Party System Institutionalization and Second-Generation Economic Reform in the New EU Member-States: The Advantages of Underdevelopment?

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ABSTRACT:

This paper investigates the conditions under which state reformers in the EU's newest member states can undertake radical free-market reforms. Does party system institutionalization, which is widely regarded as enhancing government stability, yield a political environment more conducive to reform? Or, as this paper will suggest, are there advantages to under-institutionalization? By making it difficult to create a coherent and credible opposition against reform, party system under-institutionalization may actually insulate state reformers from social and political pressures, allowing them to undertake painful reforms hard to envision in a more consolidated democracy. We address this question by comparing recent economic reform attempts in four Central and Eastern European countries: Slovakia, Estonia, Hungary, and the Czech Republic. Each country has participated to varying degrees in a second generation of radical reforms designed to take advantage of the new economic opportunities offered by an expanded European Union, particularly deregulatory and tax-related reforms.

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> "As a liberal economist, I view Slovak economic reforms positively and I prefer them to our [Czech] 'quasi-reforms.' However, the fact that the whole reform process in Slovakia went very smoothly would suggest to me that it progressed without any public support. It is extremely unlikely that such reforms could be undertaken in Germany, France, Italy or the Czech Republic in such a pace without tough debates in society."
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> --Václav Klaus, current Czech President and former finance minister as well as prime minister of the Czech Republic[1]

In 2004, the World Bank named Slovakia the global economic reformer of the year -- a remarkable turnaround for a country that just a few years earlier had generally been considered the reform laggard, to put it mildly, of East Central Europe. By the late 1990s, the country had seemed primed for economic meltdown, not accolades from the World Bank.[2] In 1999, for example, Citibank had stood within days of pulling out of the country entirely, citing its weakening currency, high interest rates, and depleted foreign reserves (Barrionuevo 2005). Slovakia's economic turnaround was based on a radical set of business-oriented reforms, including sharp reductions in taxes, the institution of a flat tax on both businesses and individuals, steep cuts in social programs, a policy of weakening labor regulations over the objections of organized labor, and generous incentives to foreign investors (IMF on Slovakia 2004; EIU on Slovakia 2004; World Bank EU-8 2004). None of this was popular with the Slovak public. As the finance minister and vice prime minister, Ivan Mikloš put it, "This government is among the most

[1] Quoted in Stupnan (2004), Zsilleová (2004).

[2] In particular, the World Bank praised the Slovak government's policies of "introducing flexible working hours, easing the hiring of first-time workers, opening a private credit registry, cutting the time to start a business in half and, thanks to a new collateral law, reducing the time to recover debt by three quarters" (*Doing Business in 2005*: 1).

unpopular, if not the most unpopular government in the short Slovakian history." The public opinion polls back him up, showing that some 70 percent disapprove of the government (Quoted in Barrionuevo 2004; see also Živnerová 2003). In terms of attracting foreign investment, the reforms have been a great success ("Dancing" 2004), even if they have yet to visibly improve the lot of the average Slovak worker (Bohle and Greskovits 2004).

Slovakia's recent economic policies both exemplify a new generation of reform in post-Communist Eastern Europe and throw into sharp relief a paradox of economic policy making in the latest stage of the transition. They also raise the question at the center of this paper: what political conditions favor the adoption of radically pro-business policies in new democracies, such as the EU's newest member states, that have already consolidated the basic elements of a market economy?

The first point here is that Slovakia's economic policies typify what we refer to here as "second-generation reforms."[3] The first-generation reforms of the post-Communist transition concerned the establishment of the basic conditions for a market economy: dismantling central planning and price controls, stabilizing inflation, establishing currency convertibility, opening up the economy to international trade, privatization, and the establishment of a market-based legal framework.[4] During the

[3] Though they do not use the term "second-generation reform," Bohle and Greskovits (2004) present a nice characterization of the concept. For other discussions of the new generation of economic reforms in post-Communist Europe, see also Tokar (2004), Zsilleová (2004), "Dancing" (2004), Jaroš (2004), "Gross" (2004), and "European Economic Competitiveness and EU Enlargement," Presentation by Ivan Mikloš (Deputy Prime Minister and Minister of Finance of Slovakia) at the Minda de Gunzburg Center for European Studies, Harvard University, April 22, 2004.

[4] For a description of this category of market-building reforms see Balcerowicz (1989), Kornai (1990), Przeworski (1991), Sachs (1993).

early to mid-1990s, they were initiated and implemented (in at least some form) across the post-Communist region.[5]

If the first-generation reforms were about building a market economy, the second generation are about attracting foreign investment once that market economy is in place -- especially, in the case of the countries of Central and Eastern Europe, potential investment flows opened up by their accession to the European Union. As Bohle and Greskovits (2004) argue, these reforms constitute a package of deregulatory policies that strengthen the position of business while undercutting that of organized labor -- a very different sort of arrangement than the post-War social welfare state of Western Europe. In many respects, the second-generation reforms of the post-Communist transition go beyond the deregulatory policies -- and even ambitions -- of EU's advanced industrial democracies.[6]

If the first-generation reforms were essentially domestically driven and independent of events in neighboring countries, the second-generation reforms occur within the framework of accession to the European Union and, in a kind of competitive deregulation, are heavily influenced by the developments in neighboring countries. As a result of Slovakia's deregulation, the neighboring Czech Republic, Hungary, and even

[5] For a survey of when and with what rigor the first-generation reforms were implemented, see the World Bank (1996).

[6] The exception here is Ireland, whose own business-friendly reforms -- and the rapid growth trajectory they initiated -- are the model that these post-Communist reforms seek to emulate ("Dancing" 2004). It seems, however, that Ireland's business-friendly development policies may be difficult to emulate. As a result of its investment incentives, flat tax, and welfare cuts, Slovakia has been accused of "social dumping" by some of its older EU counterparts (notably, France and Germany). The French Finance Minister even suggested restricting access to the EU's Structural Funds to countries such as Slovakia, which undercut the baseline European social regulations; see "Slovensko sa bráni" (2004) and Moylan (2004).

