproduced across generations and individuals feel they can realistically rise from it.

To summarize, for the Central Europe and probably for Ukraine, it makes sense to focus on three key objectives of antipoverty policy: increasing employment rate, reduction of absolute poverty and prevention of long-term poverty and improvement in social mobility.

Now that we have explored key preconditions for poverty reduction and made our objectives clear and specific, let us focus on ways to achieve them.

Our discussion of instruments will be divided essentially into two parts. The first one is concerned with stimulating employment in the formal economy. The second one focuses on other specific policies of social inclusion that seek to reduce absolute poverty and its reproduction in addition to a robust employment policy.

Stimulation of employment in the formal economy is a lynchpin of any antipoverty strategy in middle-income countries such as Ukraine. The strategy must focus both on migration of jobs from the informal economy to the formal one as well as creation of jobs in the latter. It is important to emphasize that any repressive element (police, tax authorities etc.) must play only a complementary part in the strategy. The key is to make creation of jobs in the formal economy more attractive. This can be usually achieved by a mixture of the following:

Change in tax system. These steps usually include decrease of tax rates, broadening the tax base, improvements to tax administration to achieve better collection, shift of taxation from labor to consumption and introduction of tax systems that make avoidance more difficult. In other words, successful strategies usually entail elimination of most if not all targeted breaks and subsidies in taxes in favor of a relatively low rate for everybody; focus on VAT and excise taxes as the key source of revenue; reform the expenditure side to allow a corresponding decrease in the revenue and relatively low rates of personal income tax and social security contributions. Slovakia is a good example of this strategy – it has unified its VAT at 19% as of January 1, 2004, allowing it to create a unified flat personal income tax of 19%, eliminate double taxation (such as dividend tax) and cut social security contributions by more than 3 percentage points.

Incentives for individuals to participate in the formal economy. As long as there is limited relationship between payments made by the individual (taxes and social security contributions) and what he gets back from the state, there is no incentive to participate in the formal economy as there is nothing in return. Therefore, reforms in Central European countries have contained elements that strongly link social payments by the state to contributions by the individual. In Hungary, Poland and Slovakia, the so-called second pillars of the pension system have been set up where a significant part of contributions is diverted into individual pension accounts. Even in the remaining public pay-as-you-go pension systems, there is a tendency to strengthen the link between contributions and pensions, sickness benefits and other payments, again with Slovakia being a prime example and the Czech Republic now also contemplating strengthening the link.

Access to business and individual financing. One of the great barriers to business development and economic growth in developing and transition countries is insufficient access to financing, be it in forms of loans or capital infusions. As Hernando de Soto has identified, these problems are to a large extent related to problems in having a collateral, which is, in its turn, caused by faulty legal systems and unclear property rights. Most people even in poorer countries have assets, sometimes very significant ones, but either their ownership is not formalized or there are problems in pledging it effectively as a collateral for loans. The other frequent problem is general underdevelopment of the banking sector, extensive state involvement in banking activities as opposed to banking regulation and "protection" of borrowers from creditors which makes private banks reluctant to lend. Radical restructuring and privatization of banks has been, sooner or later, a key pillar of all successful economic policies in Central Europe. The countries that have done it sooner – such as Hungary – have been more successful and did it more cheaply than laggards such as Poland, the Czech Republic or Slovakia. Slovakia has been a world leader in setting up a working system for using movable property (trucks, cars, inventory etc.) as collateral. Use of mortgages as a source of financing for business start-ups has been ever more frequent in recent years. The clear message is that creating these systems allows many more people to start or develop a business than any specialized state lending or grant programs and is much cheaper, and these small businesses tend to be principal drivers of employment in the formal economy. Additionally, such systems also create a huge incentive for existing informal economy businesses to switch to a formal sector because there are rewards for owners, such as access to bank financing.

Regulatory environment, particularly labor market legislation. It is paradoxical that poorer countries with weaker state tend to have much more complicated regulations, especially in the labor market. A survey shows that some

of the poorest countries in the world (e.g. in Africa) have some of the most rigid labor market legislations. Of course, this has the double problem of both not being enforced very well and driving employers into the informal economy. It is therefore essential to have labor legislation that is actually applicable in a given country under given circumstances and that does not prevent employers from hiring individuals by making it very expensive to lay off them when necessary. At the same time, the experience of Central Europe shows that decrease of employment in large, formerly state-owned enterprises cannot be stopped or prevented, only slowed down. The delay is usually either very expensive for the government (if it pays enterprises subsidies to retain employment) or can bring the whole enterprise under (if the government forces the employer to preserve employment). In the end, the money would be much better spent on retraining, infrastructure or social assistance. With this in mind, Slovakia has in 2003 reformed its Labor Code to increase flexibility in working time and in hiring and firing and to limit trade union power.

In addition to a robust employment policy, there are other policies of social inclusion needed to reduce absolute poverty and its reproduction. Such policies take many forms appropriate to local circumstances, so let us discuss principles on which they should be based rather than policies themselves.

The principal issue with regard to the Ukrainian experience is the issue of in-kind transfers, especially the so-called privileges. Central European countries have never had an extensive privilege system to begin with and they have progressively sought to eliminate whatever privileges remained and made sure that the government is paying for the ones that remain. There are several reasons for this approach. Non-monetary privileges tend to be costly either for the government or for the provider, they are usually badly targeted and overly generous. At the same time, they tend to create traps for individuals because they very often cannot change housing, job or something else without effectively losing a part of the privilege.

On the other hand, some Central European governments (e.g. in Poland or Slovakia) have emphasized in-kind and conditional financial transfers as a complementary instrument for the poor in addition to basic poverty relief. Provision of shelter or food for the long-term unemployed by municipalities, subsidizing school lunches, textbooks and other necessities for poor children, housing subsidies conditional on payment of rent and utility prices or child benefits conditional on school attendance are all part and parcel of welfare systems in these countries. In-kind and conditional financial transfers can be efficient if there is a high probability that unconditional cash transfers would not be spent in a way that reduced future poverty (such as education or housing costs) and if they complement a basic financially-based welfare system.

One issue that has been of paramount importance in the EU as a whole and in Central Europe in particular is designing tax and benefits systems so as to create incentive to work. Slovakia and Germany have started ambitious reforms in this area in 2003 and 2004, with the Czech Republic now following. These reforms, such as tightening of the welfare benefits, conditionality of welfare benefits on public works, child tax credits and cuts in social security contributions seek to make work pay, even work with relatively low salaries. In Ukraine, due to the low level of unemployment benefits, this issue is likely to be somewhat less relevant than the others mentioned here.

Another important issue concerns the targeting of social programs. Middle-income countries such as Ukraine cannot sustain the same level of taxation as EU countries and, at the same time, grow strongly enough to reduce poverty. Therefore, it is very important to avoid universal welfare states of the nature that many Western European countries have and to target social programs accordingly. There is a widespread illusion that since almost everyone is poor in countries such as Ukraine, the state needs to subsidize all. This illusion ignores the fact that, in the end, subsidies are financed out of taxed paid by the same poor citizens but decreased by all the costs and inefficiencies of the government. In this respect, successful non-European countries such as Chile or Korea can be a better role model. Housing, healthcare and education programs need to be carefully targeted to a guarantee of minimum care and access that is in line with what the country can afford. A very good targeting method is to focus on children from lower-income households. Integrated, effective and efficient programs from childbirth to adulthood that ensure reasonably equal access to health care, nutrition and education for all children have been shown to be among the best investments a public sector can make.

In the conclusion, let me emphasize one issue where no Central European country has been very successful, which is likely to be relevant for Ukraine. There is a high number of losers in transition who are above 45 and very often with quite low levels of education. Ability of such individuals to adjust to the new environment, especially if they lose their jobs is limited. Their reintegration into the labor market has not been very successful and they either remain among the unemployed (e.g. in Slovakia and Poland) or have been sent into disability or early retirement (Czech Republic, Hungary). ■

Pension Reform in Slovakia

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1. International Comparison

Practically, there exist three ways of providing old-age security: either by **taxes**, or by **saving** a stock of money (funded scheme), or by **insurance**, i.e. purchasing a promise of a share on future production (un-funded; often in the form of so called pay-as-you-go or PAYG scheme). In the funded scheme the workers save part of their income and accumulate these savings in order to use them after retirement. Both taxes and the insurance schemes are based on an intergenerational exchange, when current workers pay out current pensioners.

Different countries have a broad variety of pension systems relying on the tax, the PAYG, the funded schemes, or the combination of them. Some rely on the **"flat-rate" systems mainly financed by taxes** (e.g. United Kingdom, Switzerland, Netherlands, Ireland, and Denmark) providing a basic income irrespective of wages earned or contributions made. Other prefer the **"earnings-related" PAYG systems mainly financed by social security contributions** (e.g. Germany, Italy, France, Austria, Sweden) where pensions are related to past earnings, while at the same time a minimum pension is preserved. Furthermore, the countries with traditionally well-developed capital markets have at least partially relied on the **accumulation of savings** and investing them. Such countries, including USA, Great Britain and Netherlands, have developed a combination of usually "flat-rate" systems and (either mandatory or voluntary) funded plans, similar to the system recommended by the World Bank.[1]

In 1981 Chile allowed for diverting all contributions from the PAYG to the mandatory and private fully-funded scheme. It began to accumulate individual savings on personal accounts and invest them into capital market securities. Starting with Chile's South-American neighbors (e.g. Peru – 1993, Argentina, Colombia – 1994, Uruguay – 1996, Bolivia, Mexico – 1997), many countries have implemented similar reforms and closed or at least diminished their PAYG. Facing the globalization, the ageing population problem and the high unemployment that all impose financial burden on the PAYG many post-communist countries (e.g. Kazakhstan, Hungary – 1998, Poland – 1999, Latvia – 2001, Croatia, Estonia, Russia – 2002) and some rich democracies (Denmark – 1983, Switzerland, Netherlands – 1985, Great Britain – 1988, Australia – 1991, Sweden – 1996) introduced the mandatory funding. Most of them created a combined system of the PAYG and the funded pillars.

However, not all the countries are delighted with the idea of substituting their PAYG with the mandatory funding. Without any doubt, efficient PAYG has strong advantages that might explain its solid position in the continental Europe and countries with a mixed system. **Even the ageing population is not a "killer" for the PAYG – the efficient though not popular answer may be prolonging the retirement age**. Furthermore, a switch from the PAYG to the funded system requires huge transition costs that impose financial burden on the state budget. For these reasons, many countries (e.g. Germany, Italy, France, Austria, Spain, the Czech Republic, and Slovenia) concentrate on improving their PAYG and supporting voluntary funded schemes rather than on designing the mandatory funding.

Reforming their PAYG, some countries such as Sweden, Germany, Italy, or Poland have introduced the **"Notional Defined Contribution"** (NDC) system. The principle, when current workers pay out current pensioners, remains the same. However, NDC brings two major innovations: (1) each individual has his/her own notional account, where life-long money inflows and outflows are recorded, and (2) the pension is calculated as an account remainder at the chosen time of retirement divided by an estimate of life expectancy for an individual of that specific age, i.e. it depends heavily on contributions paid during the working life.

Reforms in Central Europe: Hungary (1998), Poland (1999) and Slovakia (2004) have enacted major pension reforms that involve privatization of their national pension schemes, replacing them in part with funded systems of individual savings accounts managed commercially. In Hungary, the reform left the public PAYG almost untouched with excessive redistribution and absence of individual contribution records. On the other side, Poland implemented a system of notional accounts in which benefits will reflect individual contributions in a nearly linear way. Slovakia chose similar approach even though without notional accounts. It has also designed a combined system but compared to some other post-communist countries it shifts more progressively towards the mandatory funding (Table 1). In the Czech Republic and Slovenia, by contrast, governments have decided to reform their existing public PAYG systems without privatization. At the same time, they encouraged citizens to save

[1] In its landmark report *Averting the Old Age Crisis* (1994), the World Bank set out a model based on three pillars: (1) tax-financed public safety-net; (2) compulsory saving by workers; and (3) voluntary saving.

for retirement in private pension funds on a voluntary basis.[2]

2. Reform in Slovakia

Slovakia implemented fundamental pension reform in 2004. The main drive for the reform was the widespread dissatisfaction with the pensioners' standard of living. The public pension fund has been in deficit since 1997 causing a steady decline in real pensions. The average old-age pension in 2003 reached EUR 157, around 45% of the average wage in the economy, compared to 54% in 1991. The old system was highly redistributive. The difference between the lowest and the highest pension was minimal. The system was good only for low-income workers and speculators who worked in the shadow economy and paid just minimum contributions. This trend was further enhanced by globalization process, enabling high earners to avoid contributing to the system altogether. Soaring unemployment in late 1990s together with the expected demography crisis emphasized the need for the reform. Accepting the World Bank's recommendations and learning from similar reforms in Hungary and Poland, the new government decided to build a pension system based on three pillars and a safety net for people with too low pensions. The old PAYG system was split into the mandatory social insurance (1st pillar) and mandatory saving (2nd pillar) complemented with smaller reformed system of voluntary saving (3rd pillar). The solidarity was clearly separated and reduced to guaranteeing the subsistence minimum financed from taxes.

Reform of the PAYG – 1st pillar

The reform of the 1st pillar has brought these major innovations:

1. **Gradual prolonging of statutory retirement age** from the average 55 years for women (depending on number of children) and 60 years for men to the final 62 years for both genders. All men will retire at the age of 62 from 2006 and all women from 2015.
2. **New pension formula.** Compared to the old formula, the new one gives higher pension to those who earned more and paid higher contributions during their working life and vice versa. The redistribution is being reduced in a three-year transition period. The new calculation should increase motivation to pay contributions and eliminate evasion. Consequently, it brings a danger to **people with too low income, who will receive much lower pensions. They will be supported directly from the state budget. Thus, solidarity has been clearly separated from the mandatory contributions.**
3. **New indexation of awarded pensions.** So-called "Swiss method", i.e. automatic yearly valorization by the weighted average of the consumer price index (inflation) and the average nominal wage growth in the economy. The weights will be 0.5 for both parameters. Generally, changes in the indexation weaken political influence on pensions' calculation and bind them to the development of economic indicators. This is a good message, as the indexation often used to be a subject for political fight before the reform.
4. **Early and late retirement.** Unlike in former system, the reformed PAYG allows for early and late retirement. Each month of earlier retirement reduces a pension by 0.5% and each month of later retirement raises it by 0.5%.

Potential problems: Although the new PAYG strengthens the motivation, it does not react automatically on employment changes. These have crucial impact on collected contributions and represent key limiting factors for the amount of pensions. However, neither the pension calculation formula nor the indexation rules reflect these changes and **the system continues to give non-guaranteed promises.** Based on demography expectations, this problem might be relevant as soon as in 2015. This would require another reform of the PAYG[3] including several options, among them further prolonging of retirement age, raising the contributions, change in the pension formula and/or change in the pensions' indexation (for example only by inflation which is expected to be lower than the wage growth).

Worth criticizing is also vain effort of Slovak reformers who wanted to build a universal system with the same rules for everybody. The resistance of armed forces (e.g. soldiers and policemen) was too strong and the privileges remained untouched. However, good news is that at least political agreement has been achieved to cancel these privileges.

Introduction of the mandatory funded system – 2nd pillar

The new mandatory "second" pillar will start on January 1, 2005. All citizens up to a defined age (approximately 52 years) will be allowed to choose to enter for the funded pillar until June 2006. Once entering, there will be no way back. Young people first entering the labor market will be obliged to go to the second pillar. Their assets will be managed by private pension companies competing on the market and supervised by an independent Financial Supervision Authority. The founders of pension companies will have to be credible financial institutions with at least 3-year experience. Minimum basic capital is set to SKK 300 million (EUR 7.1 million). Each one will manage three funds with different investment limits and different risk&return relationships (Table 2). Money paid to the second pillar will be a private hereditary ownership of savers. The interest earned on funds will not be taxed.

