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How to Overhaul the Labor Market:
Political Economy of Recent Czech and Slovak Reforms

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Abstract

The Czech and Slovak Republics – until 1993 two parts of former Czechoslovakia – offer a unique reform comparison. Even though Slovakia faced higher unemployment since early transition and it was subject to greater reform failures, the two countries experienced similar macroeconomic paths over the first decade of transition. However, since the currency crises of 1997(8), their depth of reforms has been very different, with Slovakia making major strides to improve the labor market. We suggest two explanations, one based on fiscal pressures, the other stemming from political developments. The Slovak reforms of 1998 to 2002 benefited from a window of opportunity created by pre-1998 policy failures. A small team of advisors working under an influential Cabinet member drafted and implemented many successful reforms in spite of resistance mounted by political opponents. After the 2002 electoral victory of pro-reform parties, the labor market administration has implemented a sweeping reform agenda, which benefits from the weakness of its opponents, notably the trade unions. In contrast, the post-1998 Czech governments are closely tied to trade unions and oppose radical reforms in the labor market despite rising fiscal pressures and unemployment.

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1. INTRODUCTION

The two countries of former Czechoslovakia offer analysts a refreshingly unique vantage point from which to compare and contrast reforms. Understanding the sources of economic policy reforms, measuring their effects, and predicting their impact in different settings is typically difficult for many conceptual reasons. Observed reforms and their effects often reflect previous policy choices, economic developments, and political environment. Distinguishing the effect of reforms from those of initial conditions is therefore hard. To aid in this task, it is useful to observe two similar economies with comparable starting positions, facing similar external shocks, of which only one chooses to pursue reforms. The Czech and Slovak Republics provide such a simplified benchmark: their peaceful Velvet Divorce of 1993 produced two entities sharing very similar institutional setup, level of development, and external environment, and somewhat comparable starting positions. Yet, their reform paths from central planning to market economy have differed substantially since 1993. This allows one to shed light on the factors affecting the type of implemented reforms and to ask about the effect of reforms in a difference-in-differences design. In this paper we apply the Czech-Slovak comparison to study recent labor market reforms of 1998-2003.

There are three major phases of Czech and Slovak post-communist economic development, which can lead to three sets of questions. First, between 1990 to 1992, the Czechoslovak Federation embarked on a rapid price and trade liberalization and initiated privatization of small firms. It is interesting to ask why the same initial reforms led to some different outcomes (unemployment, in particular) in the two parts of the Federation. A leading explanation that we adopt in this paper is that the initial shock and misallocation of resources inherited from communism were much greater in Slovakia which, with its heavy machinery and arms production, relied more on exports to the former Communist Bloc (see, e.g., Fidrmuc et al., 2002, or Svejnar, 1999).

Second, after the Federation split in 1993, the two countries pursued different macro and micro policy agenda, including different large-firm privatization programs. While the Czech privatization was carried out using the voucher method and involved the general public, the Slovak government sold enterprises in management buy-out deals and direct sales that lacked transparency. The difference in the reform and policy mix was driven by the different size of the initial transition shock: the Slovak government intended to prevent further rises in unemployment. As we point out later, these different privatization policies delivered similarly disappointing results. By 1998, both economies accumulated unsustainable internal and external imbalances that led to currency devaluations, credit crunch, government austerity packages, lower growth and higher unemployment.

Third, from 1998, the two economies again share many similar features. Both implemented macro stabilization policies followed by major bank restructuring. The eventual economic recovery in both countries was driven by large FDI inflows. The two countries, however, responded very differently to the policy challenges of rising unemployment and the need for large-scale fiscal and pension reforms. While Slovakia initiated policy changes already in 1998-2002, accelerating the speed, depth and breadth of reforms since the 2002 parliamentary elections, the Czech Republic started its first timid reforms only in 2003. This comparison applies to all three main reform agendas: (i) stimulating job creation by lowering the high tax burden and creating a favorable environment through adjustments in the Labor Code; (ii) improving labor supply and curtailing rising fiscal deficits by making the social protection system more pro-work oriented; and (iii) tackling the aging of the population by implementing pension reforms.