Austria have felt considerable pressure to lower their taxes as well.[7] Because they push for even greater economic deregulation than exists in the advanced industrial economies, second-generation reforms are, if anything, even more unpopular with the general public than the first-generation reforms were; at least in the first generation, the alternative -- the command economy -- was perceived as the clearly worse alternative. Slovakia's reforms were enacted even at the price of social riots in the eastern part of that country.[8] As a result, although all governments in the region are discussing second-generation reforms, there has been considerable variation in their capacity to enact them.[9]

The second point raised by the second-generation reforms is that the pattern of their enactment runs counter to the expectations that derive from much of the influential literature on economic transition in new democracies, particularly post-Communist ones.[10] As we will describe below, an influential strand of that literature argued that, because of its initial social costs, economic reform is most effectively undertaken by powerful executives insulated from popular pressures (Przeworski 1991). A rival argument countered that isolated executives were more likely to block reform and

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[7] Shortly after the 2004 EU enlargement, the Austrian National Council the country's corporate income tax from 34% to 25% (effective January 1, 2005). Highlighting the competition for investment flows, the Council said of the change, "The reduction of the corporate tax rate from 34 to 25% is to create vital impetus for the relocation and foundation of new businesses" (Federal Chancellary of Austria 2004).

[8] In January 2004, the Slovak government's cuts to the social welfare system took effect. These cuts were in part necessary to fund the new flat tax, but they were also advertised as a way of moving families off welfare. As reported in the *New York Times*, "the basic welfare payment for an individual fell by half to about $200 a month from its previous level around the minimum wage. A family with eight children…[saw] its payment drop from about $500 a month to about $300" (Fisher 2004). When the government began distributing the reduced benefits in February, riots and looting broke out in eastern Slovakia, particularly in areas inhabited by Slovakia's Roma minority. In order to quell the unrest, the government sent over 2,000 police and army into the afflicted areas, Slovakia's largest such deployment since the 1989 revolution; see Ian Fisher (2004).

[9] Poland, which is not examined in detail here, is also debating the adoption of business-oriented, second generation reforms; see Ratajczyk (2004).

[10] To be fair, this literature dealt with first-generation reforms.

suggested greater popular participation in politics favored reform (Hellman 1998). Yet a third important argument suggested that what really mattered was not these institutional differences but the degree of political polarization among the governing classes (Frye 2002). Polarization undermines government commitment to a given reform and hence its effectiveness.

Our argument is that the second-generation reforms, which are generally contemplated but only selectively enacted in Eastern Europe, do not fit with the predictions of any of these models. Contrary to Hellman, second-generation reforms are more likely in weakly consolidated democracies in which incomplete institutionalization attenuates the public's voice in policy-making. Contrary to Przeworski, states whose institutions do not insulate and concentrate executive power are equally if not more likely to enact second-generation reforms. Finally, counter to Frye's prediction, the second-generation reformers include countries with high measures of party polarization -- nowhere more so than in Slovakia following Mečiar -- and that polarization has not undermined the reforms' effectiveness.

What stands out about the second-generation reformers is the following. They have been parliamentary democracies with weak executives. They have had chaotic and unconsolidated party systems, whose under-institutionalization has weakened vertical accountability between government leaders and voters (O'Donnell 1999: 29-30). Finally and least surprisingly, they have been supported by conservative-led governments. Our argument is that these features -- in particular, party-system under-institutionalization -- actually facilitate second-generation economic reform. By making it difficult to create a coherent and credible opposition against reform, party system under-institutionalization

may actually insulate state reformers from social and political pressures, allowing them to undertake painful reforms hard to envision in a better consolidated, better institutionalized democracy.

In order to assess the plausibility of this hypothesis, we compare recent economic reform attempts in four Central and Eastern European countries: Slovakia, Estonia, Hungary, and the Czech Republic. Each country has participated to varying degrees in a second generation of radical reforms designed to take advantage of the new economic opportunities offered by an expanded European Union, particularly deregulatory and tax-related reforms. Slovakia and Estonia have instituted corporate and personal flat tax systems that now give them some of the lowest tax rates in Europe.[11] Hungary and the Czech Republic stand in contrast to Slovakia and Estonia, both economically and politically. Leaders in the first generation of reform, they have more recently been unable to follow the lead of reform upstarts like Slovakia. Hungarian state reformers failed to bring similar tax reform proposals to life -- even under conservative governments. Though Slovakia's reforms have received a great deal of attention from Czech political elites, the prime minister of the Czech Republic's current Social Democratic government has said that it is not his intention to copy Slovakia's radical reforms, even if they are "inspiring" ("Gross" 2004).

II. The Politics of Second-Generation Reforms

The argument outlined above differs significantly from extant conceptualizations of what political constellations most favor liberal market reforms in new democracies. A

[11] As we will describe below, Estonia's second-generation reforms began even earlier, as early as 1994.

quick and selective review of the literature that has developed around the market transition in post-Communist Eastern Europe reveals three dominant strands.

Adam Przeworski's (1991) "J-curve" was the starting point for much of this theorizing. The J-curve highlighted the tensions between economic reform and political stability, arguing that since economic reforms produce positive results only in the medium- to long-term -- after a period of greater economic pain in the interim -- governments who enact such reforms can expect strong social opposition (including defeat at the polls) as a reward for their efforts (1991:161).[12] From this logic flowed the key political precepts of the J-curve argument: (1) that governments undertake economic reforms early, while their popularity is still high enough to withstand the short-term setbacks caused by such radical transformations and (2) that government reformers insulate themselves from the inevitable anti-reform coalitions through institutions that enhance executive autonomy. In this framework, economic reformers are set against society: as Przeworski writes, to advance reforms in democratic countries "governments must either seek possible support from unions, opposition parties, and other encompassing and centralized organizations, or they must work to weaken these organizations and try to make their opposition ineffective" (1991: 182).