Investment portfolio: Equity is too volatile to provide stable income in retirement years, although it can be a valuable component of an investment portfolio during the accumulation phase. Bonds provide more stable income, at the cost of lower returns. For

[2] For more information on reforms in Central Europe (except for Slovakia) see the ILO – International Labor Office (2002): *Pension Reform in Central and Eastern Europe*, Volumes 1 and 2.

[3] This view supports also the OECD (2004) report: "The (PAYG) system remains nevertheless financially unsustainable in the long term. The planned defined benefit scheme with its strict link between contributions and benefits should, upon completion, transform workers' perception of pension contributions from quasi-taxes to quasi-savings. Further changes in the PAYG system are desirable, notably the standard retirement age should be raised progressively to 65 for both genders."

this reason, clients of pension funds invest primarily in equity, to gain the advantage of a large, though volatile return, and then shift gradually to bonds as the date of retirement approaches. In order to allow for such investment strategy, Slovak reformers require three different funds. Each saver may hold the assets only in one fund at the same time. Up to 15 years before retirement saver may not hold assets in the growth fund and 7 years before retirement it is required to completely shift assets to the conservative fund.

Guarantees: Directly, the state guarantees neither a specific performance of pension funds, nor the principal value of paid contributions. Indirectly, the law imposes strict investment limits on pension companies and secures strict regulation, but also requires the pension companies to achieve some minimum performance relative to their competitors. Moreover, the state guarantees 100% of granted pension in case of fraud or malefaction.

Investment restriction: According to law, the securities issued by Slovak emitters shall compose at least 30% of the funds' portfolio. The advocates of this limitation argued that it should "disable the outflow of domestic capital..., accumulate sources for investment into the Slovak economy..., and help to develop the Slovak capital market". However, most economists warn of the restriction's negative effects. Generally, it constrains choosing the best investment opportunities, having **negative impact on the rate of return and the amount of pensions**. Moreover, the restriction does not comply with the EU rules for free flow of capital and **limits the ability of the funded pillar to face the demography crisis**.

Transition costs: Introduction of the 2nd pillar causes high transition costs appearing in several coming decades. These costs are a big obstacle for many countries with strong PAYG pillars considering switching to the mandatory funding. Transition costs are a consequence of diverting contributions from the PAYG to the 2nd pillar – as a result the state receives less money but it still has to pay out the same pensions. Hence, transition costs depend positively on the contribution rate for the funded pillar and on the number of people switching. In Slovakia, these costs should be around 1% of Slovak GDP yearly (in 2005 circa SKK 15 billion or EUR 0.36 billion). This is also a political commitment taken with respect to the Maastricht criteria for the adoption of common European currency.[4] There are several options how to finance transition costs: Large part will be covered from (1) the reformed PAYG that will generate higher revenues after prolonging the retirement age – **here the link between the introduction of the funded pillar and the need to prolong the retirement age is evident** – and that will generate sources in the public reserve fund (4.75% of monthly gross wage, preferably for covering the PAYG deficits). Other sources are (2) privatization revenues **(government has saved SKK 65 billion, or EUR 1.55 billion especially for this purpose)**, (3) state budget and (4) loans. The PAYG reserves and privatization revenues should cover all transition costs until 2011. However, the lack of money might appear earlier in case of massive switching. Later on, other sources including further privatization, state budget endowments, and loans should be employed. In the long run, even after prolonging the retirement

Table 1. Mandatory pension schemes across some post-communist countries

Country	PAYG	Funded	"Funded" introduction
	(% of gross earnings)		
Kazakhstan	0	10	1998
Hungary	22	6	1998
Poland	12.22+13	7.3	1999
Latvia*	18	2	2001
Croatia	14.5	5	2002
Estonia	16	6	2002
Russia**	24	4	2002
Slovakia	9+6+4.75	9	2005
Czech Republic	26	0	–
Slovenia	24.35	0	–

* Contribution rate for the funded pillar should gradually increase since 2007 up to 10% in 2010 reaching the same proportion for both pillars (10%+10%).

** Contribution rate for the funded pillar should gradually increase up to 6% resulting in 22%+6% in 2006.

Source: INEKO

Table 2. Pension funds managed by pension companies

	Equities	Bonds & Money Market Instruments	Risk & Return
Growth fund	up to 80%	no limit	high
Balanced fund	up to 50%	at least 50%	middle
Conservative fund	no stocks	100%	low

Source: INEKO based on the Law on Old-Age Pension Savings

[4] OECD (2004) warns: "A special issue related to the phasing-in of the 2nd pillar concerns the fiscal compensation of the main pillar from the state budget, for the diversion of PAYG contributions. These may amount to about 1% of GDP per year in the short-term and will likely increase in the following decades. As long as no agreement is reached with the European institutions for the exclusion of such compensation from current expenditures, Slovak authorities will be faced with a difficult choice between postponing or down-scaling the 2nd pillar reform, delaying convergence with Maastricht rules, or seeking yet further spending cuts."

age up to 65 years for both genders (which is highly probable), there will be a gap in the PAYG financial balance after 2030. However, after 2054 the PAYG will turn into surplus with majority taking a combined pension from the funded and the PAYG pillars.

3. Lessons and Recommendations

Motivation: In the era of globalization it is ever easier to avoid paying social security contributions. Thus, motivation to work legally and to pay contributions is crucial for the sustainability of the pension system and the whole economy. To achieve this, the amount of pension should reflect the amount of paid contributions.

Solidarity: The motivation-oriented systems bring a danger of old-age poverty to the low income cohorts. This danger should be minimized by direct support from the social system financed from taxes. The extent of solidarity can be easily adjusted by politicians.

Transparency: The solidarity should be financed from taxes and clearly separated from the mandatory insurance and saving contributions. This enables transparent support of the weakest and creates perspective for the mandatory schemes to go voluntary and private.

Pensions and stability: Both PAYG and funded plans offer higher pensions under different conditions. While labor market (the change in labor force and productivity) determines pensions in the PAYG, capital market (the real rate of return on capital) is crucial for the funded system. A combination of both enables to diversify financial sources of future pensions between labor and capital markets and to increase the system's overall stability.

Transition costs: The introduction of the 2nd pillar brings huge costs of transformation. Without storing a substantial part of privatization revenues in Slovakia, the introduction of the biggest 2nd pillar in Europe would be impossible. Large portion of transition costs may be financed also from the PAYG savings created by restricting its generosity (for example by prolonging the retirement age, or imposing less generous pensions' indexation).

Demography crises: The ageing population is not a "killer" for the PAYG – the efficient though not popular answer may be prolonging the retirement age. However, the negative demography expectations have direct impact on downturn in pensions under the "ceteris paribus" PAYG. On the other hand, the funded system allows to export capital to the economy with stable or positive demography changes and to avoid negative consequences.

Automatic adjustments: Regular changes in the system should reflect the development of key economic indicators rather than ad hoc political interferences. For example the pensions' indexation should reflect the inflation or the wage growth or both of them instead of leaving the decision to the politicians who tend to give unrealistic promises. Optimally, the indexation should only reflect the changes in the amount of raised contributions.

Administration costs: Costs of administration are everywhere higher for private than for public pension plans, and are particularly high in case of private individual accounts.

Popularity of the 2nd pillar: The number of people switching for the 2nd pillar exceeded the expectations both in Hungary and Poland. The reason was the widespread distrust in the state pension system and the willingness to save on a personal account. This argument makes the introduction of the 2nd pillar easier. However, the number of people switching raises the transition costs. Therefore, the regulation of switching process should be considered. ■

Health Care Reforms in Central and Eastern Europe

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1. Legacy of Socialist Health Care Provision

Under the socialist system most if not all health care was provided by state institutions on the guiding principle of free universal entitlement at the time and point of service. The system was financed by payroll taxes (usually split between employees and employers) while the central budget offered significant additional funds on behalf of those who did not have income from a permanent job (children, elderly, conscripted soldiers, students, citizens on maternity leave, etc.) Health care was considered to be based on the concept of social insurance (wrongly translated as social security) which, in turn, was claimed to represent societal solidarity.

There were several inherent shortcomings in this arrangement.

Constant and serious imbalance between demand and supply. As entitlement was notionally universal and free at the point and time of providing the service, most people visited doctors and requested treatment as many times as they felt necessary. Demand for ever more complex and expensive services grew constantly while capacity and financial resources were always limited. It clearly resulted in the formation of long lines with ever growing waiting times for complex and costly operations. At the same time the quality of services deteriorated markedly almost across the board.

Social solidarity collapsed with uneven access and quality. People with money and/or connections and/or privilege and/or influence were able to jump the queue by using and abusing their power. While doing so, they demanded better service which, given the limited amount of overall financial and human resources in health care, led to a further deterioration of access and quality for ordinary people.

No link between contributions and benefits. When people felt obliged to pay for better quality and faster service at the point and time of getting it they questioned the logic of paying their payroll taxes in the first place. In a system of universal social insurance there was no individual record keeping on who had actually paid and who did not. Evading payments of social security contributions was easy and justifiable for those without connection and money to jump the queue, either. It then further undermined the financial equilibrium of the health care system and its ability to provide impetus to much needed social cohesion. Its legitimacy came in jeopardy.

2. Early Reforms of Health Care in the Visegrad Countries (V4)

When the first democratically elected governments took power privatization was put high on the political agenda. However, privatizing social services, including health care was considered a controversial issue. Physicians themselves were very much divided as to what part of their profession should be subjected to market forces.

Privatizing general practitioners' business. Reforms started with the privatization of the business of general practitioners, so-called "house doctors" practices which are usually the first point of entry for patients into the health care system. In most cases privatization did not require any physical sale of large equipment but only a new licensing system for the practice. This first tier of health care was also regarded as best provided by doctors licensed by local authorities at the lowest level of self-government; so the lowest level local governments acquired the right to issue licenses and auction off practices wherever there were potentially more than one takers.

Financing of general practitioners changed for the better. While doctors were obliged to collect patients' insurance cards with a predetermined minimum and maximum limit, they were remunerated by the local governments on a capitation basis. Patients now have the right to choose among a good number of certified doctors which has given rise to a certain level of competition, thus reinforcing incentives for quality improvements.

Free entry of private capital to health care provision. Other important aspect of early reforms was the possibility to establish new institutions for any level of health care, either sole proprietorships, partnerships or limited liability companies for general practitioners or private clinics for outpatient (ambulatory) and inpatient (in hospitals) care. However, these new establishments remained on the fringes of health care provision because people did not have much funds to pay for all costs and most of those who actually had could still use their connections and influence to get reasonably acceptable quality in state owned health care establishments at the expense of the social insurance fund. But private capital still found valuable market niches especially in high tech intensive areas of in- and outpatient care. Moreover, the state managed social insurance funds started to pay partially for a number of services offered by the private clinics since it helped to alleviate the burden of state providers with highly overstretched capacity.

Rationalization of fund management in state insurance. While ration-

alization in slack capacity (e.g. the reduction of hospital beds, the eventual transformation of hospitals into sanatoria and/or old age asylum, etc.) did not yield too many tangible results (because of heated political opposition and professional resistance) and most physicians fiercely resisted losing their legal status as civil servants with all prerogatives and privileges attached to that, governments were successful in rationalizing the management and administration of the health insurance funds, typically the largest extrabudgetary funds (after pension) in the fiscal sector with or without self-government.

3. Co-payments as a Measure to Limit Excess Demand

It is actually only in Slovakia where the government was able to introduce a much debated co-payment system for both visits to general practitioners and outpatient care establishments and a daily fee for staying in hospitals (invariably a flat fee for basic services). That seems to be quite important for limiting unnecessary visits, superfluous checkups and prescriptions, in itself leading to a marked reduction of drug overuse, which is quite rampant in V4. The amount of funds in concept of co-payment flowing into the health care system is limited because the individual amount to be paid is only symbolic and there are many exemptions, especially for poor people and the elderly. But the purpose of the system is not to cover any significant fraction of the costs but rather to make the population sensitive to costs at all. The Slovak system has already proved its merit in that regard. Other countries, like Poland and Hungary introduced user fees for higher quality and more comfortable hotel services in hospitals (such as single bed rooms with TV and telephone, etc.). Although the role of these fees in overall financing is limited, it might be important for some hospitals and it certainly has led to improved capacity utilization at a good number of individual establishments.

4. Identifying Basic and Supplementary Services

The Slovak Parliament approved six fundamental pieces of legislation two weeks ago. These laws for the first time in the history of transition try to identify separately so-called basic and supplementary health care services and render their provision to tax-based state financing and individual mandatory health care insurance, respectively. While this has been and still remains an arduous process and not without much political interference, the concept of separating these two sets of health care services cannot be overemphasized. This is the first time the general public is obliged to accept that the scope of state funded health care is not unlimited and universal entitlement does not imply inalienable citizens' right to get all types of health care services without any consideration to costs. This part of the new set of legislation also has important constitutional implications as the Slovak constitution guarantees the rights of every citizen to health care very broadly.

5. Catalogizing and Categorizing Health Care Services

The new Slovak legislation mandates the government to set up a commission to describe all illnesses and define diagnosis and therapy very precisely in each and every case (the process called catalogizing in Slovak). This is indispensable for the insurance system (both public and private) to assess its eventual financial obligation but also for the physician to calculate what amount of insurance income he or she is entitled to get in each individual of exam and cure. Categorization of health care services, in turn, is vital for the patients; that will define the share of payment (both insurance and co-payment) required from them. In most cases therapeutic services are going to be financed in a multi channeled manner, i.e. part of the costs will be covered by the state, another part by mandatory insurance and the remainder by co-payment, i.e. private payment at the time and point of sale. The art of this categorization exercise is to find a dynamic equilibrium not only in financial flows but, more importantly, between self-care and social solidarity.

6. Multipillar System of Financing with Mandatory Private Health Insurance

Although the Slovak reform is stopping short of establishing a substantive mandatory private insurance system, it is indispensable that governments tailoring long-term reforms should contemplate such a move. The arrangement could be similar to what is already a widespread practice in reformed pension provision; a multipillar financing offered by strong private institutions defending the interest of patients while competing for their money. As time goes by and the newly created health insurance supervisory system acquires teeth and valuable experience, more and more of what is now covered by state owned insurers could be ceded to competing private health insurance companies. That would also reinforce the effectiveness and efficiency of state health insurance funds because management and surveillance practices prevalent in the private sector could spill over to the public sector as well. This is true even though the accelerated pace of innovation in the health care business makes categorization of services a moving target and, hence, the definition of justifiable costs will always remain somewhat arbitrary.

7. Competition among In- and Outpatient Care Establishments

There is still heated ongoing debate on the issue of privatizing hospitals and outpatient clinics. Unfortunately that was at the center of government proposals in Hungary and the new law based on that was quickly killed by the constitutional court. It is

important to emphasize that the ownership of secondary (specialists) and tertiary (intensive hospital care) health care providers is much less important than the issue of their financing. Without fostering fierce competition among hospitals and clinics it is impossible to improve the quality of their services, they will not be interested in cost control at all. Competition can be created by free entry and exit and full liberalization of ownership without necessarily obligating existing providers to privatize. Patients should have the freedom to choose among secondary and tertiary providers while these latter should have the obligation to accept all people certifiably insured and the right to refuse all who do not have proper insurance. (The state health insurance fund will cover all expenses of medical services in life threatening situations, like accidents, catastrophic events, epidemics, terrorist attacks, etc.)