In sum, the key policy agenda of the first and second stage of transition was liberalization, privatization and restructuring. During the third stage (after 1998), however, the policy focus shifted towards addressing fiscal pressures and implementing investment climate reforms. While labor markets provided an efficient reallocation mechanism during the early transition years, they became the battlefield of key growth-supporting reforms in late transition.

In this paper we address labor market reforms affecting the investment climate during the third transition phase with a particular focus on their political economy. We therefore stress reform areas (i) and (ii). First, lower taxation and a flexible Labor Code directly improve the investment climate. Second, pro-work reforms of the social support schemes increase labor supply and lower labor costs at the low end of the labor market, where one would expect a high cost-elasticity of demand. As we argue below, policy area (ii) is also crucial for all three reform areas from the political economy perspective. Finally, we note that both reform areas (ii) and (iii) lead to sound government finances, which lowers the likelihood of future tax increases, reinforces the positive effect of tax cuts on investment conditions, and supports future sustainable growth.

To build an understanding of the reform impetus, we first survey the early transition evolution of pro-market reforms and political developments in both countries (Section 2). Next, we offer a brief description of the two labor markets (Section 3). In Section 4, we cover the most recent reforms, discuss their sources, and the difficulties in their implementation. Here we also comment on their first observable impact. (Measuring reform effects is mainly the agenda of future research as the majority of the Slovak and Czech reforms have been implemented only recently.) Finally, the concluding section discusses the political economy of the reform process. We ask two key questions:

(a) Why have recent reforms been much faster and far-reaching in Slovakia?
(b) What, if any, are the obstacles to implementing a wide set of reforms at once?

In answering both questions, we differentiate between the two post-1998 Slovak governments (both headed by Prime Minister Mikuláš Dzurinda, leader of a center-right party), because they demonstrate a different type of political economy interplay. While reforms faced political opposition and personnel capacity constraints in the wide left-right Slovak coalition of 1998 to 2002, the second Dzurinda Cabinet is a coalition composed of four pro-reform parties.

We highlight two factors behind the faster Slovak labor market reforms. First, the unsustainable and reckless pre-1998 policies pursued by the governments of the authoritarian Prime Minister Vladimír Mečiar left Slovakia's post-1998 government in a much more vulnerable fiscal position compared to the Czech case. Containing the fiscal deficit required a reform of the social support scheme, which also bolstered pro-work motivation of the labor force. The extremely low Slovak employment rate provided a strong stimulus for labor market reforms. Second, a number of “soft” factors helped the post-1998 Slovak government implement bold reforms, including the general sense of political and economic failure following the last Mečiar government (1994-1998). In 1998, Slovakia was not only facing an economic and financial crisis, but was also excluded from the integration processes that the Czech Republic, along with Hungary and Poland, benefited from. Slovakia was not admitted in the first round of accession to the NATO and OECD, and was excluded from the first group of ten countries negotiating accession to the EU. A related feature of the Slovak political scene is the relative under-development of the trade unions and other interest groups under the Mečiar governments, which in turn benefited the speed of reforms after 1998.

In contrast, the 1998 Czech economy enjoyed lower indebtedness and was not “punished” by rising costs of short-term debt; its labor market was more dynamic and featured lower unemployment. The Czech Republic fully participated in the integration processes. There was, therefore, lower fiscal, political, and unemployment-level pressure to reform the labor market. Furthermore, the Czech political scene continues to be dominated by a party, the Social Democrats, which constantly faces the dilemma of having to carry out unpopular reforms against its own convictions and political agenda.