As powerful as the logic of the J-curve appears *a priori*, it has invited two major challenges. First, Joel Hellman (1998) challenged this argument's assumption that the most politically consequential opposition to economic reform would come from that greater part of public who lose from reform in the short term. Paradoxically, it is the short-term winners who pose the greatest threat to sustained economic reform since these

[12] As Przeworski writes, "under such conditions, democracy in the political realm works against economic reforms" (1991:161).

are the few, usually politically connected who benefit from a partially reformed -- that is, quasi-privatized, selectively deregulated -- economy. Although aware of the high costs to society at large, these short-term winners are capable of blocking completion of the reform process, preserving for themselves the benefits of the partial-reform trap.

After Hellman's analytical shift, the political institutions recommended by Przeworski appear in a more sinister light. Przeworski's ideal, a strong executive who is politically insulated from electoral pressures is precisely the situation to be avoided: by capturing this executive, a few short-term winners can hijack economic policy making and block further reforms. Przeworski's ambivalence to wide political participation proves misguided: to move from the partial stage of reforms to the next, more advanced stage, net winners have to be restrained, and judging by the reform record of the post-Communist states, the best solution to this challenge is to expand political participation by including the losers in the policy-making process (1998: 228). As Hellman writes, "postcommunist systems with a higher level of political participation and competition have been able to adopt and maintain more comprehensive economic reforms than states largely insulated from mass politics and electoral pressures" (1998: 234).

A third, more recent argument about post-Communist economic reform shifts the debate away from institutions (should they emphasize executive dominance or political participation?) and looks instead at the degree of polarization among domestic political actors (Frye 2002). Frye argues that economic performance, not reform enactment is the more important criterion for transition success, and economic performance, in his view, depends on the political struggle between ex-communist and anticommunist factions engaged in a war of attrition over economic resources. In sharply polarized political

systems, the "electoral calendar" hinders economic reform: as elections approach, the odds of a change in economic policy increase and growth rates plummet. Reform enactment is not the problem; reform *over*-enactment -- that is, policy reversal -- is the problem.

The debate among these three models played out with reference to the market-building phase of the post-Communist economic transition; whatever their relative explanatory power for that period, they are all poorly adapted to explaining second-generation economic reforms. Once Hellman's "partial-reform trap" has been overcome, expanding political participation in economic policy-making to the greatest extent possible may no longer be the best strategy in an environment of governments chasing foreign capital through competitive deregulation.

Does this mean a second wind for Przeworski's argument? We think not for two reasons. First, the executive-centered political systems recommended by Przeworski are those that, for the reasons suggested by Hellman, have had the most difficulty consolidating their first-generation reforms (Russia, Ukraine, Romania, more?) and thus are ill-positioned to court international investors now. Second, although the governments that have gone furthest with second-generation reforms have been able to do so in the absence of a credible opposition, their ability to do so has not been the result of strong executive institutions. Instead, the requisite absence of effective opposition was the result of low levels of party system institutionalization, which frustrated the translation of what was often very real social resistance into a credible political opposition.

Finally, we think Frye's analysis offers little guidance for this stage of transition because the dichotomy between ex-Communists and anti-Communists is less important

as time goes on. Moreover, we feel that operationalizing political polarization in terms of anti-Communists and ex-Communists provides a misleading picture for a number of important cases, notably that of Slovakia. Slovakia's second-generation reforms were possible only after the toppling of the Mečiar government in 1998, an alternation of government between political camps so diametrically opposed that it was described as Slovakia's second revolution (Bútora et al. 1999).

What do we mean by second generation economic reforms? As noted above, second-generation reforms are a package of policies designed to position Central and Eastern European countries advantageously for the anticipated influx of the new economic opportunities made possible by an expanded European Union, particularly deregulatory and tax-related reforms. The policies in this reform package share the following core features:[13]

1. Radical, across-the-board tax cuts for business and a preference for flat-tax systems,
2. Generous investment incentives to foreign investors, including long tax holidays, land grants, and the loosening of labor regulation to the benefit of employers.
3. Undercutting of the position of organized labor in the process of deregulation,
4. Deregulation and tax cuts funded at least in part through a reduction of the state's commitment to the social welfare system,[14]

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[13] See also Jakoby and Morvay (2004: 341).

[14] This has the effect, of course, of focusing the costs on the poorest in society -- witness the riots in eastern Slovakia described above (footnote 8).

It hardly needs to be pointed out that these are the kind of policies that, whatever their appeal to economists, are bound to be unpopular with large portions of the wider voting public.[15] Their advocates hope, of course, that such reforms are the bitter pill that leads to better outcomes for everyone in the longer run; but to point this out is to ignore the political problem that democratically elected governments need to worry about the short-term consequences of their policies.[16] In what kind of political system would the government pursue policies that seem destined to raise fierce social opposition in the immediate term? Our short answer to this question is in a political system that frustrates the translation of social opposition into credible political opposition.

Second-generation reforms are most likely under the following two political conditions. First, and more trivially, it is necessary to have a conservative-oriented government. Even though the competition for foreign investment increases the pressure on all governments to deregulate regardless of their political stripe, a policy package consisting of flat taxes and reduced social spending enforced over the opposition of organized labor is more than most social democratic governments would contemplate. Second, in the absence of a benevolent despot who can force such austere policies over all political opposition,[17] the chances for sustaining such a policy package are greatly

[15] All of these policies have, in the short term at least, benefiting business at the expense of labor and the poorer in society. Flat taxes reduce the state's ability to redistribute income. On the difficulty of retrenching the welfare state, see Pierson (1994).

[16] Pavel Kohout (2004), for example, argues that Slovaks are voting for the reform according to their long-term economic interests. We disagree: the constantly changing panoply of parties in the Slovak party system makes it difficult for voters to select parties based on long term interests. It also insulates committed conservative reformers, when they emerge, from effective opposition to their policies.