8. Decentralization of Secondary and Tertiary Care

Most of hospitals and outpatient clinics will most likely remain in the hands of either local or regional governments because the provision of health care services is always one of the most important pillars of self-government (the other being primary and secondary education). That outcome can only be reinforced by reforms of subsovereign government if the direction of these reforms will be the creation of larger units at the lowest level of self-government. In V4 countries, most notably in Poland, where the government decided to decentralize the management of the state health insurance fund, hospitals and larger units of outpatient care are now managed at regional level of subsovereign government. In smaller countries, like the Czech Republic, Hungary and Slovakia there is no obvious anchor level for managing larger health care providers in the hierarchy of public administration, but decentralization is still possible and desirable (subsidiarity in the EU).

9. Preliminary Thoughts on Reforming Health Care in Ukraine

Ukraine is a large country, similar to Poland in size of its population and economic potential but with no perspective to join the EU in the near future. This makes health care reform probably easier and more difficult at the same time.

Recently Ukraine has been quite successful in recharging the batteries of its economy. Real growth has reached unprecedented high levels, fiscal equilibrium has largely been restored. Now it is time to address structural issues in public finance which can also make the fiscal stance sustainable in the long run.

Ukraine can now afford spending substantially more on maintaining and improving general public health standards, including prevention of epidemics, such as HIV/AIDS, tuberculosis, discouraging smoking and drinking, etc. This is indispensable for fighting demographic decline and lengthen life expectancy for new generations, too. Primary care should be better equipped to discover serious illnesses and determine more precisely the correct path for patients in secondary and tertiary establishments.

It is highly advisable to consider the introduction of co-payments for doctor visits no matter how symbolic that might be. This is important to prevent overuse of primary care and reduce the pace of growth for the use and abuse of prescription drugs. In addition, further decentralization of financing in- and outpatient care establishments is necessary in order to improve the management and control of these institutions. After careful planning and analysis the introduction of mandatory private health insurance is to be considered. That will improve substantially the awareness of the population of the costs of health care and provide sufficient incentive for self care. Privately funded and managed insurance companies should compete for the money of the patients while secondary and tertiary health care providers should compete for contracts with the insurers. When supported by powerful professionals the position of patients vis-a-vis physicians can be strengthened considerably and, therefore, the quality of services is expected to substantially improve.

The financing of health care should also change over time. Health care contributions paid by the employers need to be reduced and the overall amount of such contributions should be in line with the costs of providing basic services for all people employed. A low and single rate health care tax should be levied on all personal income to underpin social solidarity in the system. In addition, all individuals should be obliged to choose among competing health care insurers and buy various levels of coverage for themselves and their families. The central budget will obviously remain responsible to provide funds to both the state health care fund and private insurers on behalf of all people without regular income, such as citizens on maternity leave, etc. ■

Tax Reforms in the Visegrad Countries and Their Relevance to the Ukrainian Situation

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Short Description of the Tax System

The Visegrad countries, namely Czech Republic, Slovak Republic, Poland and Hungary have established relatively matured tax systems, with all major taxes in place. This process was mostly completed in mid-1990s. The tax reform did not take place in vacuum, and it was part of the transformation process and strategy of these countries to join the European Union (EU).

The table below provides the basic information and reveals differences between the taxation systems.

Having in mind that the EU harmonizes the indirect taxes and all the V4 countries had the same strategic goal – membership in the EU – the differences in the tax regimes are not trivial, but they are within the harmonized brackets of the EU. Tax system of the Slovak Republic is the most straightforward with limited number of rates and exemptions. The three other countries still have a few rates of the PIT. The highest rate of the CIT is in the Czech Republic, but the process of reduction of these rates is not completed yet.

The process of the tax reform was initiated by Hungary at the end of the 1980s by introducing all three main taxes, i.e. VAT, PIT and CIT. The other V4 countries followed and by 1994, all V4 countries had these taxes in place. One has to observe that Ukraine completed this process in 1992.

Main Process of the Reforms

There have been witnessed three main processes since 1994. The first one has been to increase the revenues from indirect taxes and decreasing the revenues from direct taxes, mostly CIT. The main arguments for such strategy was to reduce risk of decreasing revenues during the slow down of the economy, and to provide more neutrality into the tax system (see table below for details). By and large countries decreased the rates of the CIT, and now they have lower rates than the average in the EU. At the same time they usually kept the initial rate of VAT, but they eliminated the exemptions in this tax, and increased the rates of the excise taxes.

Some countries, like Hungary were very active to provide special tax privileges for large, international investors. Such procedures were found as harmful and contradicted with the state aid rules by the European Commission and were lifted as on May 1, 2004 the latest.

The second process was to make tax system compatible with the European Union regulations. This was done for instance by increasing the rates of the excise taxes till the minimum required by the EU, and to eliminate exemptions in the VAT regime. This process was spread over many years in order to avoid inflation shocks.

The third process has been to increase complexity of the system

Table 1. The main features of the tax regime in the V4 countries

	Czech Republic	Hungary	Poland	Slovakia
VAT regime				
rates, %	5 and 19	3, 15, 25	3, 7, 22	19
turnover threshold*	35,000 EUR	35,000 EUR	10,000 EUR	35,000 EUR
Excise taxes				
gasoline	339.90 EUR/1000 l	407.56 EUR/1000 l	320.28 EUR/1000 l	375.53 EUR/1000 l
diesel oil	312.00 EUR/1000 l	334.71 EUR/1000 l	249.62 EUR/1000 l	331.30 EUR/1000 l
beer	0.752 EUR/hl/Plato	1.654 EUR/hl/Plato	1.5 EUR/hl/Plato	1.21 EUR/hl/Plato
alcohol	830.95 EUR/hl	756.05 EUR/hl	962.59 EUR/hl	605.70 EUR/hl
CIT rate, %	28	16	19	19
PIT rates, %	15, 20, 25, 32	20, 30, 40	19, 30, 40	19

Note: VAT – value-added tax, CIT – corporate income tax, PIT – personal income tax.

* VAT is payable only if a company's turnover reaches the threshold.

Source: Excise Duty Table, EC, May 2004; VAT rates applied in the member states of the EU as on 1/9/2004, DOC/2008/2004-EN

Table 2. Tax revenues to GDP in V4 countries in 1999–2002, %

	Total								
		in this:							
		PIT	CIT	VAT	Excise	Social contributions	Customs	Property taxes	Other
Czech Republic	36.4	4.8	3.2	5.6	3.5	15.0	0.5	0.3	3.5
Poland	33.6	4.6	1.8	7.4	4.0	9.6	0.6	1.2	4.4
Slovakia	31.0	3.5	2.0	7.4	2.9	12.7	0.4	0.2	1.9
Hungary	37.6	7.5	2.4	8.4	3.6	11.3	0.8	0.2	3.4

Source: Mitra, Pradeep i Nicholas Stern, *Tax Systems in Transition*, World Bank Policy Research Working Paper 2947, January 2003

mostly by increasing various allowances, deductions and exemptions in order to secure various social and economic goals, like to increase demand for education, for housing, for R&D expenditure etc. This process led to high compliance costs, problem of interpretation of regulations and abuse of the system by taxpayers. Only Slovakia was able to eliminate this problem to much extent by introducing flat rate and single rate for VAT, and at the same time to revoke most of the privileges. The problem of overloading the tax system with special tasks was augmented by notorious changes of the tax system during the budget debates. It means that the most important amendments were adopted during the discussion on the Budget laws, but as changes in the various tax acts. These changes aimed to satisfy various needs mention above. The PIT was especially exposed to such practices, but the changes in VAT and CIT were also numerous and significant in all four countries. This process made the tax system unpredictable and costly for both administration and taxpayers.

In recent years one may observe (since 2000) that there is a tendency to limit the special treatment and privileges in tax system, which is linked to reduce the rates mostly in CIT and PIT. This means that the efficiency principle of tax system was taken seriously again.

(Nota bene: This principle calls for a tax system, in which economic agents' decisions are indifferent to taxes. In other words, if there were not any tax system, economic decisions would be the same.)

The tax issues got a high rank in the main legal acts. Namely, the constitution of the Republic of Poland provides, that taxes may be levied only by Parliament. So the power of executive is limited only to technical details of tax system, as defined in tax acts. This limits the changes of tax acts, but doesn't solve the problem entirely.

Main Problems

Tax administration was a major challenge in the tax reform. Taxes played only limited role in planned economy. They were a part of the allocation system, next to fixed prices, subsidies, and credits. Number of taxpayers was low, and a range of discretion of tax officers high. Taxpayers, which were mostly state-owned enterprises, did not have the strong incentives to reduce (read: look for loopholes) their tax liabilities. This situation was changed dramatically in transition. There are many private firms, they operate in market environment, and therefore they have strong motivation to reduce their tax liabilities.

The costs of tax reform were also training and capital expenses for tax administration in the first stage of tax reform. There is one more aspect of this point. The costs and efficiency of tax administration depends on well-trained and equipped staff, but also on designing of the taxes, system of appealing of tax officer decisions to courts and civil servant rules. Poorly designed tax rules, which are not clear and ambiguous increase compliance costs of the tax payer. At the same time tax administration is exposed to corruption and costs of running such administration is high.

The problem of complicated and unclear tax regulations remains probably the most important one in these countries, except Slovakia, which introduced the far-reaching tax reform in 2004. Slovakia introduced the flat PIT rate at 19% and reduced most of allowances and tax privileges. At the same time single rate of VAT was introduced. It meant that the reduced rate was totally eliminated, and all goods and services are not taxed with single rate of 19%. Lastly, the CIT rate was reduced to 19% to be in line with the PIT rate.

Such problem is to certain extent limited by courts for administration issues, which may revoke or change administrative decision of the tax officers. Nevertheless there is a major problem of interpretations of tax rules and regulations.

The creation of the self-governmental units was an important part of transformation. Public responsibilities were delegated to these units, but the own financial revenues were not fully secured. Local taxes provided only lim-

Table 3. Share of tax and non-tax revenues of govervent and self-goverments as share of GDP

	1999–2002		1999–2002
	% of GDP		% of GDP
Czech Republic	41.1	Slovakia	40.4
Poland	40,4	Hungary	44.0

Source: Mitra, Pradeep i Nicholas Stern, *Tax Systems in Transition*, World Bank Policy Research Working Paper 2947, January 2003

Table 4. The main tax revenues during transformation, % of GDP

	PIT		CIT		VAT+excise tax	
	91–95	99–02	91–95	99–02	91–95	99–02
Czech Republic	5.0	4.8	5.3	3.2	11.5	9.1
Hungary	7.0	7.5	3.5	2.4	11.6	12.0
Poland	8.2	4.6	4.4	1.8	10.2	11.4
Slovak Republic	5.5	3.5	7.7	2.0	12.5	10.3

Source: *New Europe*. *Report on Transformations*, Krynica 2004, Instytut Wschodni

ited revenues for local governments and states' grants are main form of revenues. Moreover the rules of providing the grants have been changing and it limits the ability of the self-governments to plan multi-year projects.

The ratio of tax revenues to GDP in all countries is very high in comparison to their level of economic development. At the same time they are running the budget deficits. This means that reduction of tax revenues either by cutting rates or tax base should be executed steadily and with caution.

A list of taxes, fees and levies, which are in the tax systems of the Visegrad countries is very long. Some of them bring very limited budget revenues, but at the same time they bring a high compliance and administration costs.

Tax harmonization, or as the EC states tax integration may be a factor, which may limit the scope of the further steps of tax reforms even if the new directive is not passed. There are several ways to do so. First, the members states may put pressure on other countries in order to limit tax competition, for instance as far as CIT is concern. Secondly, the European Court of Justice took some decisions on tax systems based on the Treaty's rules of non-discrimination, and free movement of capital, goods, services and labour. The bottom line is that the ECJ secures these rules, and prohibits some tax solutions, which hampers these rules.

But the main challenges, tax administration capabilities and clear regulations of the tax acts may be addressed by the national executives.

Lessons

1. The Visegrad countries had a full blood strategy for its transition process at least since the association agreement with the EU. It was clear what kind of institutional framework was going to be created. So perspective of accession was instrumental not only for designing some solutions of indirect taxation, but also to build administration capacity, and the whole institutional framework. This was probably the most important single factor of the tax reforms and their achievements. Ukraine ratified agreement on the Joint Economic Space between Russia, Belarus, Ukraine and Kazakhstan in 2004, and at the same time it made clear aspiration for the EU membership. This dualism in selecting the strategic goals will make tax reforms more difficult. For the V4 countries, a clear political perspective was instrumental for progress in tax reform. From the other side, Ukraine having the main taxes in place, should not replace them or introduce the new major taxes. Such moves would reduce investment attractiveness of the country and make tax system non transparent.
2. The major achievements of these countries was to shift the main budget revenues from direct taxes, mostly profit taxes to indirect taxes, mostly VAT and excise taxes. This reduced the risk of high fluctuation of state revenues during the business cycle, and provided more economic efficiency into the system. This was also instrumental for attracting foreign investors. Ukraine clearly reduced its revenues from the CIT over last years. However there is still scope for farther rate cuts. The current rate of CIT is still high in comparison to the neighboring countries.
3. There is a clear tendency to broaden the tax base and reducing the top marginal tax rates in the income taxes in last years. Such moves (and accelerated appreciation, or tax transparency) are considered to be more efficient tools for attracting foreign investors then tax holidays for investors. Ukraine may follow such policies.
4. There remain numerous problems in tax system in most of the Visegrad countries. The most important ones are ambiguity of regulations and tax administration capability. This problem is elevated by the high frequency of amendments of tax acts, which usually are done at least once a year.
5. Problem of tax administration was addressed by technical progress, such as training and hiring, and by new equipment. There were also some legislative solutions, which aimed to protect the taxpayer rights. The most important one was to introduced the solution, that an appeal against decision of the tax authorities as final under administration proceedings, may be brought to court for administrative issues. Such solutions has at least two advantages. Firstly, tax payer right is protected from discretion power of tax officers. Secondly, court's explanation serves as interpretation of tax laws. In Poland there is two-tier courts for administrative issues, and there are 14 regional courts and the supreme court for administration. About 40% of the tax administration decisions is revoked by the court. Such solution may be useful in Ukraine. The risk of abuse of discretion power of tax officers will not evaporate with dissolution of the Central Tax Office.
6. The problem of ambiguity of tax regulations may be reduced by the constitutional rule that Parliament (Verhovna Rada) may not increase

state budget deficit set by the Council of Ministers in the budget draft, including the new tax allowances or exemptions. This will not solve all the risk of non-clear amendments of the tax acts. Ukraine may follow the Slovak example to make its tax system easy and transparent. (To some extent it has already done).