While there were strong forces supporting the reform process in Slovakia, there were also significant obstacles to reform. We stress the importance of the quality of staff at key ministries for designing and implementing quality reforms. Human capacity constraints appear to be one of the defining issues in Slovakia. They are driven, in part, by the brain drain to the richer Czech Republic and by a lack of capacity-building international assistance to post-1998 Slovak government officials. (During the mid-1990s, due to the undemocratic policies under the Mečiar governments, most foreign assistance was directed to the non-governmental sector). We offer examples of successful reforms conceived outside of the central bureaucratic structures as well as a case of state capture by interest groups facilitated by the lack of qualified personnel. In contrast, while the Czech public administration appears to be better equipped to develop and implement reforms, it faces a lack of political will and directive. The lesson we offer is that under macroeconomic pressure and in the absence of strong trade unions, a few determined policy makers with the help of a small group of advisors and with targeted donor support can manage to completely overhaul all aspects of the labor market in a short time span.

2. REFORM BACKGROUND AND IMPETUS

The labor market reforms which are the focus of this paper cannot be separated from the broader set of reforms pursued by the Czech and Slovak governments. The impetus for reforms, including those of the labor market, is closely linked to the initial reform strategy pursued by both countries. Indeed, as we argue below, it was the policy failures of early transition that made radical reforms possible. In this section, we therefore review the economic and political developments in the Czech and Slovak Republics since the breakdown of the Communist regime in 1989. We organize this section using the three major phases of transition outlined in the introductory section. The two early stages are crucial for understanding the political economy of recent labor reforms in both countries. The first stage of transition was harder for Slovakia, which helps to explain why Slovak policies in the second stage were unsustainable. This in turn helps to explain why in the third reform stage (post-1998), Slovakia managed to implement sweeping reforms. The description of the third stage of transition also provides background for the difficulties of labor reform implementation, which we bring out in Section 4. Finally, this section also shows that while early transition policies focused on liberalization and firm restructuring, labor markets became a key policy area only after 1998.

2.1 Transition Paths until 1998

Early Reforms within the Federation

Until 1989, former Czechoslovakia retained a strict centrally planned system within an authoritarian political regime; it enjoyed a low level of debt, sound government finances, and macroeconomic stability (Fidrmuc et al., 2002). The initial Czechoslovak pro-market reforms featured rapid price liberalization, decentralization of wage setting, privatization of small firms, and opening the country to world trade. This occurred on the background of pre-emptive stabilization policies of initial devaluation, fixed exchange rate, and stringent monetary regime. The reforms were successful in that the country maintained a relatively balanced budget and contained inflation. Furthermore, in the Czech lands, the unemployment rate stabilized around 4 percent. In contrast, in Slovakia, unemployment reached 12 percent almost instantly and remained high thereafter.

Why was initial unemployment so different in the two economies? The demand shock from the fall of central planning was felt more in Slovakia due to its industrial structure (higher share of steel, heavy machinery and arms production). There were many one-factory towns in Slovakia and their downsizing led to a drop in local demand for services. (The structural nature of Slovakian unemployment is confirmed by its persistence in the mid 1990s despite the significant economic growth.) In contrast, early Czech transition featured vigorous job creation in the *de novo* small firm sector and a rise of self-employment, which helped absorb the labor force shedding from large firms (Jurajda and Terell, 2003).

In 1993, the per capita income of Slovakia (Czech Republic) was over 7 (10) thousand US$ after PPP adjustment. Even though Slovakia was a net recipient of transfers within the Federation, it suffered more from the rapid initial reforms. This negative impact of early transition reforms in Slovakia helped fuel demands for political independence, which contributed to the eventual disintegration of the Federation in 1993. It is important to note that while the Czech general public offered its politicians full support for reforms, Slovakia was *a priori* more hesitant in supporting pro-market reforms and was even more so after the sharp rise in unemployment. The Slovak political leader, Vladimír Mečiar, criticized rapid early reforms and offered a vision of a socially oriented market economy, which in the Slovak context meant a strong role for the state in economic matters.