[17] Russia is, in fact, an example of this scenario -- a domineering executive insulated from the political opposition; see Myers (2004) and Neilan (2004). Under Putin, Russia is the only other country the post-Communist region to have adopted a flat tax.

increased in an under-institutionalized party system. Under-institutionalization is the enabling factor because it prevents social opposition from finding effective political voice. By making it difficult to create a coherent and credible opposition against reform, party system under-institutionalization can insulate state reformers from social and political pressures, allowing them to undertake painful reforms hard to envision in a more consolidated democracy.

Party system institutionalization matters because it is the most important mechanism of vertical accountability, the ability of electorates to discipline governments through the threat to "vote the rascals out."[18] As Mainwaring writes, "A weakly institutionalized system is characterized by considerable instability in patterns of party competition, weak party roots in society, comparatively low legitimacy of parties, and weak party organizations" (1999: 3). In institutionalized party systems, elections present voters the choice among a manageable number of stable parties with familiar coalition-building preferences.[19] Under-institutionalization means that, rather than choosing among a manageable number of familiar and relatively stable parties, voters are faced with too many party choices, many of them new, unfamiliar, and with uncertain prospects. Government coalitions may be fragile and programmatically heterogeneous, but often the opposition is even less organized. Lacking clear constituencies, the opposition parties are less resistant to cooptation by the government. The fragmented

[18] This is especially true in new democracies, where political parties are less constrained by institutions of horizontal accountability (O'Donnell 1999).

[19] See Mainwaring (1999: 3-4); Mair (1997); Toole (2000: 458); Shabad and Slomczynski (2004 & 2002); and Kreuzer and Pettai (2003).

nature of the opposition means that the opposition vote is divided among many parties who may not cooperate with each other.

All of this creates considerable maneuvering room for a determined reform team. If they can control the key ministries, if they come prepared with comprehensive legislative agenda, they can, to paraphrase Slovakia's finance minister and deputy prime minister Ivan Mikloš, get approval for reforms which the parliamentary parties do not fully understand.[20] By the time they do understand, it is too late to go back. As the quote by Václav Klaus with which this paper began suggests, this kind of maneuvering would not be possible in an institutionalized party system. The government parties would be too worried about their future prospects to allow their ministry appointees to propose such radical policies; failing that, the opposition would be sufficiently organized to deter the government with the threat of a no-confidence vote; and very certainly, the overwhelming popular resistance to the program would find some reflection in the reform's reception by political parties within and outside of the government.

A variety of measures of party-system institutionalization have been proposed:[21] for simplicity, here we use electoral volatility, which captures both the stability (or lack thereof) of parties' constituencies and their internal organization. We measure volatility

[20] The architect of Slovakia's second-generation reforms Ivan Mikloš stated that the IMF told Slovakia's economic team that their plan was too radical, that they should implement it gradually over a period of at least three years. According to Mikloš, the Slovak team told the IMF, "No way; we'll do it now while we have the opportunity." (Mikloš presentation; see footnote 3.)

[21] Shabad and Slomczynski (2004) have measured institutionalization in terms of inter-party switching. Kreuzer and Pettai (2004) measure institutionalization in terms of the electoral success of non-established parties: start-ups, splinters, and mergers.

by calculating the net change in the vote shares of all parties across elections (Mainwaring 1999: 28).[22]

III. Country Case-Studies

Having laid out and situated the argument, the remainder of the paper will test its plausibility by looking closely at four countries in Central and Eastern Europe, two of them with a history of poorly institutionalized party competition and two of them that stand out as among the most institutionalized in the post-Communist region. Which elements of the second-generation reform package has each country adopted and how radical has been its implementation of those elements? Before moving to the country case-studies, we will briefly present three aggregate comparisons in table form.

First, Table 1 depicts the variation in electoral volatility, a straightforward and compact measure of party-system institutionalization. As Table 1 shows, both Hungary and the Czech Republic have below-average and declining volatility scores. Estonia's scores are consistently higher than the Czech Republic and Hungary's; however, they are declining over time. Last, Slovakia's volatility scores remain stubbornly high and show no signs of declining over time.

[22] Because frequent splits and mergers represent lack of institutionalization, we count splits and mergers as fully new parties. This maximizes volatility, but does so consistently while avoiding difficult judgment calls about party continuity.

Table 1: Electoral Volatility (1990-2004)

	Czech Republic	Hungary	Estonia	Slovakia
1st Election	68.9%	21.1%	70.7%	55.7%
2nd Election	29.8%	31.5%	45.5%	33.3%
3rd Election	16.9%	19.3%	32.4%	48.5%
4th Election	22.4%	-	-	40.9%

NOTES:
* Only those political parties were counted that gained at least one parliamentary seat in at least one election.
** Hungary has a mixed electoral system. In order to be consistent with the remaining three cases, only the results of the party list elections were used to calculate the volatility index in Hungary.
*** Table covers all of the elections from 1990 to 2004. These were 1990, 1992, 1996, 1998, and 2002 for the Czech Republic; 1990, 1994, 1998, and 2002 for Hungary; 1992, 1995, 1999, and 2003 for Estonia; 1990, 1992, 1994, 1998, and 2002 for Slovakia.
SOURCE: University of Essex, *Political Transformation and the Electoral Process in Post-Communist Europe* (http://www.essex.ac.uk/elections/, accessed on January 23, 2005)

Second, as mentioned above, the under-institutionalized Slovak and Estonian party systems have permitted and sustained governments the most radical second-generation reforms. The far more institutionalized Hungarian and Czech party systems have either prevented altogether or seriously attenuated their governments' ability to follow Slovakia and Estonia's lead. Table 2 compares the variation in the magnitude of reform, looking only at the size and nature of tax cuts. Slovakia and Estonia have succeeded in enacting much more radical cuts in tax than the Czech Republic or Hungary. They have also replaced progressive tax systems with flat tax ones, whereas the Czechs and Hungarian have not.