7. There is an important problem how to tax the small business. There is not universal answer to that. The Hungarian reform of taxing small business of 2004 may be a good example to follow, or by and large to introduce the simple presumptive tax with simple tax base (e.g. revenues, or number of employees). The Hungarian simplified tax for entrepreneurs (EVA) under Act XLIII of 2002, available to certain business units with a max. of HUF 15 million annual sales revenue, VAT included, and active under the same legal form for at least two years. The tax rate is 15%, and this replaces VAT, the company car tax, the entrepreneur's personal income tax for sole proprietors and personal income tax payable on the entrepreneur's dividend base, the corporation tax for business companies and the personal income tax on dividends. The local business tax base is half of the EVA base. The current Ukrainian system seems still to be complicated, and difficult and costly to execute.
8. Tax frauds, e.g. in VAT refunds may be addressed by exchanging information with tax administrations from other countries. There is a good example of special administrative unit in a country, which deals with the major taxpayers, including exporters. Ukraine should address that problem due to serious tax arrears in VAT refunds. But first move may be done towards the large taxpayers.
9. There are numerous problems relating to power of tax officers, e.g. lifting and/or postponing of collecting of the tax liabilities. Tax expenditures are part of the state aid rules, and therefore are subject to the EU regulations in the V4 countries. Such problem remains in Ukraine. The power of such decision should have a ceiling at each level of administrative level.
10. The taxation of energy resources is to much extent harmonized in the EU, and further steps are foreseen (e.g. excise tax on electricity). Taxation of energy is Ukraine reveals two shortcomings. Firstly, collection of taxes is not secured. Secondly, the level of taxation is low. The increase of taxes on energy may be linked to reduction of labor taxes, and in such way it may be favorable for the economy.
11. The grey economy is relatively big, and it reflects the weakness of tax administration, structure and unbalances of economy (unemployment and large small business sector) and high regulatory burdens. The best way to limit the grey zone is to provide adequate and reasonable institutional framework: a clear and transparent legal system, strong and capable tax administration, which create competitive markets. This is easier to say that to implement. In my view, the cost of reduction of the grey economy (which consists of very small and small firms and households) is high in comparisons to benefits.
12. The revenues from the environmental taxes and fees have been growing in Europe. In the future Ukraine may probably shift part of the taxation revenues from labor to natural resources.
13. The number of taxes and fees is too high for any standards in a country like Poland. One may say the same about Ukraine. ■

Business Environment Reforms in Central Europe

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The aim of such reforms is to improve productivity of a given country and to increase GDP growth. Those issues have been addressed from very beginning of the transformation of post communist countries after 1989. The rights to be owner of capital assets, land and to employ people have been the first restored after the end of communism. However, during the last 15 years of economic transformation it has been discovered that many processes are more complex than many people believed. There have been three main ways how to create viable enterprises:

1. Creation and development of Small and Medium Enterprises (SMEs).
2. Privatization and transformation of large (larger) state enterprises.
3. Support to Foreign Direct Investment (FDI).

With certain simplification it can be said that for relative success of central European countries mainly SMEs and FDIs are responsible. The policy of FDI promotion has been started in Hungary already in late eighties. The other countries have joined Hungary in full scale competition after 1998. The competition in FDIs can be seen in following picture:

The other success stories are SMEs. Economic freedoms obtained after fall of communism allowed the development of SMEs. Starting from scratch, very natural selection of entrepreneurial talents is something externally beneficial for post communist countries. The SMEs are of crucial importance in two areas: employment and political stability. SMEs, mainly those in services and manufacturing were helpful in absorption of labor surplus from old state sector. SMEs are also one of the pillars of stability and democracy. Only democracy with large class of entrepreneurs and owners can be really stable. There can be market economies with efficient large companies and tiny class of owners, which may tend to lack of stability and lean toward authoritative regime.

Privatization and transformation of large enterprises can be hardly described as a success. The results of those companies are fluctuating between average performance and the failure. One research in the Czech Republic from 1999 has shown that FDIs are clearly outperforming companies privatized by voucher, to local entrepreneurs or those once still state owned.

Despite all efforts to improve management and corporate governance in those privatized or still state owned enterprises, the stories about success are rather rare.

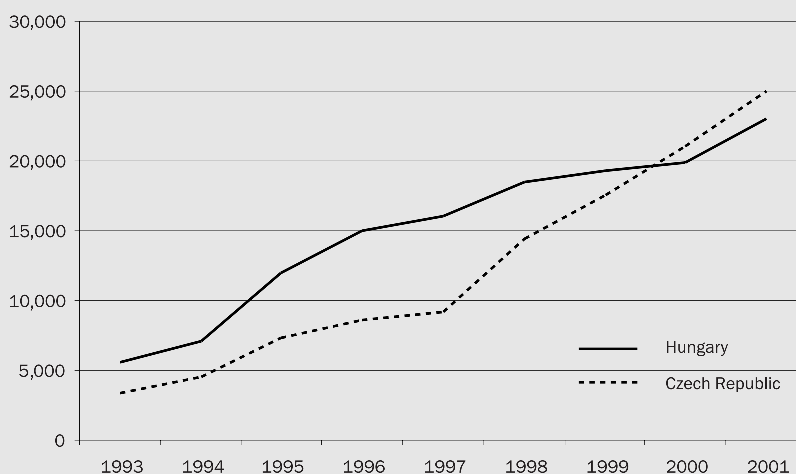
It seems that the best results can be reached by stimulation of FDIs and SMEs. Here is however useful to ask questions:

1. For whom the new companies will produce goods and services?
2. Where they will produce?
3. How they will produce?

The excellent business environment can be for nothing, if there is not market for the products. It means that from FDIs are the best ones those serving foreign markets. Those serving domestic markets are usually improving quality of products, productivity, but they are also in direct competition with domestic enterprises. Even more acute are the markets for SMEs. The success stories of quick development of SMEs are connected with those regions where the consumers are foreign tourists or generally foreigners. Those are capital cities and border areas with easy access from wealthier countries. To get those wealthy consumers is necessary to create for them as easy as possible visa regime (preferably no visa), easy access by all means of transport, large number of border crossing points (Czech-German border has every 15 km crossing point) and last but not least the offer of hotels, pensions etc.

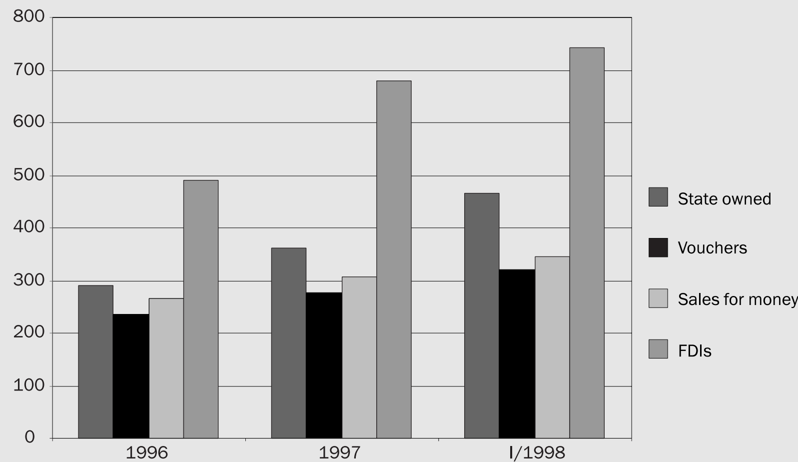
Where to produce is another important issue. Foreign companies do prefer Greenfield investment, to build new fac-

Figure 1. Cumulative investment, USD mn



Source: Czech Ministry of Finance and OECD

Figure 2. Value added per employee in the Czech companies after privatization, ths. of crowns



Source: Mladek, J.: "Nejhorsi vysledky maji kuponove zprivatizovane podniky", *Hospodarske noviny* (Voucher privatized companies have the worst results), 15.2.1999

tories on the green field. The aim of the countries should be brownfield investment, but this is the target for future. Companies do prefer green field because they are afraid of the problems connected with take over of existing assets, mainly of hidden liabilities. Those can be of different types, but ecological ones are major nightmare of brownfield investment. To get FDIs in current harsh global competition is necessary to prepare for them the possibility to buy the land for new companies construction. Long term lease (50 years, 99 years) can be substituted for land ownership, but it is clearly **second best option**. The buy out of the land from private owners in order to sell it to foreign investor can be nightmare sometime as was seen recently in Slovakia in purchase by the state from private owners for carmaker. The nationalization of the land by the state should be avoided if possible. Protection of the private ownership is one of the cornerstones of market economy. Nationalization with compensation to private owner can be used in public interest (highway, railway) but is a bit questionable if is used in favor of other private owner (carmaker). Generally country should provide for FDI not only land for reasonable price, with demanded infrastructure, qualified labor force and some tax holiday. The last thing is the most questionable, because creating unequal conditions between FDI or large investors and the rest of the economy (this is the case in the Czech Republic). The second option is so called equal tax that is decreasing tax burden for all companies. The price of this approach is the increase in indirect taxation (VAT, excise taxes).

For SMEs the question where to produce is even more acute. Here the experience of Central Europe is saying the most efficient way how to obtain the assets were restitution or better reprivatization in kind. The old owners or their heirs have got back restaurants, hotels, service facilities, production sites etc. Contributing to it had been small privatization that has been used for small assets. The other sources of those facilities were bankruptcies and liquidation of large companies.

When there is a market for the company products and a company has where to produce, we are coming to the conditions for business. There are two areas where the government can act directly: telecommunication and banking. Phone connection, fax and internet are minimum conditions to be in business. This can be reached by privatization of telecom to strategic investor and/or by development of competition in this area. More difficult is banking sector. All banks in the country should be run by international standards, competition encouraged and thus to solve the problems with time needed for money transfer and the time needed for creation of the account.

Licensing of the businesses is the permanent trouble. There is no easy solution. Some activities must be licensed, but too much of licensing is undermining the economic activity. Partial solutions are classes of licensing. Some trade should be free, some licensed moderately and some heavily. The aim is to have as much as possible free trades, but the distribution of trades is question for political debate.

Taxation is another important issue. Overall taxation or tax burden in Central Europe is rather low. The issue for discussion is distribution of tax between direct taxation (inclusive so called health and social insurance or payroll tax) and indirect taxes. There is a belief that low direct taxation can stimulate economic growth, the pioneer of the approach is Slovakia with 19% flat income tax. The other countries in Central Europe are following with certain delay.

Specific problems are misusing the social benefits and sick insurance. Slovakia in 2004 took drastic measures to minimize of those benefits and to increase incentives to work. Even the Czech Republic, having more cautious approach in last years, is following this trend. Sick payment was reduced and more controls, including criminal investigations are done. There were companies whose only business was to suck sick insurance from the system. Another step is obligatory public works (8 hours per week) for unemployed people. It should stimulate their activity to look after job or to get out of the scheme. ■

Slovak Tax Reform: One Year After

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Abstract

This paper presents detailed information on the Slovak tax reform adopted in 2004 and the first results it brings after one year in place. Most apparent is the increased attractiveness of Slovakia for foreign investors. Slovak Investment and Trade Development Agency contracted EUR 1.7 billion foreign direct investment in 2004 what is 47% increase on a yearly basis. In terms of new FDI jobs the increase is even higher – 69%. In 2005, the surge of foreign investment continues. The agency claims the suitable business environment and the tax system among the most important factors referred by investors when choosing Slovakia. They especially welcome the lower corporate income tax and the abolished tax on dividends. However, the investors prefer good infrastructure as the most important factor, when deciding where to invest, followed by cheap and qualified work force, and generous state aid.

Another important outcome is the fierce international tax competition evoked by the reform. Slovakia was the 7th country in Europe introducing the flat tax on personal income (19%). Soon after, two other countries joined the club: Georgia and Romania going down to 12% and 16% respectively. The largest opposition parties in the Czech Republic and Poland are also agitating for a flat tax and have promised to implement one if victorious at the polls. Austria reacted swiftly by reducing its corporate tax rate from 34% to 25% from 2005 even though it intended to go down "only" to 31% originally. In 2004, the Czech Republic decreased its upper VAT tax rate from 22% to 19% and its corporate taxes are falling from 28% to 24% in 2006. Hungary reduced its corporate tax rate from 18% to 16%; and Poland from 27% to 19%. Western democracies with much higher corporate taxation (Germany 38.3%, France 34.3%, Netherlands 34.5%, Italy 37%, and the UK 30%) blame Slovakia for "tax dumping" and call for "tax harmonization" within the EU. They point out, that new members are able to lower taxes only thanks to the massive regional aid received from richer EU countries.

From fiscal perspective, better than expected tax revenues in 2004, especially for direct taxes, arouse enthusiasm, however, this development will have to be confirmed in 2005 yet.

It might be assumed, that the tax reform together with the entry to the EU played the crucial role in the fast improvement of the Slovak economy in 2004. The expected negative influence of higher indirect taxes on price level and household consumption was not confirmed by the evidence. The household consumption grew by strong 3.5% in 2004 compared to the expected 2.0%. However, the definite impetus of the reform for the overall macroeconomic development including the growth in employment will show up after a longer time period.

Abbreviations

CIT:	Corporate income tax
ESA 95:	European System of Accounts 1995
Est.:	Estimation
EU:	European Union
EUR:	Euro
FDI:	Foreign direct investment
GDP:	Gross domestic product
INEKO:	Institute for Economic and Social Reforms
IMF:	International Monetary Fund
MW:	Megawatt
NGO:	Non-governmental organization
OECD:	Organization for Economic Co-operation and Development
PAS:	Business Alliance of Slovakia
PAYG:	Pay-as-you-go pension system
PIT:	Personal income tax
SARIO:	Slovak Investment and Trade Development Agency
SKK:	Slovak koruna
SR:	Slovak Republic
UK:	United Kingdom
VAT:	Value added tax
WIT:	Withholding income tax

Introduction

In autumn 2002, a new centre-right government came into power in Slovakia. At that time, there was a tax system generally considered as unsustainable, too complicated, changing too often, bringing in more exemptions and special rates, and thus distorting the business environment. The tax reform became one of the most important initiatives of the new government. From among four coalition parties only one – Christian Democrats – called for a radical reform – the introduction of flat tax on personal income. The Policy Statement of a new government undertook only to *"reduce income tax rates and to analyze the possibility of implementing a flat-rate tax"*. In fact, the actual reform pushed by the Finance Minister Ivan Mikloš introduced the flat tax and went far beyond these original objectives. **The new tax system became effective as of January 2004.** The goal was to create a simple, fair and business friendly system. This should have been achieved through:

Foreign investors in Slovakia

	2002	2003	2004	2005 (Est.)
Number of projects signed	25	22	47	40
Number of new jobs projected	5,400	7,970	13,500	20,000
FDI contracted (mn EUR)	311	1,164	1,707	1,951 – 2,073

Source: Slovak Investment and Trade Development Agency

1. **Shifting the tax burden from direct to indirect taxes**[1]; i.e. taxing consumption rather than production. This should support incentive to work. Moreover, in the era of globalization and increasing labor mobility the collection of direct taxes becomes more difficult to control and it is easier to avoid paying them compared to the indirect taxes. As a result, the relatively high direct taxes are harming country's fiscal position and competitiveness – people "escape" to a shadow economy or to countries with lower direct taxation. The shift towards the indirect taxes should reduce tax evasion.
2. **Elimination of all exceptions, exemptions and special regimes.** The business surveys quoted the excessive complexity and frequent changes in the old tax law as one of the major business barriers[2]. The old system included 90 exceptions, 19 sources of un-taxed income, 66 tax-exempt items, and 37 items with specific tax rates (Table 1). The reform virtually abolished all of them[3], making the tax system much simpler and transparent, and eliminated speculation aimed at paying lower tax rates.
3. **Introduction of flat tax rate on personal income**: This measure limits the economic disincentives caused by higher taxation of higher income cohorts. The equal opportunities imposed by a new system should increase labor productivity, as it encourages higher work effort at any income level.
4. **Elimination of tax instruments aimed at achieving non-fiscal goals**: Many of such instruments aimed at providing social policy objectives. However, tax instruments usually address everybody and not only those in need. Thus, they have only little to do with solidarity. The reform intended to clearly separate solidarity, when it replaced virtually all such instruments by targeted measures helping those really in need.[4] For instance, the child allowance has been cancelled and a new form of targeted social compensations and entitlements has been introduced, which should ensure a fairer distribution of income particularly benefiting low-income families with children.
5. **Elimination of double taxation of income** (such as tax on dividend) To assure tax fairness and simplicity the Ministry of Finance decided to tax all types and all amounts of income equally. **Searching for the best rates the government applied the same 19% rate for personal income tax, corporate income tax, and value-added tax (VAT).**