Unsustainable Policies after the 1993 Breakup

After gaining independence, Slovakia slowed down economic reforms and fuelled growth through the expansion of public expenditures, including extensive public infrastructure investment starting in 1996 (INEKO, 2000). Furthermore, Slovakia's politics under Mečiar governments - coalitions of populist and nationalist political parties - were characterized by the incestuous relationship between the political and economic power, attempts to control the media, privatization deals benefiting the cronies of the government, contracts designed to strip enterprises of assets and funds, and other forms of economic corruption. This evolution is illustrated in Table 1, showing Slovakia lagging in the economic and especially in the political dimension of reforms. Murky privatization deals excluding foreigners, the postponement of the much needed industrial restructuring, and the exclusion of key sectors (banking, insurance and public utilities, the so called "strategic enterprises") from privatization were in part meant to support employment. Indeed, the lag in restructuring and maintenance of over-employment led to further unemployment increases once the unsustainable policies collapsed after 1998.

Table 1 Economic and Political Liberalization

	1989	1993	1997	2000
Economic Liberalization				
Czech Republic	0	0.52	0.6	0.63
Slovakia	0	0.49	0.56	0.59
Political Liberalization and				
Czech Republic	0.17	0.92	0.92	0.92
Slovakia	0.17	0.58	0.67	0.92

The Economic liberalization index is re-scaled so that it ranges between 0 (a centrally planned economy) and 1 (a liberal market economy). The index is the average of eight sub-indices of progress in reforms reported by the European Bank for Reconstruction and Development in its Transition Reports. The Democracy index is re-scaled so that it ranges between 0 (no democracy) and 1 (complete democracy). It is the average of the two indices (political freedoms and civil liberties respectively) constructed by the Freedom House (see www.FreedomHouse.org).

Interestingly, a similar development, albeit less pronounced, occurred in the Czech Republic under Vaclav Klaus' center-right governments on the backdrop of pro-market rhetoric and a market based privatization program. Large-scale privatization applied to most state-owned assets in the economy (except the banking sector) and over half of the face values of these companies were distributed through the voucher (coupon) privatization scheme of 1993-1995. The privatization program transferred property rights from the state to a wide group of dispersed owners. Its failure point was the lack of rules and institutions that would protect the property rights, defend the interests of minority shareholders, and regulate the functioning of the many investment funds that sprang up. The Czech Republic's early transition thus became infamous for its weak legal structure, asset stripping (Cull et al., 2001), incestuous ownership relations, and poor investment protection.

Why were the results of the Czech and Slovak privatizations similarly disappointing? In both economies large-firm privatization followed a tacit doctrine of economic nationalism as most property was transferred to local owners. These owners borrowed from state-owned banks to pay for state-owned enterprises. They lacked the managerial know-how and further capital to restructure, expand and operate firms that faced fierce international competition due to a high degree of openness of both economies. Asset stripping was the result of the easy access to bank credit in early transition coupled with a weak legal and institutional framework. Large banks remained under government control in both countries in order to "fuel" the transition with credit while bankruptcy and foreclosure laws remained weak, creating strong incentives for lax financial discipline. As a result, even though both economies were growing, banks were accumulating non-performing loans at a distressing rate. While both Hungary and Poland lowered their share of nonperforming loans on all loans from about 28 percent in 1994 to less than 10 percent in 1998, the relevant Czech (Slovak) share stood at 33 percent (44percent) in 1998 (World Bank, 2001a). In sum, privatization of both types was not accompanied by effective legal and institutional reforms and state-owned banks failed to impose payment discipline on newly privatized enterprises. In both countries the privatization deals led to an upsurge of crony capitalism and a widespread stripping of assets, infamously known as “tunneling”.