Table 2: Top income tax and corporate tax rates in the Czech Republic, Slovakia, Hungary, and Estonia

	Income Tax In…		Corporate Tax In…	
Country	2004	2005	2004	2005
Czech Republic	32	32	31	28
Estonia	**26**	**26**	**0**	**0**
Hungary	40	38	18	16
Slovakia	38	**19**	25	**19**

Notes: The bolded text in the table indicates that this is a flat tax.
Sources: "Flat tax: Economic Panacea or Pandora?" *Enlargement,* January 23, 2005 (http://www.euractiv.com/Article?tcmuri=tcm:29-134426-16&type=News, accessed February 26, 2005) and the Heritage Foundation

Finally, Table 3 provides a summary of the adoption and implementation of second-generation reforms across countries. The following case-studies delve more deeply into the specifics of each country.

Table 3: Comparison of Second-Generation Reforms By Country

Country	***Tax Cuts***	***Flat Tax***	***Investment Incentives***	***Reductions in State's Welfare Commitments***	***Reduction in Power of Organized Labor***	***Overall Performance of Country in Reform Process***
Estonia	Radical	Yes	Extensive	Yes	Somewhat	Radical
Slovakia	Radical	Yes	Extensive	Yes	Extensive	Radical
Hungary	Moderate	No	Neutral	No	Not much	Weak
Czech Republic	Moderate	No	Neutral	No	Not much	Weak

Slovakia

Why is it that a country that for many years had been criticized for its economic and democratic performance is suddenly viewed as a model for others to follow? How could the Slovak government undertake radical second-generation reforms seemingly

with no reaction from a public who, in the short term at least, are negatively impacted by them?

The ability of the country's reformers to pass and implement such radical policies is best explained by a fluid, weakly-institutionalized party system. As the Economist Intelligence Unit notes, "Slovakia's political party system remains weakly consolidated, particularly in comparison with neighboring countries such as the Czech Republic and Hungary" (EIU on Slovakia 2004: 21). Other observers have noted that the country's party system lacks parties linked to clearly defined socio-economic constituencies, making it easier for the Dzurinda government to pass and implement these reforms (Stupnan 2004). The government did not even attempt to engage in a sufficient discussion with the public, saying simply that the public would eventually reap the benefits of its reforms.

Why is the Slovak party system still significantly under-institutionalized compared with neighbors such as Hungary and the Czech Republic? There are several reasons,[23] but perhaps the most significant one is the legacy of former Prime Minister Vladimír Mečiar. It was the last Mečiar government of 1994-1998 that shortly before the 1998 election "forced the country's democratic parties to unite in resistance, notwithstanding their considerable ideological differences" (EIU on Slovakia 2004: 21).[24] Six years after that election, there are still two parties in the governing coalition that are in fact a result of his forceful unification: the current Prime Minister Mikuláš Dzurinda's

[23] See Krause (2000) and O'Dwyer (2003).

[24] Shortly before the 1998 elections, in a bid to disqualify a number of the opposition parties, Mečiar's government changed the electoral law to require *all* parties, even those in electoral alliances, to win 5 percent of the vote for representation; see Bútora et al. (1998).

Slovak Democratic and Christian Union (SDKÚ) and the Party of Hungarian Minority (SMK).

Between 1998 and 2002, the Slovak party system underwent its newest round of party reorganization. Old parties such as the post-Communist SDL' and the Movement for Civic Understanding (SOP) disappeared, while new ones such as the populist Smer of Robert Fico and the pro-business ANO quickly vaulted to popularity.[25] Despite the lack of party consolidation, the most recent elections of 2002 resulted in the formation of a center-right governing coalition, which has spearheaded the Slovakia's second-generation reforms. Reflecting the ongoing lack of party institutionalization, since 2002 the two main parties of the current government coalition of ANO and SDKÚ, have experienced numerous defections by their parliamentary deputies, leading to the loss of their majority in the parliament.

Though weakened by these defections, the post-2002 government has still been able to pursue its reform agenda thanks to the breakaway MPs from both coalition and opposition parties who have continued to support the government in key legislative votes (EIU on Slovakia 2004: 13). Because the major opposition parties, Mečiar's HZDS and Fico's SMER, are internally divided and their leaders hostile to each other, their resistance to the reforms has amounted to little more than rhetoric.[26]

In the first two years of its tenure, the government has enacted major reforms of the tax system (sharply reducing tax rates and instituting a flat tax for both individuals

[25] Some of the parties which first emerged in 1998 underwent significant reorganization between then and 2002: the governing SDK, for example, was reorganized into SDKÚ.

[26] Indeed, as a further indication of the unpredictable nature of party behavior in uninstitutionalized party systems, currently there is open discussion in Slovakia of a pending coalition agreement between Dzurinda's governing SDKÚ and Mečiar's HZDS, whose overthrow by Dzurinda in 1998 was called Slovakia's second revolution; see Nicholson (2005).

and businesses), and it has liberalized the Labor Code (EIU on Slovakia 2004: 22).[27] It has aggressively courted foreign direct investment with 10-year tax holidays and government subsidies for employee re-training and job creation (Gajdzica 2003).[28] In terms of welfare policy, it has initiated fundamental restructuring of the pension, health care, and social welfare systems. The pension reform introduced a second, fully-funded, privatized pillar (World Bank EU-8 2004). As noted above,[29] the welfare reforms essentially halved benefits and required recipients to engage in some form of work. Finally, the Dzurinda government's second-generation reforms were implemented over the heads of -- indeed, in the face of criticism from the country's unions. Ending an officially recognized tripartite bargaining system in place since 1989, the government dismissed the unions as a partner in the reforms ("Vlada" 2004; "Tripartita" 2004). This surely contributed to the successful implementation of reforms, but as Przeworski notes, such a strategy raises the question of democracy (1991: 182).

As a result of the policies of the post-2002 government, Slovakia now has one of the least demanding regulatory and tax environment, combined with a minimal social policy. Low taxes and low welfare payments by employers are among the reasons why many businesses relocate from Western Europe to Slovakia ("Slovensko" 2004).