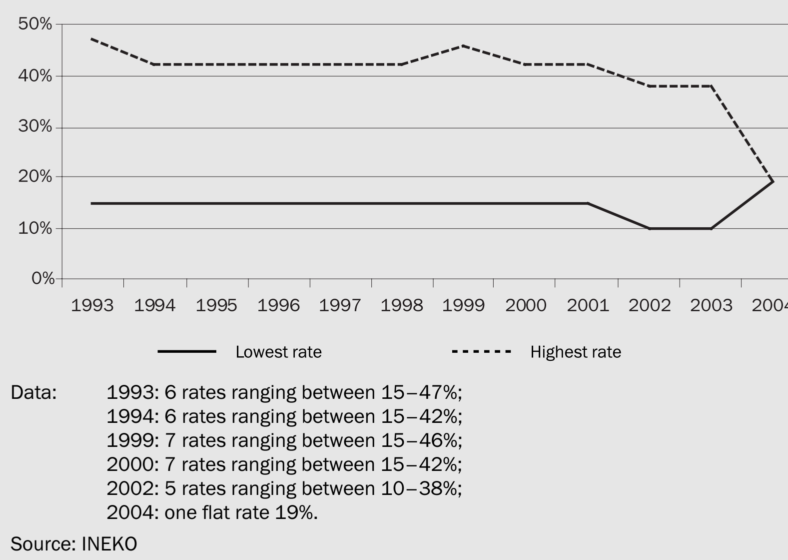
Personal Income Tax

The old system was strongly progressive with five tax rates for different incomes: 10% (for the lowest), 20%, 28%, 35% and 38% (for the highest). The new system introduced one flat rate – 19% for all incomes. It also increased a tax-free income (i.e. basic tax allowance deductible from the tax base) to 19.2 times living minimum (from SKK 38,760 or EUR 968 per tax payer yearly to SKK 80,832 or EUR 2,021 per tax payer yearly in 2004). As a consequence, everybody with wage below approximately half the average wage in the economy is not paying any taxes at all. Others are paying 19% from the difference between their income and tax-free income. Thus, a new system is tax-free for low income brackets but it still ensures slightly progressive taxation for middle and high income brackets. Raising the basic tax allowance was an important precondition for viability of the whole reform as it compensates low income brackets for higher imposed flat tax rate. Besides basic tax allowance, the new act replaced a child allowance deductible from the tax base (SKK 16,800 yearly) by a tax bonus deductible from the tax (SKK 4,800 yearly) or payable in case of too low or negative tax – which is conditional on at least one parent being employed; and increased a non-working spouse allowance from SKK 12,000 to SKK 80,832 per tax payer yearly.

Corporate Income Tax

The corporate income tax (CIT) rate has been decreased from 25% to 19% (Figure 2). The dividend tax (15% in the

Figure 1. Personal income tax rates in Slovakia



Data: 1993: 6 rates ranging between 15–47%;
1994: 6 rates ranging between 15–42%;
1999: 7 rates ranging between 15–46%;
2000: 7 rates ranging between 15–42%;
2002: 5 rates ranging between 10–38%;
2004: one flat rate 19%.

Source: INEKO

[1] However, even before the reform, Slovakia had one of the lowest direct tax burdens relative to GDP (Eurostat 2005): In 2003, Poland (19.7%), Slovenia (20.8%) and Slovakia (23.2%) recorded the lowest shares of direct taxes in the total tax burden, compared to the EU-25 average of 31.6%.

[2] PAS (2003).

[3] For instance, contributions to voluntary pension schemes up to SKK 12,000 yearly remained un-taxed.

[4] Tax reform has been complimented by welfare reform aimed at (1) curbing the abuse of social benefits, (2) careful targeting of social aid to those really in need, and (3) insuring work incentives.

Table 1. Some of special tax rates cancelled by the reform

Tax rate	Type of income
0%	Income of small hydro-electric power stations (up to 1 MW)
1%	Rent, when the agreement on buying the rented object has been made
2%	Lump-sum tax on income up to SKK 500 thousand yearly*
2.25%	Lump-sum tax on income up to SKK 1 million yearly*
2.5%	Lump-sum tax on income up to SKK 1.5 million yearly*
2.75%	Lump-sum tax on income up to SKK 2 million yearly*
5%	Bank interest on personal long-term deposits (above 3 years)
15%	Return on equities, profit sharing in Ltd. companies, agriculture
18%	Income of tax payer employing more than 50% of handicapped persons
20%	Interests, prizes and awards
25%	Corporate income, consultancy
28%	Personal income SKK 180–396 thousand yearly
35%	Personal income SKK 396–564 thousand yearly
38%	Personal income above SKK 564 thousand yearly

* selected self-employed entrepreneurs, based on their trade.

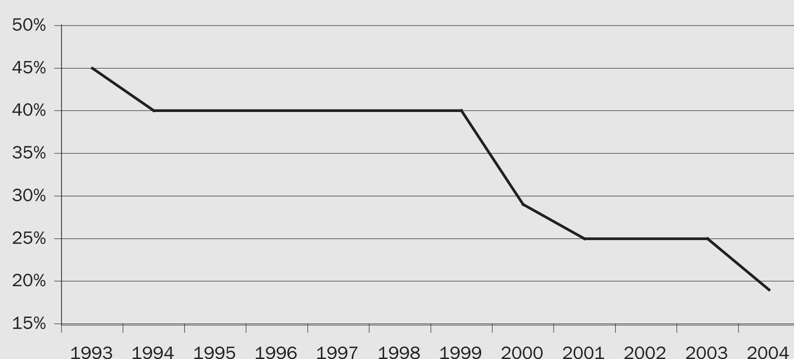
Source: Ministry of Finance of the SR

old system) perceived as a double taxation of profit has been cancelled – 2004 was the last year of paying dividend tax. Thus, Slovakia appeared to have one of the lowest effective taxation on investment income faced by a private investor (combined corporate tax and dividend tax) in the OECD (Figure 3).

IMF (2005) notes, that besides the low CIT rate, the liberalized treatment of loss carry-forwards assists businesses. Losses can now be deducted from taxable income over the following five years, and annual write-off installments are no longer required to be equal. The previous treatment of losses had detracted significantly from the competitiveness of the CIT law. Private accountants in Slovakia informed in 2003 that their clients were more concerned about their inability to write off legitimate losses, than whether the CIT rate was 15 or 25 percent. Including the inability to write off advertising expenses and limits on the tax deductibility of vehicle depreciation, some clients faced effective tax rates of 35 percent or more (in some cases reaching 80 percent), despite the then statutory CIT rate of 25 percent. The new CIT law remedies this problem.

Pushing through tax fairness and simplicity the reform has also abolished majority of exemptions, tax relieves, special tax bases and rates. For instance, lump sum tax for small-businesses has been abolished and replaced by lump-sum expenses of 25% of total revenues (60% for craftsmen). As the IMF (2005) notes, tax base reductions for certain sectors, such as agriculture and forestry, have been cancelled; and investment incentives have also been scaled back: the reform cancels legislation providing for tax holidays (of up to 10 years) for newly established firms. However, the government may still individually grant investment incentives, in compliance with the EU law on state aid.

Figure 2. Corporate income tax in Slovakia



Data: 1993: 45%; 1994: 40%; 2000: 29%; 2001: 25%; 2004: 19%

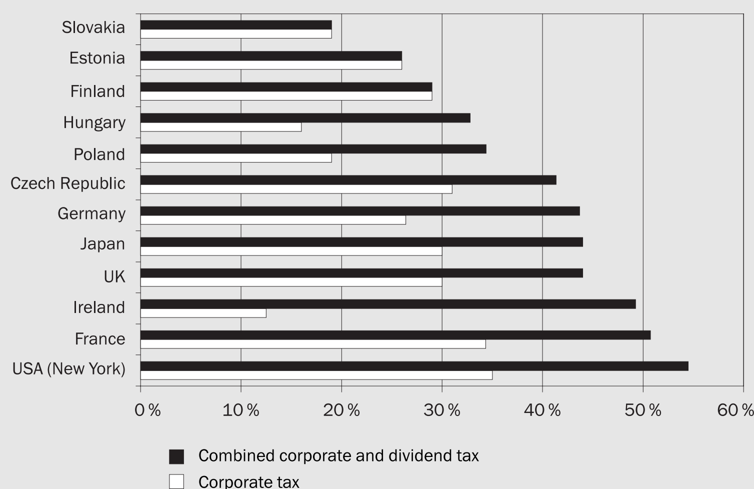
Source: INEKO

The Parliament approved a new Income Tax Act in October 2003 and repeatedly in December 2003 after President's veto. It came into force on January 1, 2004.

Value Added Tax

In the old system there were two VAT rates: standard rate of 20% and reduced rate of 14%. Tax reform unified both and introduced one VAT rate of 19% (Figure 4). This was politically and socially the most difficult reform decision, as it directly conveyed into higher prices of goods and services taxed formerly at a reduced rate. These included, for example, basic food, medicaments, electricity, coal, construction works, books, newspapers, magazines or hotel and restaurant services. The unification intended to reduce speculation aimed at paying tax at a lower rate. Another argument proposed by the Ministry of

Figure 3. Effective taxation on investment income faced by a private investor



Source: INEKO based on Ministry of Finance of the SR, and KPMG (2004)

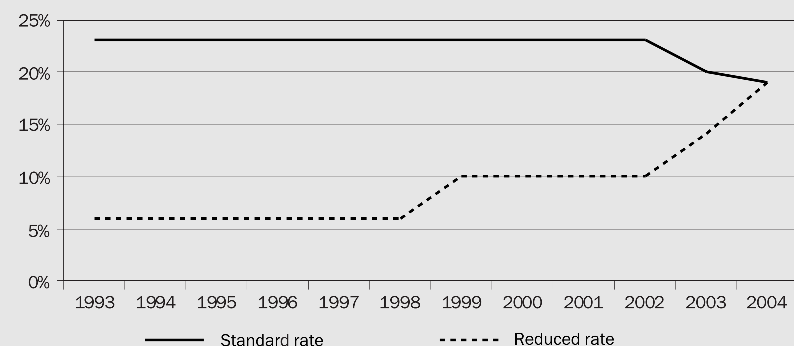
Finance was that by keeping the reduced rate the state is endowing everybody and not only those who really need it. Furthermore, higher taxation was aimed at assuring fiscal viability of the reform as it compensated for the expected loss of direct tax revenues. The Parliament approved the amendment to the VAT Act in June 2003 as a first tax reform measure, coming into force on January 1, 2004. Timely approval of this unpopular measure was a key precondition for success of the whole reform.

Excise Duties and Some Other Taxes

With effect from August 1, 2003, the tax reform included increase in the excise duty tax rates on mineral oils, tobacco and tobacco products, spirits and beer. These changes were basically on demand and in compliance with the EU regulations. However, as a consequence of shifting the tax burden onto the consumption, the new rates exceeded the minimum required by the EU in all cases with the exception of tobacco products, where Slovakia agreed to phase in the increases by 2007.

With effect from January 1, 2004, gift tax and inheritance tax have been abolished. Real estate transfer tax was cut from 6% to 3% and abolished with effect from January 1, 2005. All these taxes presented multiple taxation of the property. Another reason for their abolition was the especially low revenue they generated (gift tax accounted for 0.08%; inheritance tax for 0.04%; and real estate transfer tax for 1.21% of total tax revenue in 2003).

Figure 4. VAT rates in Slovakia



Data: 1993: standard rate 23%, reduced rate: 6%;
1999: reduced rate: 10%;
2003: standard rate 20%, reduced rate 14%;
2004: one unified rate 19%.

Source: INEKO

Shortly after tax reform, the government approved the fiscal decentralization which included transfer of 70.3% of total personal income tax revenues to municipalities and 23.5% to eight regional self-governments (only 6.2% goes further to the central government with effect from 2005), and significant changes in the structure of local taxes concerning real estate tax, road tax and local fees. In principle, the fiscal decentralization significantly strengthened the fiscal competences of municipalities, especially in the field of local taxes. As the IMF (2005) notes, the decentralization defines 12 local taxes and one local fee which municipalities are free to set themselves; central-government ceilings no longer apply to these taxes.

Fiscal Implications

When deciding about the final tax rates, the government's goal was to ensure a fiscally neutral outcome in the first year after the reform. To keep the same tax revenues, the reduction of direct taxes required higher indirect taxation. By 2006, tax revenues should go down relative to GDP with stronger proportion of indirect taxes and weaker of direct taxes (Table 2).

Choosing 19% rates the government took more conservative estimate in order not to overestimate the revenues. The outcome was hardly predictable, as the major changes in taxation evoke new behavioral patterns of individuals and firms. Lowering taxes usually means lower tax revenues; however, as long as it brings more people to work, the effect may be exactly opposite. The actual tax revenues in 2004 exceeded both plans and revenues collected in 2003 (Table 3). Especially the direct tax revenues were higher than plans, although the tax rates decreased substantially. However, this optimistic development can not be attributed solely to the tax reform. Among other reasons these have played the crucial role:

1. Direct taxes paid in 2004 were counted out of the tax bases from

Table 2. Fiscal impacts of the tax reform (ESA 95, in % of GDP)

	2002 (reality, before reform)	2006 (forecast, after reform)
Total tax revenues	19.0	17.3
Personal income tax	3.4	2.4
Corporate tax	2.7	2.2
Withholding income tax (incl. dividend tax)	0.9	0.4
VAT	7.6	8.4
Excise duties	3.1	3.2
Gift, inheritance, real estate transfer taxes	0.2	0.0

Source: Ministry of Finance of the SR

the previous year[5]. Hence, higher revenues in 2004 result to a large extent from high tax bases in 2003.

2. All firms and self-employed individuals paid the old tax rates until the end of March 2004, which is also the deadline for submitting the tax declaration. Thus, a large part of direct taxes in 2004 has been paid under the old rates.
3. Better than expected development of economy – higher economic growth transferred to higher wages and consumption, and higher tax revenues in 2004.

Regarding the sharp decrease in the revenues on withholding income tax, following factors need to be taken into account (IMF, 2005):

1. Some of these taxes may have been diverted to CIT collections: Firms may now be reporting as profits, income previously taxed at a lower rate as capital income.
2. Companies may have retained earnings in 2004 rather than paying out dividends, to avoid the final year of dividend tax.

Collections of indirect taxes have risen in 2004 confirming the projections. However, these results have been affected by other factors, which are difficult to disentangle from the tax reform (IMF, 2005). Among them, tax administration changes required upon EU accession played a special role. Also, the basis for 2003 has been distorted – VAT collections for 2003 were lower by 1% of GDP, owing to one-off refunds paid following a change in the VAT law in 2002.

Based on the above reasoning, it is still impossible to conclude final remarks on the fiscal implications. The promising results of 2004 must be definitely confirmed in 2005 yet.

Macroeconomic Implications

As mentioned before, better than expected macroeconomic development helped the overall fiscal balance in 2004. This is partly due to the better than expected outcome of the tax reform. Particularly, partly based on the reform, the Ministry of Finance projected the average inflation rate at 8.1%. In reality, the average inflation was 7.5%. This contributed heavily to the better than expected real growth of GDP, pulled in particular by dynamic household consumption (Table 4). Still, it might also be assumed, that the tax reform together with Slovakia's entry to the EU in May 2004 played the crucial role in fast improvement of the whole economy. However, the real macroeconomic impact including the employment will show after a longer time period.