The Crisis of 1997(8) and its Political Upshot

In the Czech Republic, the soft budgetary constraints and weak corporate governance of enterprises allowed wages to grow two times faster than productivity, which led to a high demand for imports of consumer durables and an increase in foreign trade and current account deficits. These were financed by an inflow of short-term foreign capital attracted by high interest rates locked in by the fixed exchange rate regime. In Slovakia, the annual fiscal deficits including local governments and other public funds mushroomed to about 5 percent of GDP in 1997 and 1998. The high local demand was also satisfied through an increase in imports, leading to unsustainable levels of current account deficits on the order of one tenth of aggregate product in 1996 to 1998 and soaring debt. There was no short-term financial capital available to finance Slovakia’s current account deficit. The weak investment protection and the exclusion of the banking and “strategic” sectors from privatization made for low FDI inflows in both countries.

By 1997 in the Czech Republic and by 1997/1998 in Slovakia, the implicit liabilities of soft loans to large old firms became explicit. Combined with the growing fiscal deficits, they led to the destabilization of both economies. (The liabilities of the banking sector exacerbated external imbalances, which highlights the need for a coordinated firm restructuring and sound macroeconomic policies.) Shortly after the Czech current account deficit ballooned to over 7 percent of GDP in 1996, a speculative attack on the Czech currency in May 1997 forced the surrender of the Czech fixed exchange rate regime. A similar currency crisis hit Slovakia in 1998 when Mečiar’s last year in office left Slovakia with a gross foreign debt of about 60 percent of GDP, of which approximately 40 percent were short-term liabilities. As a result, the Slovak currency was also allowed to float. Furthermore, the Slovak sovereign interest rate spread tripled during 1998 (Oliveira Martins and Price, OECD, 2000).

Table 2: Macroeconomic, Fiscal, and Labor Market Indicators

	1996	1997	1998	1999	2000	2001	2002
Read GDP growth rate							
Czech Republic	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0
Slovak Republic	5.6	4.0	1.3	2.2	3.3	4.0	4.4
Private consumption real growth rate							
Czech Republic	7.9	2.4	-1.8	1.9	2.3	3.8	3.9
Slovak Republic	8	5.4	5.8	-0.2	-3.4	4	4.9
Fixed investments real growth rate							
Czech Republic	8.2	-2.9	0.7	-1	5.3	5.5	0.6
Slovak Republic	32	12	11.1	-18.8	-0.7	11.6	4.1
Current account / GDP							
Czech Republic	-7.1	-6.7	-2.2	-2.7	-5.3	-5.7	-6.4
Slovak Republic	-10.2	-9.3	-9.7	-4.9	-3.5	-8.6	-8.2
General Government Balance / GDP, excluding extraordinary items							
Czech Republic	-1.9	-2	-1.5	-3	-4.8		
Slovak Republic	-1.4	-4.3	-4.7	-4.5	-6	-6.6	-8
ILO Unemployment							
Czech Republic	3.9	4.8	6.5	8.7	8.8	8.1	7.3
Slovak Republic	10.9	11.8	12.5	17.1	18.7	19.2	18.5
Registered Unemployment							
Czech Republic	3.1	4.3	6	8.5	9	8.5	9.2
Slovak Republic	12.6	12.9	13.7	17.3	18.2	18.2	17.8
Employment growth rate							
Czech Republic	0.6	-2	-1.4	-2.4	-0.2	0.3	-0.4
Slovak Republic	-1.4	-2.3	-1	-1.8	-1.4	1	0.2
Real wage growth							
Czech Republic	8.7	1.3	-1.3	6.2	2.4	3.8	5.3
Slovak Republic	7.1	6.6	1.6	-3	-4.9	0.1	5.8

Sources: World Bank (2002, 2001), OECD (2002, 2003), Czech and Slovak Statistical Offices, National Banks and Ministries of Labor

The Czech National Bank used high interest rates to stabilize the currency and also strengthened provisioning requirements, leading to a credit crunch. Meanwhile, the government was forced to implement a strict austerity program. This naturally sent the economy into recession. Meanwhile Poland and Hungary enjoyed strong growth. In a perfect parallel, Slovakia's government was also forced to implement a strict austerity package in 1999 while interest rates were high, similarly resulting in a credit crunch. (The central bank pursued a tight monetary policy to balance the inflationary effects of the previous fiscal expansion.) In both countries, registered unemployment increased by over 4 percentage points between 1997 and 1999 while wage growth slowed down (Table 2).