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[27] Other pro-business policies of Dzurinda's government included cutting the time required to start a business by a half, introducing flexible working hours, and reducing the time it takes to recover debt by three-quarters (Barrionuevo 2004).

[28] Some commentators have criticized the government's selective assistance to strategic investors (i.e. PSA Peugeout Citroen or Hyunday/Kia); see Jakoby and Morvay (2004). They note with interest that the government has refused to publish the terms of its contract with PSA [and Hyundai-Kia], despite the fact it is investing public money.

[29] See footnote 8.

Estonia

Like Slovakia, Estonia's most radical second-generation reforms coincided with a period of considerable party-system flux and exceedingly fragile coalitional politics. In Estonia, this period came earlier than in Slovakia -- so early in fact that it seems difficult, temporally speaking, to separate Estonia's first- and second-generation reforms.[30] As early as 1994, the conservative Estonian government of Mart Laar was enacting a flat tax and privatizing its pension system. As a result, Estonia has been perhaps the most important model for second-generation reforms for the rest of the region.[31] Mart Laar's conservative government of 1992-1994 found itself in a similar political environment as Mr. Dzurinda's conservative government in Slovakia after 2002;[32] it inhabited a chaotic party system, which insulated it from political opposition, allowing it considerable freedom to enact economic measures that would have been blocked had left-of-center parties been better organized. Since the enactment of these initial reforms, however, a period of left-of-center government and some greater degree of party system stability have delayed enactment of further reforms by Estonia's conservatives.

Despite more recent signs of institutionalization, Estonia looked for most of the 1990s like its under-institutionalized Baltic neighbors. As Kreuzer and Pettai write, by standard measures of institutionalization such as electoral volatility and fragmentation "the three Baltic party systems appear so atomized and in flux that they barely resemble

[30] Substantively, the difference between reforms designed at building a market and those aimed at attracting investment remains clear.

[31] Thanks to those reforms, international observers have described Estonia's economic transition as "remarkable" and its record in implementing sound policies that have supported strong growth and a stable price level as "enviable" (IMF on Estonia 2004: 1).

[32] Mart Laar headed two of Estonia's post-Communist governments: October 1992 to November 1994 and March 1999 to January 2002.

anything like established democracies" (2003: 83).[33] No Estonian government since independence has seen out its full term, largely because they have all been multiparty coalitions whose differences, mostly of personality, eventually fractured them. For the radical reformers around Mart Laar, this environment insulated them from political opposition. As then Prime Minister Mart Laar said in a recent interview, it was not necessary for his team to explain their economic reforms to the public; Laar's comments highlighted the limited ties between political parties and the electorate as well as the elite-driven politics of Estonia at the time (Jaroš 2004). As in Slovakia, the enactment of second-generation reforms undermined the government's popularity eventually, and in 1995 it was replaced by a left-leaning coalition. Surprisingly, the 1995 coalition did not reverse Laar's reforms, even though prior to forming a government, the very same parties had campaigned on such a promise.

What exactly did the Laar government's second generation reforms consist of? As noted above, it was the first government in the former communist bloc to introduce a flat tax. The personal income tax is 26 percent for all; the corporate tax on reinvested profits is 0 percent; and the social tax (which finances health and pensions) is set at 33 percent ("Flat Tax" 2005; EIU on Estonia 2004: 33).[34] It was also the first government to launch other important structural reforms such as the introduction of a second pillar in the

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[33] Kreuzer and Pettai in fact argue that volatility and fragmentation are measures ill-suited to post-Communist democracies, and by alternative measures that they propose, they argue that Estonia began to show signs of party consolidation in 1999 (2003: 94). Since Estonia's most radical second-generation reforms occurred in the still chaotic party system of the early- to mid-1990s, this is consonant with our argument. (We would also point out, however, that even the traditional measure of volatility shows signs of decreasing by the third round of parliamentary elections, which occurred in 2003. As we describe below, since that period, it has been more difficult to legislate pro-business reforms.

[34] "Value-added tax (VAT) is levied at a flat rate of 18 percent except for a 5 percent rate on heating fuels, medicines, books and periodicals, cultural performances, funerals, accommodation services and certain chemicals" (EIU on Estonia 2004: 33).

pension system aimed at moving from a pay-as-you-go system to a fully-funded defined-contribution system, and the establishment of a new unemployment insurance scheme (IMF on Estonia 2004: 1). The country introduced various measures that were specifically aimed at foreign investment, including giving foreign companies the right to buy land as well as lease it. As a result, Estonia has benefited from a favorable foreign investment climate, which "has enabled the country to modernize its industrial sector faster than most of its neighbors, take advantage of global growth areas such as electronics, and reorient its trade away from the former communist bloc towards the richer and more stable Scandinavian markets" (EIU on Estonia 2004: 31).

Estonia's core second-generation reforms were enacted under the first Laar government. Not surprisingly, the following left-of-center governments did not deepen these reforms, though they also did not undo them. Since 2003, the conservatives have regained control of government and have announced their intention to enact a new wave of foreign investment-oriented legislation, including further lowering the income tax.[35] It is too early to guess the fate of these proposals, but it appears that the greater institutionalization of the Estonian party system in comparison with 1994 has weakened the conservative government's hand.[36] The government's commitment to lowering income tax rates by 2 percent is received negatively by the poorer voters, who strongly

[35] As a result of the 2003 election, Estonia's government consists of Res Publica, a right-of-center party formed only in late 2001, the neo-liberal Reform Party, and the rurally oriented Estonian People's Union.