Table 3. Tax revenues in 2003 and 2004 (in SKK billion, ESA 95, on accrual basis)

	2003 (before reform)		2004 (after reform)			
	Reality	Share on total	Plan	Share on total	Reality	Share on total
Tax revenues	**217.6**	**100.0%**	**232.0**	**100.0%**	**233.5**	**100.0%**
Direct taxes (PIT & CIT & WIT)	**82.7**	**38.0%**	**62.2**	**26.8%**	**68.9**	**29.5%**
Personal income tax (PIT)	39.9	18.3%	27.1	11.7%	34.1	14.6%
Corporate income tax (CIT)	33.6	15.4%	23.7	10.2%	29.1	12.5%
Withholding income tax (WIT)*	9.1	4.2%	11.4	4.9%	5.7	2.4%
Indirect taxes (VAT & Excise)	**118.3**	**60.9%**	**157.0**	**67.7%**	**149.5**	**64.0%**
VAT	80.7	41.9%	113.8	49.1%	104.9	44.9%
Excise duties	37.6	19.0%	43.2	18.6%	44.6	19.1%

* includes revenues on dividend tax.

Source: Ministry of Finance of the SR

[6] Income tax is payable monthly (forward payments) based on your previous year payments/tax base, so in 2004 they might have been higher during the year yet the tax office might have to return a larger share of income tax collected once firms hand in their complete tax statements in March 2005.

Table 4. Performance of the Slovak economy

	2003 (reality)	2004 (plan)	2004 (reality)
Inflation	8.5%	8.1%	7.5%
Change in household consumption	-0.8%	+2.0%	+3.5%
GDP growth	4.5%	4.1%	5.5%
Change in real wages	-2.0%	-0.6%	+2.5%

Source: Statistical Office of the SR, State budget for 2004

Table 5. Foreign investors in Slovakia

	2002	2003	2004	2005 (Est.)
Number of projects signed	25	22	47	40
Number of new jobs projected	5,400	7,970	13,500	20,000
FDI contracted (mn EUR)	311	1,164	1,707	1,951 – 2,073

Source: SARIO

Table 6. Ranking of the most important factors to foreign investors

1.	Locality (utilities network, transport infrastructure)
2.	Work force (cost, structure)
3.	State aid (investment incentives)
4.	Business environment (taxes, payroll taxes, Labor Code)
5.	Geography (distance to customers)

Source: SARIO

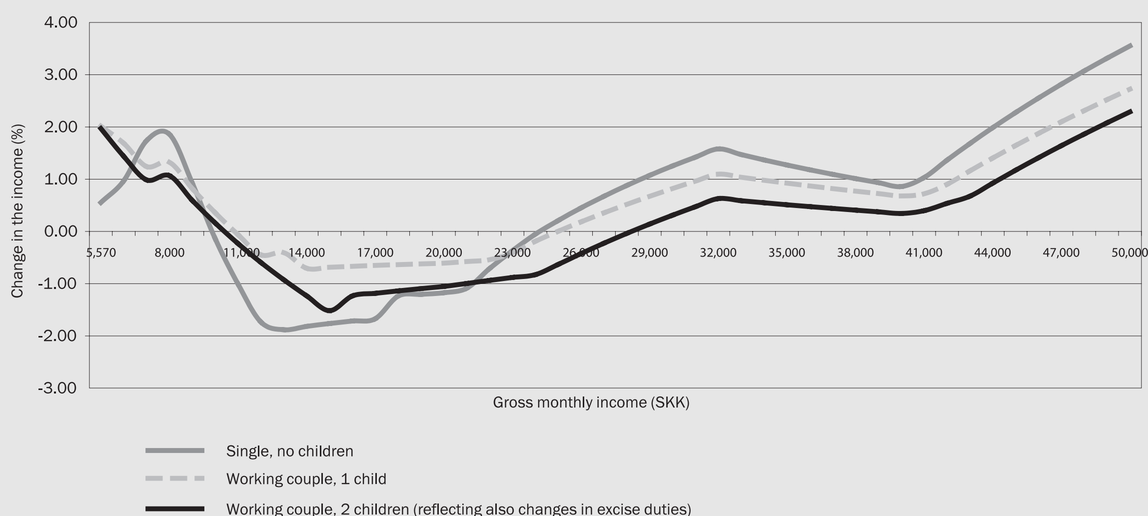
Income Distribution Effects

The introduction of flat personal income tax eased people with high income. Higher tax deductibles eased mainly people with low income. The unification of VAT and rise in excise duties burdened everybody almost equally, depending on the structure of consumption. As a result, low- and high-income brackets are better-off after the reform; middle-income brackets are worse-off (Figure 5). Generally, all people with monthly income of SKK 10,000 to SKK 23,000 are immediate losers. With the average wage of SKK 15,825 in 2004, the majority of population falls within losers. However, the loss is relatively mild with maximum of 2% of income for singles without children. Families with children have lower losses thanks to the new child bonuses. Moreover, the model counting the income effects of the reform is static and reflects only immediate changes. It does not reflect dynamic changes such as higher economic activity surging the GDP growth, wages, and employment in the short and long run.

Foreign Direct Investment

Slovak Investment and Trade Development Agency (SARIO) reports increased interest of foreign investors to operate their businesses in Slovakia. In 2004, it contracted EUR 1.7 billion foreign direct investment what is a 47% increase on a yearly basis. In terms of new jobs projected the increase is even higher – 69%. In 2005, the surge of foreign investment inflow continues (Table 5). The agency claims the suitable business environment and the tax system among the most important factors referred by investors when choosing Slovakia. They especially welcome the lower CIT and the abolished tax on divi-

Figure 5. Income distribution effects of the tax reform (reflecting changes in direct taxes and VAT)



Source: INEKO, Business Alliance of Slovakia

dends. However, the investors prefer good infrastructure as the most important factor when deciding about where to invest, followed by cheap and qualified work force, and generous state aid (Table 6).

International Reactions

Slovakia was the 7th country in Europe introducing the flat tax on personal income. Soon after, two other countries joined the club: Georgia and Romania going down to 12% and 16% respectively (Table 7). The largest opposition parties in the Czech Republic and Poland are also agitating for a flat tax and have promised to implement one if victorious at the polls.

After reducing corporate income tax and canceling dividend tax, the Slovak tax system became one of the most attractive for foreign investors and residents within the OECD. Most of foreign managers of Slovak subsidiaries and affiliates of international banks and enterprises started to pay taxes in Slovakia. The reform evoked fierce tax competition among Central European countries spreading further to the west. Austria reacted swiftly by reducing its corporate tax rate from 34% to 25% from 2005 even though it intended to go down "only" to 31% originally. In 2004, the Czech Republic decreased its upper VAT tax rate from 22% to 19% and its corporate taxes are falling from 28% to 24% in 2006. Hungary reduced its corporate tax rate from 18% to 16%; and Poland from 27% to 19%. Western democracies with much higher corporate taxation (Germany 38.3%, France 34.3%, Netherlands 34.5%, Italy 37%, and the UK 30%) blame Slovakia for "tax dumping" and call for "tax harmonization" within the EU. They point out, that new members are able to lower taxes only thanks to the massive regional aid received from richer EU countries. However, any "tax harmonization" would require unanimous voting in the EU structures what makes it hardly applicable.

Political Considerations

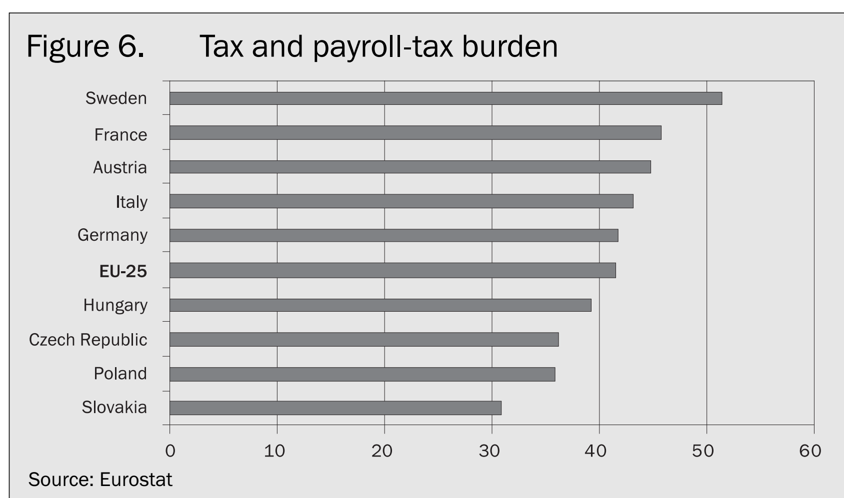
Based on February 2003 poll of opinion ordered by the Ministry of Finance, three quarters of respondents considered the tax reform necessary. Among the main reasons people mentioned high complexity of the old legislation, high tax rates, and high administrative complexity of the tax system. Majority was willing to accept 15% tax rate on income, only one fifth was willing to accept a higher rate. Asked to judge the fairness of taxation only 21.6% preferred flat tax and 70.9% preferred progressive taxation. Respondents generally agreed that the taxes should be low in order to support business and employment, and to reduce tax evasion.

Advocating the reform proposal, the Ministry of Finance claimed that the lower direct taxes support the investment in the middle and the long run, attract foreign investors, and improve production potential of the economy. Together with milder progressiveness they should better motivate people to work and bring positive effects on economic growth and employment. On the other hand some opposition parties, the trade unions and the President criticized negative short term effects on income mainly for the middle class, the "injustice" of weak progressiveness, the need for more solidarity, the need to use taxes as a tool for social policy, and the threat that the reform will deepen social imbalances. Even after the reform the main opposition party Smer proclaims, that if successful in the following elections it will renew the standard VAT rate and the progressiveness in the income taxation. According to public opinion polls, Smer has the greatest support from among political parties in Slovakia.

Key preconditions for successful reform were good timing (unpopular first, i.e. approving of the VAT rates unification), compensation for low income people (i.e. increase of the basic tax allowance deductible from the tax base; introduction of re-payable child bonuses in case of low or negative taxes; etc.), and gaining support from key target groups:

1. Entrepreneurs – communication, the reduction of corporate income tax, and abolishment of dividend tax
2. Bank analysts and NGOs – involvement in the reform process (joint

Figure 6. Tax and payroll-tax burden



Source: Eurostat

Table 7. European countries with flat-tax regime

	Estonia	Lithuania	Latvia	Russia	Serbia	Ukraine	Slovakia	Georgia	Romania
	1994	1994	1995	2001	2003	2004	2004	2005	2005
PIT	26%	33%	25%	13%	14%	13%	19%	12%	16%
CIT	26%	15%	15%	24%	14%	25%	19%	20%	16%

PIT – personal income tax, CIT – corporate income tax.

Source: Grecu (2004), INEKO

organization of seminars and conferences, inviting to calculate the fiscal impacts of the reform)
3. Journalists and public – transparency, special web page, inviting foreign experts advocating the flat tax, positive reform evaluation by international organizations.
4. Opposition Members of Parliament, the President – communication, especially after the "veto" after the first approving of the Income Tax Act.

Table 8. Social contribution rates (2003, in % of the gross wage)

	Employee	Employer	Total
Slovakia (2003)	12.8	38.2	51.0
Slovakia (2004)	13.4	35.2	48.6
Czech Republic	12.5	35.0	47.5
Hungary	12.5	32.0	44.5
Poland	25.0	20.4	45.4
EU-15 average	12.5	24.1	36.6

Sources: Ministry of Finance of the SR (2004); and OECD statistics

Changes in Payroll-Tax System

Slovakia has one of the lowest tax and payroll-tax burden in the EU measured as % of GDP (Figure 6). However, the payroll-tax contributions measured as % of gross labor income belong among the highest in the European Union (Table 8). Moreover, the payroll taxes (social contributions) total almost 40% of the overall tax and payroll-tax burden.

Effective from 2004, Slovakia substantially changed its payroll-tax system. Nominally the rates decreased just slightly but their character shifted heavily. Formerly, almost all benefits based on payroll-tax contributions were distributed equally or with only small regard on the amount of paid contributions. This is typical for taxes. Because people do not see the link between their payment and future benefits, they usually tend to avoid paying such kind of contributions. After the reform, mainly the pension contributions constituting almost half of payroll-taxes started to reflect the payment-benefit link much closely (Table 9). The reform also raised the ceilings for paying the social contributions from fixed SKK 32,000 monthly to 3-times the average monthly wage (SKK 43,095 since July 2004).

Table 9. Payroll-tax burden (employee plus employer's contributions as % of the gross wage)

	2003	2005	Change	Character
Pensions	28% (tax)	28.75%	+0.75%	
- old-age*	–	19%	–	insurance/ saving
- disability	–	6%	–	insurance
- reserve fund	–	4.75%	–	tax
Health	14%	14%	0%	tax
Sickness	4.8%	2.8%	-2.0%	insurance
Unemployment	3.75%	2.0%	-1.75%	insurance
Guarantee**	0.25%	0.25%	0%	insurance
Accident***	0.2% to 1.2%	0.3% to 2.1%	+0.1 to +0.9%	insurance
Total pay-roll taxes	**51% to 52%**	**48.1% to 49.9%**	**-2.9% to -2.1%**	

* Old-age insurance is being reduced by 0.5% for every nourished child for one of parents.

** Guarantee insurance serves for covering unpaid wages for employees of insolvent firms.

*** Actual percentage depends on a job risk grade.

Source: INEKO

Pensions: Accepting the World Bank's recommendations and learning from similar reforms in Hungary and Poland, the new government decided to build a pension system based on three pillars: mandatory social insurance (pay-as-you-go or PAYG – 1st pillar), mandatory saving (Funded – 2nd pillar), and voluntary saving (Funded – 3rd pillar). First stage – the reform of the old PAYG system – became effective as from January 2004 and changed calculation of new pensions. Compared to the old formula, the new one gives higher pension to those who earned more and paid higher contributions during their working life and vice versa. The highest-to-lowest new pension ratio rises from 1.8 to 5.8 in a three-year transition period. This should increase the motivation to pay contributions and eliminate evasion. However, it also endangers people with too low income, who will receive much lower pensions and will have to be supported directly from the state budget. Second stage of the reform – the introduction of mandatory saving – became effective as from January 1, 2005. Until the end of June 2006, virtually all citizens may decide whether to divert 9% of their gross wage from the PAYG to their personal accounts managed by private pension companies competing on the market. Money saved on the accounts remain private ownership of savers and may be inherited.

Sickness: In the old system, all sickness benefits have been paid by the state. After reform, the period has split into a short-term and long-term part. First ten days of a sickness leave is being paid by an employer – the benefit in the first three days is 25% of daily gross wages; in the other days (4 through 10), it is 55%. From the eleventh day onwards, sickness benefits are being paid, as before, by the state, at 55% of gross wages. The aim of such changes was to eliminate abuse of the sickness benefit – people

often pretended to be ill as their loss of income was not so high, firms often recommended their employees to take a sickness leave when they had no work for them. In a new system, the employers lost motivation to send people on sickness leave and started to watch their employees and control the reasons of their sickness. As a result the average length of a sickness leave measured as a percentage of the working-time shortened substantially from 5.1% in 2003 to 3.7% in 2004. On the other hand, even sick people tend to stay at work now or take a holiday instead of a sickness leave.

Unemployment: Eligibility period for benefits has been cut from 9 to 6 months. As the IMF (2005) notes, the benefits are paid on condition that the unemployed has contributed for 24 of the previous 36 months. The replacement rate is 50% of past gross income; previously, this has been 55% for the first six months, falling to 45% for the last three months. Benefits remain subject to a ceiling raised from about 50% to 60% of the economy-wide average wage.