[36] Relations between the second Laar government and organized labor were not easy. The 2002 European Commission Report on Estonia criticized Laar's 1999-2002 government for lack of effort in developments in social dialogue: "In the area of social dialogue, the relationship between the Government and the social partners was still marked by difficulties in implementing effective tripartite social dialogue within the various newly established structures. During the reference period, this lack of confidence was illustrated by controversies over the modification of the labour legislation and over the decision-making process used to set the national minimum wage for 2002" (European Commission 2002: 76).

support the opposition Center Party, which has pledged to replace the flat tax with a progressive tax system. Whether or not the Center Party will be able to deliver on its opposition rhetoric remains to be seen. If the party-system institutionalization hypothesis is true, it would seem that the odds are against it: the time of pushing through radical economic policy shifts is drawing to an end as both sides of the party spectrum, conservative and social-democratic, establish more stable constituencies, better defined programs, and predictable patterns of coalition formation.

Hungary

Hungary excelled in the first generation of post-Communist market-building reforms but, despite the efforts of its conservative-led government from 1998 to 2002, has only very selectively and partially implemented the second-generation reform agenda.

Like the Czech Republic, Hungary has experienced a high level of political stability.[37] The four democratic parliamentary elections since 1990 have resulted in formations of stable governments. The center-right and center-left governments have alternated in power throughout that period and so far, each Hungarian government has been able to serve out its four-year term. Party politics have also been relatively stable; all four parties represented in the current parliament have been present in the legislature since the early 1990s. Also like its northwestern neighbor, two parties, the center-left Hungarian Socialist Party (MSZP) and the center-right Fidesz - Hungarian Civic Union, have anchored the party system. The Socialists led the government in the 1994-1998

[37] See Toole (2000).

period and has been the senior coalition partner since 2002. The conservative Fidesz led two coalitions in 1990-1994 and 1998 to 2002. In contrast to Slovakia and Estonia at the time of their second-generation reforms, then, the Hungarian party system was characterized by relatively stable, programmatically defined, and socially-rooted parties that behaved in predictable ways in forming coalitions. This greatly enhanced vertical accountability in the Hungarian political system.

The Hungarian economy smoothly accomplished the first generation of market-building reforms in the early to mid-1990s. These reforms included liberalizing foreign trade, freeing prices, reducing subsidies, and privatization.[38] In 1995, the Socialist-led government introduced an austerity program, the so-called Bokros Package, which was designed to decrease the government deficit and external account imbalances (EIU on Hungary 2004: 6). Although the Bokros Package resulted in economic recovery, that recovery came only after the 1998 elections, in which impatient voters punished MSZP for the negative effects of the austerity measures.

The center-right coalition that came to power in 1998 promised a number of pro-business reforms, including lower taxes, but given the strength of the opposition these amounted to at best modest changes.[39] Responding to advice of international monetary organizations and, more recently, competitive pressure from Slovakia, both Fidesz and

[38] Hungary has been one of the Central European region's most open economies and it continues to benefit from large influx of the foreign direct investment. Hungary has "consistently been ranked among the leading transition economies in EU, OECD and other multilateral progress reports" (EIU on Hungary 2004: 29). Its successes were based on the long-lasting effects of significant structural reforms and privatization during the 1990s (IMF on Hungary 2004).

[39] The conservative government of Fidesz was actually criticized for spending too generously on social benefits. It loosened fiscal policy significantly during the last two years in office, which lead to large deficit in 2002. Shortly before the 2002 election, the government increased payments of pensioners and public-sector workers and raised the minimum wage by 75 percent (EIU on Hungary, 2004; IMF on Hungary, 2004).

the MSZP have promised pro-business tax cuts. Neither have been particularly successful. Fidesz did manage to make cosmetic changes in this area during its period in government, and the Socialists also made modest reductions in 2004 in rates of income tax, from 20, 30, and 40 percent to 18, 26, and 38 percent, respectively, but overall, personal and employers' taxes remain high (EIU on Hungary 2004). Only after Hungary missed out on some high-profile foreign investments in the region was the government forced to cut the corporate tax from 18 to 16 percent, but efforts to reform the local business tax and the employers' payroll tax have been postponed (EIU on Hungary 2004). The future of any further tax reduction is very uncertain given the poor showing of the governing MSZP in the recent elections to the European Parliament. Contrary their electoral program and the advice of international observers, the Socialists are now contemplating a more left-wing stance on tax, with some influential MSZP officials in recently calling for an assertive policy "to narrow income inequalities and improve condition of Hungary's poorest people" (EIU on Hungary 2004: 33). They propose increases in social spending funded through a higher personal income tax.

Unlike Slovakia, Hungary has preserved a strong voice for organized labor in negotiations over economic policy regardless of the government's political stripe. In fact, the European Commission has praised Hungarian government for its progress in the area of social dialogue and for its firm intention to improve the involvement of social partners in the decision-making process (European Commission 2002: 30).

In a final departure from the second-generation reform script, the conservative Fidesz government of 1998-2002 did not contemplate reducing the state's commitment to the welfare system, nor has the current socialist government. Although the healthcare

system, for example, is in need of major reform, the current government has postponed even pilot reform projects and has continued to shy away from a comprehensive reform of the system (EIU on Hungary 2004). Consistently, there are government "overruns in spending on health, housing subsidies, and interest payments" (IMF on Hungary 2004: 1). Experts from the IMF have been concerned with the government's policies and have recommended scaling back housing subsidies, greater public sector wage restraint, "rationalizing government employment, continuing pension reform, improving the targeting and structure of social benefits and subsidies, and reforms in education and health care" (IMF on Hungary 2004: 3). Although the government acknowledges the importance of these reforms, it appears to be unable to do so (World Bank EU-8 2004).

Regardless of how these issues are resolved, it is clear that no Hungarian government has been able in recent years to commit to second-generation reforms, for both of the major parties seem to believe that these reforms would hurt both the middle and the lower classes. For the while, the Socialist government has the luxury of waiting: based on the success of its first-generation reforms, it is still the region's leading recipient of foreign direct investment per capita (EIU on Hungary 2004). However, the meteoric rise in Slovakia's FDI flows is certainly a threat for the future.[40]

The Czech Republic

Like Hungary, the Czech Republic's party system stabilized early, with the rapid establishment of two anchoring parties on the right and the left, the conservative Civic Democratic Party (ODS) and the Social Democratic Party (ČSSD). Also like Hungary, it

[40] The most recent figures suggest that foreign direct investment in Hungary has slowed considerably as investors look to other countries such as Slovakia; see Condon (2005) and Schweizer (2005).

has been reluctant to embrace second generation reforms. If we consider the post-1998 period, this reluctance seems over-determined since this was period of Social Democratic government in an institutionalized party system. What is interesting, however, is that even the Czech Social Democrats have felt compelled to make some deregulatory changes under the pressure of their neighbors -- which only underlines the importance of second-generation reforms.