Conclusions

After one year in place, Slovak tax reform brings both firm and tentative conclusions – increased attractiveness of Slovakia for foreign investors, increased international tax competition, and better than expected impact on household consumption are among firm ones; better than expected fiscal implications still need to be confirmed in the following years.

Compensation for low income people is one of key preconditions for successful reform – the flat personal income tax includes large tax-free thresholds. As a consequence, the low income brackets do not pay taxes at all and the middle income brackets pay taxes slightly increasing with their income. Moreover, the tax reform has been complemented by welfare reform aimed, among others, at careful targeting of social aid to those really in need.

Flat tax brings simplicity – the elimination of virtually all exemptions makes system better to administer for the government and easier to understand for the tax payers.

Foreign investors welcome lower corporate taxation – however, even more important factors for deciding about the allocation of foreign direct investment seem to be a good infrastructure, cheap labor force, and generous state aid.

High direct taxes have negative impact on work incentives and vice versa – as a consequence, lower direct taxes bring more people to work, and must not necessarily mean lower state budget revenues.

Lower direct taxes and stronger payment-benefit link in payroll taxes help fight the shadow economy and reduce tax and payroll tax evasion – in a global economy the collection of direct taxes and payroll taxes becomes more difficult to control and it is easier to avoid paying them compared to the indirect taxes. As a result, the relatively high direct and payroll taxes are harming country's fiscal position and competitiveness – people "escape" to a shadow economy or to countries with lower taxation. The shift towards indirect taxation and stronger payment-benefit link in payroll taxes should reduce this evasion. ■

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Public Administration Reform in Slovakia and Other Central European Countries and Its Implications for Ukraine

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Introduction

This paper deals with the place of public administration reform within the wider scope of changes that have taken place in transition countries, particularly in countries of Central Europe. The rationale for the paper is based on the fact that public administration suitable for a functioning market democracy is a necessary prerequisite for many other systems and, consequently, public administration reform is the key enabler for other reforms.

This general statement is even more true under conditions that combine an advanced stage of reforms with public and political pressure for extremely rapid change. Both of these conditions make public administration reform more, not less important. At the same time, politicians usually do not pay enough attention to issues of public administration because they are seen as politically unrewarding and too technical; such neglect can derail many other changes that politicians prize, but by then it is usually too late.

At the same time, public administration reform in transition countries faces a significantly different environment than in developed countries. There are several reasons for this. One is that the overall speed and scope of change is without precedent as it entailed complete political and economic transformation. In transition countries, public administration reform is a part of unparalleled management of decline and scope of publicly "guaranteed" services has significantly decreased. It is implemented in an environment with blurred boundaries of the public sector (everything was public before transition) and with evolving rule of law and very high level of uncertainty. Due to existence of new states and lack of readiness for change, it also starts from a very weak administrative capacity.

Taking these factors as its departure points, the paper is organised in the following order.

The first section looks at the heritage of communism and the paradigms of public sector functioning that it has left for the transition. Even though transition has started more than 15 years ago in Central Europe, these initial conditions are still relevant in explaining what paths reformers have taken and how they have panned out.

The second section looks at the wider context of public sector change within transition, explaining that it is the twin movements towards non-majoritarian governance and the market that are the organizing principle of the last 15 years.

The stage is then set for three sections that deal with three key pillars of public administration change: civil service reform, agencification and decentralization.

The concluding section summarises finding and recommendations from previous sections.

Heritage of Communism

Since communism meant a totalitarian system based on collective ownership of all means of production and repressive and intrusive political system, both outsiders and insiders often tend to see it as an environment with very low level of autonomy for individual actors in any area. Such a view tends to perception of the whole communist society as a centralised, vertically and horizontally integrated hierarchy, where the centre (e.g. central committee of a communist party and its government apparatus) directed resources and activities of sectors, organisations and individuals. It ignores, however, several important factors.

The officially tightly-knit hierarchy contained thousands of organisations with legal autonomy. While the system could rely to some extent on its ability for arbitrary use of power to resolve conflicts between interests in this hierarchy, arbitrary use of power in itself was an insufficient answer to daily routines of administration in a complex society. The communist system lasted from 40 to 70 years in countries of Central and Eastern Europe as an industrialised economy where citizens were provided with a welfare-to-cradle superstate (issues in quality, responsiveness and ability to generate wealth nonwithstanding). No economic, political and social system would be able to last so long in these complex conditions unless it developed a relatively predictable system for conflict resolution between both individual and organisational interests. (see Beblavý (2002)

As several authors, including Mlcoch (2000), argue, the hierarchy was largely an illusion: "In a closed system of hierarchical management, the planning was a widespread social game based on a all-encompassing dichotomy between the real rules and the official ones. In reality, local "controlling" groups tried to maximise their share of a social pie in the inverted pyramid. Planning was an instrument and an ideological smokescreen to utilise a monopoly power over allocation of scarce resources, information

and decision-making processes within the social reproduction process."[1]

By 1970s and 1980s, the public administration was penetrated individually (by compulsory party membership on many levels), but it was nearly invulnerable collectively (see Sootla (2002). As Hojnacki (1996) writes: "There can be little doubt that during the last several years of the communist rule, the major force in both policy-making and policy implementation... was the communist-led bureaucracy that was almost immune to political pressure from any source." (Hojnacki (1996), p. 147)

Since the hierarchy involved not only public sector as understood in the OECD countries, but also the whole corporate sector (enterprises), the well-known problems of information flows and information asymmetries were even more acute than in public sectors of OECD countries due to span-of-control problems and lack of accountability systems. Managers of organisations were the real masters of the system because of their unique position in the information flows and decision-making. In other words, the real rulers of communist countries were, to quote Burnham (1972): "the men who are running the factories and mines and railroads, the directing members of the commissariats and subcommissariats of heavy and light industry and transportation and communications, the heads of the large collective farms, the expert manipulators of the propaganda mediums... the managers in short." (Burnham (1972), pp. 221–22)

Since the "public" and "corporate" sectors were treated equally under the communist system – both were controlled by sectoral ministries and were subject to similar regulatory environment – this blurring not only led to enterprises behaving like "civil service", but also to "civil servants" behaving like corporate managers. In other words, the two groups were part of a unified system and a continuum, where there was neither a sharp distinction between the two in the eyes of actors themselves nor much difference in systems and incentives regulating their behaviour.

Governmental organisations during the communist period generally had no accountability systems. On the other hand, they had a number of legal relationships with other elements of the government. Since the "public sector" organisations themselves and their ministries saw them on par with "corporations" and as the regulatory framework was similar, this led to high level of both de jure and de facto autonomy.

All of this led to a situation where the real heritage of communism is not a hierarchical, disciplined public sector with a distinctive culture and ethos, but a chaotic free-for-all, where organisations often had legally defined autonomy, rights and responsibilities, their staff and particularly managers remained responsive to political pressure individually, but acquired very little accountability, felt certain informal ownership rights and the distinction between public- and private-sector mentality remained blurred or non-existent in eyes of most actors. Public administration employees also on the whole lacked skills and information needed to participate in policy-making in a new world of market democracy.

Transition: Shift to Non-majoritarian Governance and Marketization of the Society

There are many ways of thinking about the transition process that began in 1989 in countries of Central Europe, but this paper argues that the analytical framework that puts public administration change into wider context is the one that sees transition primarily as a shift along two axes:

- Move towards values of the market economy: **competition, efficiency and hard budget constraint**.
- Devolution of formal power through change of ownership or limits on the central executive: **non-majoritarian governance**.

In the "corporate sector", this has generally meant privatisation or at least corporatisation of government businesses and consequent withdrawal of the state into a new governance structure to match this, which has involved independent central banks, competition authorities and independent sector regulators (banking and financial markets, utilities, telecom) as well as professional chambers and self-regulating professions (law, health and pharmacy and other professions).

In the public sector, three major tendencies can be recognised:

- Civil service reform, encompassing large-scale change in government employees and rules that govern them.
- Agencification, meaning devolution of many function of the government to public bodies that are not legally and financially incorporated into ministries.
- Decentralisation of wide range of public service to locally and regionally elected authorities.

While other major reforms could easily be added – e.g. in areas such as financial management or ministerial organisation – it is the three that have been the mainstay of public administration reforms and it is to these three that our attention turns to in the following sections.

Civil Service Reform

To understand civil service reform, we need to understand what civil service is. There is no single definition, which would be universally accepted except that it means a subset of public sector, which excludes certain groups of employees. In most countries, employees of organisations with corporate status are excluded. In 20 out of 34 countries surveyed by OECD, health professionals are not included and in 18 out of 34 countries, teachers are not included. (see Synnerstrom et al. (2001)

These views are reflected in this paper, which does not focus on teachers and health professionals or employees of public corporations. It does however include both central and local public administration employees.

Transition countries inherited a public administration, which was problematic in several aspects:

- its employees were responsive to political pressure and vulnerable as individuals;

[1] This analysis is based on the situation in the Czech Republic, but is generally applicable to nearly all transition countries. The only difference is that some countries such as Hungary, abandoned these games faster or allowed parts of their society to opt out of it already during 1980s.

- the bureaucracy as a whole had very little political accountability toward the people or the party/ies;
- public administration as a whole lacked skills and information needed to participate in policy-making in a new world of market democracy;
- due to state control of all organisations, there was a lack of public service ethos as the distinction between "civil service" and other government employees (including enterprises) was blurred.

To gradually remedy this situation, all civil service reforms in Central Europe, in some way, pursue some of the following essential components:

- to replace some of the public administration employees with new employees with a different set of skills and preferences;
- to give the remaining and incoming public administration employees incentives to mould their behaviour in a desirable manner;
- to equip public administration employees with skills that enable them to respond to incentives in a desirable manner.

Timing and sequencing of a major civil service reform are primarily determined by the fact that a government needs to work every day. Policy documents and laws must be prepared and public services delivered. Therefore, in a way, no time is "right" for a civil service reform because many other pressing "real" issues always present themselves. As one can see from Table 1, countries in Central Europe are extremely varied in timing of civil service reform.

However, several factors influence, to some extent, the optimal timing of civil service reforms.

Civil service reform is usually ranked among the so-called "second generation" reforms in transition. The first generation usually involves (see e.g. Zemanovicová (2000), Beblavý and Sicáková (2001) implementation of "simple" speedy systemic changes (privatisation, liberalisation of prices and trade, macroeconomic stabilisation). The second generation, on the other hand, involves "messy" and "wicked" complex issues such as education, health care, social security and public administration. These involve sectors, where there are no clear-cut best practices, no universally accepted model, a high number of individual stakeholders with difficult monitoring of their efforts and a complex political economy.

Management of civil service reform, in this context, means inter alia:

- primary and secondary legislation concerning civil service – preparation, interpretation, monitoring of implementation and amendments thereof;
- management of transition of the existing public administration employees into the new system (exams, oaths, lay-offs etc.);
- organisation of training for existing and new civil servants;
- setting up institutional solutions for recruitement, dismissal, evaluation and remuneration systems of civil servants (which usually require complex institutional underpinnings).

The key issue in the management of civil service reforms has been the **choice of responsible institution**. The Central European experience suggests three options:

- ministry of interior (Hungary and Slovenia). It offers administrative continuity, an extensive pool of employees with wide administrative experience and close relationship with local governments, but it is also very conservative and has little knowledge of some elements of the public sector. This system was preferred by countries with a decentralised system or where some of responsibility for implementation was switched to other agencies;
- ministry of labour (Czech Republic and Slovakia). Such ministries placed extensive emphasis on labour and social aspects of a civil service reform at the expense of the rest of the civil service reform and had much less contact with the lower tiers of the public administration than an interior ministry;
- a separate agency (Poland, after the start of reform: Slovakia and Czech Republic). Once created, such an agency usually becomes a focal point for further civil service reform, but makes it hard to strike a proper balance in its creation between power and accountability. They are either too powerful and influential without the requisite accountability or become too weak politically and financially.

Concerning the issue of timing, no time is "right" for a civil service reform because many other pressing "real" issues always present themselves. Such a reform is both more meaningful and more urgent when the early transition measures have already been taken and there is at least a fragile consensus on the size and function of the state. At least a rough consensus is also needed within the society and the political elites that civil service should be at least partially set aside from political struggle and that reform will serve interests of all. Therefore, even in two countries where the civil service reform was started already in early transition (Hungary, Slovenia), either major changes were later implemented as transition progressed or the civil service reform was of much "looser" nature.

Another key influence is decentralisation. If decentralisation takes place before civil service reform, the number of relevant stakeholders will increase so significantly that any agreement on comprehensive civil service reform will become extremely difficult. Simultaneous decentralisation and civil service reform strain the capacity of public administration to its utmost. Decent-

Table 1. Passage of civil service legislation in countries of Central Europe

Country	Passage of initial civil service legislation
Slovenia	1990
Hungary	1992
Poland	1996
Slovakia	2001
Czech Republic	2002

Source: OECD SIGMA, laws of respective countries

ralisation after civil service reform probably presents the least problems unless it creates problems for restructuring of public administration because of tenure and other considerations. Such a sequencing is rare, primarily because most transition countries can sooner find a political will to decentralise than to comprehensively reform their civil service.

The second key issue in sequencing of the civil service reform was understanding the political economy of reform in balancing contemporaneous benefits and costs. Another factor to take into account in sequencing components of the civil service reform, is the fact that a new legal framework for civil service is usually both a focal point and a necessary precondition for further action. Much of the action therefore has to be structured around it.

The analysis of Central European experience warns against structuring the civil service reform as a series of sectoral civil service reforms. On the other hand, it points to the option of creating a core civil service with different rules and regulations and then gradually expanding it as a viable option. On the other hand, we can recommend an introduction of conscious "big bang" moment in the reform. Such instruments should be used even with the risk of backlash, but on a well-thought, limited and persuasive basis.

The push for reform in public administration in general and in civil service in particular, is never-ending. Nonetheless, in case of transition countries, one can make a conceptual distinction between two phases of civil service reform. The first one involves creation of a new system of a civil service in all the aspects mentioned above. When all of this is fulfilled, the second phase of consolidation can begin. The final architecture of the system can also have serious internal inconsistencies or omissions. It can therefore be recommended, when all the components are in place, to undertake a review of the civil service system to uncover these inconsistencies and remedy at least the most important ones.

Agencification

Agencification means devolution of many functions of the government to public bodies that are not legally and financially incorporated into ministries. In the sense that it is used in developed OECD countries, it generally encompasses creation of autonomous agencies for many executive functions, e.g. tax collection, social security administration, prison administration or distribution of cultural grants. Autonomy of agencies is not in their complete independence from the government, but in some measure of autonomy that can range from having top management that is accountable to ministers but has some autonomy in how it delivers agency services all the way to regulators that might be independent not only in their decision-making, but also in setting pay conditions or appointments of officials.

In transition countries, we have witnessed over the last 15 years not only agencification as defined above, but also similar processes concerning institutions which would not be called agencies in the West, but their creation and granting of some measure of autonomy have gone, in transition countries, along similar lines. These are institutions such as constitutional courts, central banks, control/audit offices, public media, various extrabudgetary funds, competition authority and regulators for banking and financial markets as well as utilities. Indeed, one can argue that agencification in this wider sense has been one of the key components of public administration reform in these countries, which is why this section focuses on its analysis.

Any analysis of the process of agencification should include an analysis of the role of individual actors in the process and their incentives. Indeed, this paper uses incentives and expectations as its principal tool of analysis. First of all, let us introduce groups of the most important actors:

- managers of agencies and agency staff (in the case of already existing organisations) or managers and staff of those parts of the ministerial structure that might be structured separately;
- ministers and political parties;
- foreign actors (European Union, International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, etc.);
- other influential stakeholders (e.g. trade unions);
- general public.

Each of these groups **can** have ex ante incentives to support agencification and increase in autonomy of a given agency based on its **expectations**. A stylized summary is provided here.

For managers and staff of agencies, the incentives are usually related to an increase in autonomy, a decrease in uncertainty and an increase in pay and other benefits. For staff, the status of autonomous agency can also mean release from many restrictive regulations valid in the rest of the government (procedural, decision-making, etc). The decrease in uncertainty is slightly paradoxical and related to frequent absence of a civil service system and frequent political changes in policy directions in many transition countries, particularly in the early to mid-1990s. Arm's-length relationship with the government can thus increase certainty in terms of employment, but also in terms of planning. Last, but definitely not least for both managers and staff, autonomous status is often related to freedom from governmental pay rules or, if not that, at least their relaxation.

For ministers and political parties, the motives for agencification are, in this stylised approach, based on expectations of decreasing responsibility, decreasing financial burden and increasing patronage. The distance between a ministry and an agency can be exploited as a tool for decreasing political responsibility for agency's actions and problems. The expectation of decreasing financial burden is often related to an increased motivation for an agency to improve its financial situation. This occurs by generating revenues and decreasing costs, as well as more frequent use of some sort of extrabudgetary means of financing for agencies. Expectation of increasing patronage is based on the fact that the number of positions, which are attractive for patronage purposes, usually increases in the case of autonomous agencies due to the existence of boards and an increase in the number of managerial positions.

Foreign actors can support creation of agencies in the expectation of improved performance and professionalism. This is related to the point made above with regard to incentives of staff and managers. Since foreign actors

also often have very narrowly focused priorities (based on projects in which they are involved or due to donor specialisation), it is often useful for them to increase the autonomy of an agency or even create a new one, if such an agency can have a focus similar to the one of a foreign actor.

For the media and the general public, autonomous agencies frequently hold a promise of improving services and decreasing tax burden based on expectations already explored above: increased professionalism and stability as well as efficiency gains.

However, as any observant reader has probably noted, many of these expectations are mutually exclusive, i.e. they can hardly all be true at the same time for the same agency. It is hard to reconcile increasing pay and benefits for employees and managers with a decreasing financial burden for the public purse unless dramatic efficiency savings can be made. Increased independence and professionalism does not square well more patronage for politicians and political parties. Even though decreasing political responsibility and improvement in services are not mutually exclusive by definition, it is difficult to see why a decrease in accountability to the public should lead to improvement in services for the same public.

What generalisations can one make about the process and results of the agencification process? First of all, agencification in these countries was rarely, if ever, pursued within systemic conceptual and legal framework. The latter would set out in advance the goals, the instruments, their relationships and the timetable across the board. Due to the low quality and capacity in public administration and the political classes, agencification usually occurred as a quick sectoral fix based on a combination of the incentives mentioned above. The result is often paradoxical. On one hand, the legal, accountability and financial framework for autonomous agencies is patchy and is often taken over by specific solutions and exceptions. This very often creates unexpected results, perverse incentives and negative consequences. On the other hand, there has rarely been substantial institutional innovation and creation of complex new institutional frameworks. This paradox is due to the sectoral, quick-fix nature of agencification. The need for a speedy specific solution creates incentives to tweak existing, easy-to-use forms rather than try significant institutional innovation.

When institutional innovation is undertaken, it is frequently exercised by use of institutional transplants from other countries, most often in the context of foreign advice or aid. The problem plaguing such solutions is that when institutional transplant is imported, other elements setting up its legal, accountability and financial framework are often lacking (e.g. activity-based budgeting, financial control and audit mechanisms, and general accountability mechanisms for executives within the civil service rules). This is to be expected as such frameworks are very complex and often invisible even (or particularly) to those who work in the given field in a country providing the model. As de Soto (2001) writes in a slightly different context about the role of property administration mechanisms such as landownership registration in the process of economic development, experts from developed countries themselves usually do not know how the system came about and do not ask themselves these questions, since their own system is “natural”. It’s but only ex post when it is transplanted that the missing elements are uncovered, often in a costly manner.

Another conclusion about agencification in transition, which differentiates it from many developed countries, is the use of agencification as a means of raising the tax burden. This is most often done in one of the two following ways. One is the so-called stealth taxation, i.e. non-transparent and earmarked taxation. Its forms are numerous – from taxes on the general population in the form of the so called compulsory insurance payments to taxes on a specific group such as taxes on the regulated subjects to finance the regulator. The other one is by creating or increasing user charges at least to cost-recovery level and reducing tax funding of public services. Neither of the steps is usually compensated by an equal decrease of other taxes or increase in transfers to the public, so it can be seen as a politically expedient way of doing the difficult thing in politics – increasing taxes.

An unsurprising result of the previous two factors is that agencification is usually implemented without thinking through the consequences, particularly without trying to simulate the incentives of individual players in a dynamic system.

On the other hand, given all the issues analysed above, it is surprising that transition has been marked by an excessive faith in institutional solutions. Many policy-makers, but also observers confused institutional reform with a reform of the system. To be more specific, many countries created so-called independent insurance institutions in the areas of health and/or pensions and/or unemployment, based on German or other models and confused this with a health care or pension reform.

The dynamic transition environment requires constant revision of the informal “social contract” between politicians and agencies. However, once substantial autonomy is granted, agencies become players in their own right that can and do resist changes they dislike. This gives rise to frequent public and political conflicts. This is related to the issue of policy entrenchment. Agencies generally have more information and expertise than ministries on policy issues related to their work. Larger agencies also have more resources for public relations, work with media and stakeholders. As a result, the expected split of policy/execution tasks between ministries and agencies does not de facto apply as agencies are very often informally or even formally responsible for preparation of policy and legal changes in their area that are officially submitted by the ministry in question. Agencies can and usually do block changes they dislike using their relationships with stakeholders as well as the media.

What recommendations can one make on the basis of these findings? Autonomy for an agency is meaningful if a clear formal or informal contract can be written between politicians as repositors of a public mandate and an agency. In other words, it should not be an agency’s mission to decide what its mandate is. To create an agency for a given area without a clear set of goals

just to get rid of a thorny political issue is a recipe for problems.

The second recommendation is a need for consistency in the creation of an agency. If a financial market regulator is being created, it is not truly relevant what the governing arrangements for a similar agency in the United Kingdom are, but how would any arrangements fit within a particular legal system as well as informal rules in the country where it is being created. Internal consistency means that the actual rules governing an agency's activities and incentives are mutually consistent in supporting efficient, effective and accountable functioning of an organisation.

Institutional solutions not only need to be internally consistent, they also need to be robust. Robustness, roughly speaking, means that a system will continue to work relatively successfully even if much goes wrong in the systems underpinning it, e.g. under budgetary duress or if important elements of the outside system change (civil service rules, public procurement rules, etc.). This is due to the extremely dynamic environment of transition.

For reasons explained above, it is also recommended that each reform pushing for the creation of autonomous agencies or for an increase in autonomy of existing agencies should be required to answer a simple question about accountability: How is it going to create real accountability in a transition environment where the cost of reputation is low, formal mechanisms often slow and the wrongdoing usually not of provably criminal nature? If it cannot convincingly be answered, agencification might not be an answer.

One should also generally prefer market-based solutions if meaningful markets can be created. However, this recommendation needs to be balanced with transaction costs of a market- and contract-based relationship. Particularly in transition countries, one needs to ask whether effective contract enforcement as an important element in consideration of transaction costs exists? This ties in with the overall issue of institutional capacity. In countries with underdeveloped legal regimes, systems based on command-and-control principles require a less sophisticated set of institutions and management tools and can be therefore sometimes preferable. A related issue is whether formal accountability mechanisms cannot be complemented by a very powerful informal accountability mechanism – customer choice. If at least a significant part of customers has a choice in selecting their service provider, this can alleviate some of the accountability problems.

However, accountability is the ex post mechanism to guarantee efficiency, effectiveness and quality. The ex ante mechanism is the process of management/board selection. Anecdotal evidence suggests that the quality of the process for making that choice has significant consequences for the functioning of a public organisation, possibly even more significant than in more stabilised environments. Finally, a reader convinced by our explanation of why agencification has been taking place in many transition countries will agree that it is often driven not by a need to grant some elements of the public sector a clear mission and autonomy to achieve it, but by piece-meal sectoral efforts to increase professionalism in parts of the public sector. Agencification measures are then a selective attempt at public sector reform, including reform of financial and governance aspects. If professionalism is the issue though, one might ask if transition countries would not be better served in using that energy for an overall reform of the institutional framework for the public sector and particularly on civil service reform.

Decentralisation

The third pillar of change in public administration since 1989 has been decentralisation. By decentralisation, we do not mean a shift of power and responsibility to local administration appointed and controlled by the centre (called deconcentration), but shifting power and responsibility to locally and regionally elected politicians. Extensive decentralisation has taken place in all Central European countries though generally in several stages.

The first stage took place immediately after political changes of 1989 and meant introduction of locally elected municipal governments with responsibility for essential municipal services in all four Visegrad countries.

The second stage was a gradual or rapid transfer of other responsibilities to municipalities during the following years.

The third stage was a creation of regional governments which has usually come as the last one (though not in Hungary, for example).

Since the Czech Republic, Hungary and Slovakia are relatively small countries, two layers of self-government were sufficient. In Poland, more similar to Ukraine in size, an intermediate layer of self-government has been added.

After 15 years of decentralisation, elected self-governments are now responsible for an astonishingly wide range of services and the control of central government over their spending and policy decisions is smaller than in many other OECD countries. Local and regional governments not only deal with water, sewage, waste, local roads or transport, they also frequently deliver primary and secondary education, health care or economic development.

For example, in Slovakia, more than 2900 municipal self-governments have been established in 1990 with very limited powers. These powers were extended significantly during the 2002–2004 period, when responsibility for local hospitals, social services, planning, roads and culture as well as primary education was shifted downwards. Eight self-governed regions were only established on January 1, 2002, with responsibility for regional roads and transport as well as large hospitals and secondary education.

This was followed, in 2005, by the so-called fiscal decentralisation through which local and regional governments were assigned more than 90% of the personal income tax and received complete autonomy concerning the so-called local and regional taxes, primarily the real estate tax at the local level and vehicle tax at the regional level.

Probably the most important result has been the ability of local and regional government to absorb successfully these new responsibilities. Particularly in cases where new administrative units – whether municipalities or regions – were based on genuine community and long-standing local identity,

the decentralisation has been a success, giving more local choice and responsibility to the electorate and bringing higher efficiency to service delivery. At the same time, since local and regional governments tend to face more effective hard budget constraint than central government, they have been better at making hard choices such as closing schools when demographic choice requires it.

Creation of multiple mutually independent layers of government has created more complexity, but also more choice for the electorate. Where before the voter had just one vote on all the public issues, his/her ability to select different parties and individuals in municipal, regional and national elections has made it possible to exert more control though also often more confusion. At the same time, voters do not necessarily judge their elected representatives on the conduct of their formal powers, but on what they believe is important. For example, responsibility for economic development has not been assigned to the municipalities, but has remained with the central government and the regions. Nonetheless, since it is the overall economic development rather than the state of schools or sewage which worries people, particularly in the economically backward regions, mayors have poured extensive amounts of energy into building industrial parks and wooing investors, knowing that this might make or break them during the election.

Decentralisation has also shown that in some areas, both politicians and the electorate can only learn by trial and error. One of the most contentious elements of any decentralization is what public goods are national public goods and which ones are regional or local. This issue is not decided in one-time quasi-rational policy discussions, but is a living political issue based on specific cases and scandals. This has rarely led to complete reversals of decentralisation by returning specific responsibilities to central government, but increases in central government control over a certain issue after initial decentralisation have been much more frequent.

A key remaining problem, particularly in the Czech Republic and Slovakia, is the challenge of efficient and rooted community. In these two countries, as in France, many small municipalities of few hundred or thousand inhabitants have their identity going back for centuries and as such present a nearly ideal case of deeply rooted and accountable local community. They are unfortunately too small for delivery of many public services though. Their amalgamation into larger units, even if necessary, can lead to dilution of the original rationale for decentralisation – that it allows people to exercise choice in a historical and local community where they feel at home.

On the negative side, with decentralisation of finance and service delivery, corruption has also been decentralised. In smaller communities, traditional modes of social control has often proven to be sufficient to counter this, but in medium-sized and large entitites, decentralization has lessened tendency to corruption, but there is no highly developed and sophisticated local civil society which often exists on the national level. Building local and, in some cases national, civil society therefore remains a major challenge in all four Visegrad countries.

Policy capacity of subnational governments has also been slow in developing and, again particularly with smaller municipalities, there is a genuine challenge of human resource available for governance.

On the whole, decentralisation has quickly embedded itself into political and social fabric of the Central European countries because it has generally interacted with a pre-existing identity and has been least successful where it has not.

Conclusion

The paper dealt with the place of public administration reform in the wider scope of changes that have taken place in transition countries, particularly in countries of Central Europe. It pointed out that in Central Europe, and probably in Ukraine, public administration suitable for a functioning market democracy is a necessary prerequisite for many other systems and, consequently, public administration reform is the key enabler for other reforms. Even though it is more important that in developed OECD countries, it faces, at the same time, a significantly more challenging environment.

The paper looked at the heritage of communism and the paradigms of public sector functioning that it has left for the transition and the wider context of public sector change within transition, explaining that it is the twin movements towards non-majoritarian governance and market that are the organizing principle of the last 15 years. It then analysed the three major pillars of public administration change during transition: civil service reform, agencification and decentralization.

Rather than describing technical aspects of various reforms, the paper focused on summarising lessons from the three pillars of public administration reforms that can be useful for Ukrainian policy-makers. Therefore, it would be unhelpful to do a summary of these summaries in the conclusion. Instead, let us offer some key thoughts on each of the three pillars by the way of conclusion.

The most striking experience of 15 years of civil service reform in Central Europe is the simultaneous importance of all three if its pillars – changing incentives, changing people and investing into people. One or two without the third bring much less than an expected sum of their benefits. It is impossible to change all of the civil service as the society does not contain a sufficient number of high quality people to replace them. However, without changing a large number of civil servants, other changes will not happen. Whatever mix of “new” and “old” civil servants one possesses, if they do not possess the right incentives and the right training, the outcomes will be suboptimal.

When one thinks of agencification, it is astonishing that in so many countries so many policy-makers so many times thought that the key to change and success is to make institution into a more or less autonomous agency when, in fact, agencification rarely brings the expected benefits, not because it is a wrong strategy, but because too many hopes tend to be invested into what is, after all, an institutional repackaging. On the other hand, agencification can make quite a lot of sense as a part of a wider public

administration reform package as we have seen not in Central Europe, but in the UK with the creation of Next Steps agencies in 1988.

When one deals with decentralisation, the key question always is: will the locally elected politicians prove to be less or more accountable than the centrally elected ones and who is better at protecting citizens from the arbitrary use of power? Will local elites prove to be an instrument of protection or of extortion? In Central Europe, the answer generally seems to be that there is a strong case for decentralisation precisely because there is a genuine local identity, but at the same time, there should be no expectation that problems that grip national politics will somehow disappear by decentralisation. Rather it can be expected that most of them will be decentralised together with power, but with much wider dispersion of outcomes reflecting highly variable quality of local democracy.

Ukraine is not a country at the beginning of transition; it has just taken a different, more tortuous route along the way that all postcommunist countries need to take if they want to arrive in the "promised land" of being part of the First World. It is the assumption underlying this paper that Ukrainian policy-makers can find lessons from routes by other countries, such as Slovakia, useful when they chart the future course. ■

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