The trend of steadily declining and below-average electoral volatility illustrated in Table 1 is one indication of the institutionalization of competition in the Czech party system.[41] Its government alternates regularly and is composed of a manageable number of stable, programmatically distinct, and socially rooted parties. Since 2002, the parliament contains only four political parties. With a fragile majority in the lower house of the Czech legislative body (101 seats in the 200-member parliament), the current Social Democratic government faces a strong opposition that can threaten to block reforms that can have a negative effect on the population. As a result of this institutionalization, social discontent is rapidly and efficiently translated into political voice and opposition. Even the Social Democratic governments' partial economic reforms have upset its core voters and led to retractions and reactions by the government. For example, when the ČSSD's voters punished the governing coalition in the 2004 European Parliament elections for what were seen as overly liberal reform steps, ČSSD Prime Minister Špidla was forced to resign. His deputy Prime Minister, Stanislav Gross, soon replaced him as Prime Minister.

[41] See also Toole (2000); Krause (2000); and Shabad and Slomczynski (2002 and 2004).

Like Hungary, the Czech Republic established itself as one of region's magnets for foreign investors in the early 1990s, and like Hungary, it has felt compelled to adopt some elements of the second-generation reform agenda in order to stave off the emerging competitive threat from Slovakia for future foreign investment.[42] Its adoption of the second-generation reform agenda has been selective and partial.

First, the Social Democratic government has reduced taxes. It cut the corporate income-tax rate from 31 to 28 percent, effective January 1, 2004 in an effort to maintain regional competitiveness. It also reduced the upper rate of the value-added tax from 22 to 19 percent in 2004 (EIU on the Czech Republic 2004). The government supported additional exemptions for investment in high unemployment areas, such as ten-year tax holidays for newly established firms (five years for already existing companies), low-cost land, and infrastructure support (EIU on the Czech Republic 2004). Even as it adopted these tax cuts, the Czech government was careful to distinguish them from Slovakia's tax reforms: Prime Minister Stanislav Gross declared that his government did not want to copy Slovakia's flat tax ("Gross" 2004). Indeed, as Table 2 shows, the Czech tax reforms have been considerably smaller than the Slovak ones, and more importantly, they have not attempted to change the progressive nature of the tax system.

Second, the Czech government has not been able deregulate without consulting organized labor. The doctors' strike in June 2003 and the civil servants' strike in April 2004 are examples of the voice exercised by organized labor in the process of economic reform (Shafir 2004). In its latest report on the Czech Republic's progress towards accession, the European Commission stated that the Czech Republic meets the

[42] The Czech Republic is the leading recipient of foreign direct investment on a per capita basis among the post-communist countries (IMF on the Czech Republic, 2004).

commitments and requirements in the areas of labor law and social dialogue and noted that "effective tripartite social dialogue is well established" (European Commission 2003: 33-35).

Far from attempting any reforms of the welfare system, the government has sustained commitments here that have drawn warnings from international monetary organizations such as the IMF or the World Bank, who have advised it to reform the country's pension system, continue with social expenditure reforms, reduce high labor taxes, and strengthen fiscal policy implementation.[43] As the international observers suggest, these changes are necessary because Czech growth is lower when compared with other new EU members, and its long-term unemployment and fiscal deficits continue to rise. The latter is largely a reflection of government's high spending on subsidies.

Since the ČSSD campaigned in 2002 on a promise to expand the scope of the welfare state (EIU on the Czech Republic 2004), it is not surprising that it would be reluctant to accelerate the pace of fiscal consolidation. Both the Špidla and the Gross governments have been either reluctant or unable to take radical steps to reform the pension system -- the largest single component of welfare spending. The two ČSSD governments' since 1998 have tightened requirements for unemployment compensation and reduced sickness benefits; however, Klaus and other conservative political elites have, with some justification, characterized these steps as "quasi-reforms."

[43] In its annual report, the IMF, for example, warned the Czech authorities of the negative impact that its aging population might have on public finances within 10-15 years and suggested "ambitious expenditure reforms to ensure long-term fiscal sustainability [and urged] to expedite the reforms of the pension and health systems given the lags between the introduction of these reforms and their impact on public spending" (IMF on the Czech Republic 2004: 3).

IV. Conclusion

We have argued that a new kind of economic reform is emerging in the post-Communist countries now joining the European Union and that extant models of this region's economic transition offer little explanatory power for it. We have argued, further, that the pioneers of the new reforms are the laggards of the first generation of market-building reforms in Central and Eastern Europe. Counter-intuitively, the ability of the former reform laggards to succeed where the former leaders hang back is a result of persistent features of their underdevelopment politically. In particular, the under-institutionalization of their party systems insulates committed reformers (should they be present) from political opposition, allowing them to undertake radical reforms hard to imagine in a consolidated democracy. By weakening vertical accountability, under-institutionalized systems prevent the translation of what may be very real, very consequential social opposition to the government into effective political opposition.

Our comparison of Slovakia, Estonia, the Czech Republic, and Hungary offers support for this hypothesis, though more research is necessary to establish it more definitively. In addition to expanding the sample to include more countries, we feel that ministry-level comparisons within the one country would be helpful. Since, in our model, so much of the work of second-generation reforms is accomplished by committed technocrats freed by dysfunctional party competition from political pressure, it would be very fruitful to compare the actions of two different ministries within the same country, one committed to reform and the other not.

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