The timing of the economic crisis corresponds to a government change in both countries. In the Czech Republic, the economic downturn shattered the illusion of successful reforms and contributed to the fall of the long-serving center-right coalition government of Václav Klaus. Following his political party's finance scandals, a part of the party broke off and established a new liberal party. The political pendulum then shifted to the electoral victory of left-wing Social Democrats who emphasized a socially oriented market economy and welfare state. In contrast, in Slovakia, the 1998 elections ushered in a more pro-reform government. The depth of the 1997-1998 crisis provided Slovakia with a window of opportunity for reforms led by the anti-Meciar left-right coalition of Mikuláš Dzurinda, which took over among a general sense of economic and political failure in the country.

2.2 Policy Divergence after 1998

The active policy response to the economic slowdown consisted of two main steps in both countries: The new governments (i) recapitalized, restructured and sold major banks to foreign strategic partners; and (ii) helped attract massive foreign direct investments by introducing investment incentive packages (first in the Czech lands, later in Slovakia). FDI was also spurred by the looming EU accession. In Slovakia, FDI inflow rose from 2.5 percent of GDP in 1998 to 10 and 6 percent in 2000 and 2001, respectively, while the relevant Czech figure rose from 2.4 in 1997 to over 13 percent in 2002. (FDI also safely financed current account deficits.) As a result, both countries were able to generate substantial GDP growth, but FDI did not help to lower unemployment in either country. During 1998 to 2002, Slovakia significantly improved investment climate regulation and strengthened the legal and institutional foundations of business with, e.g., improved bank and financial market supervision, strengthened corporate governance standards through the company law part of the commercial code, bankruptcy law, and new secured transactions (collateral) legislation in line with international best practices (Mathernova, 2002). Slovakia also caught up with the Czech Republic on the political front: it joined the OECD in 2000, was offered NATO entry in 2002, and joined the first wave of countries negotiating EU accession so that both parts of former Czechoslovakia will join the EU in May of 2004.

Fiscal Pressures as a Driving Force of Reforms

Following the crises of 1997 and 1998, fiscal reform became a key policy issue in both economies. As we highlighted above, Slovakia faced large fiscal deficits, double digits current account deficits and increased sovereign interest rate spreads. Below, we argue that public deficits became the defining policy issue also in the Czech Republic, thanks in part to its extensive social security system. We argue that fiscal pressures materialized in a number of labor-market policies that we describe in detail in Section 4. In this section we provide an overview of the general policy agenda of both countries. While the initial stabilization policies and the active policy response to crises was similar in the Czech and Slovak Republics, the two countries started to diverge in three key policy areas: (i) tax and labor law reform, (ii) social protection reform, and (iii) pension reform.

At the end of the first transition decade, the tax burden (especially on labor) was very high in both countries. For example, the tax revenue of the Czech government as a fraction of GDP was comparable to that of Germany. Despite high tax revenue, both countries faced the need to reform public expenditures. In particular, the social safety nets were extensive and very expensive. The concurrent economic recovery made it clear that public finance deficits were not merely cyclical. Yet, most categories of expenditures (including social welfare, housing, and transport subsidies) were locked in upward trajectories. For example, between 1994 and 1999, the Czech social security and welfare expenditures rose by 3.2 percent of GDP. These deficits occurred while the demographic situation had not yet deteriorated. Starting approximately in 2010, both countries will face a dramatic aging of the population. The Czech population is aging particularly fast in comparison to other Visegrad countries, including Slovakia. The deficit of the current pay-as-you-go Czech pension scheme is projected to reach 3 percent of GDP by 2020.

The post-1998 Slovak government was a wide left-to-right coalition of political parties. While the government's agenda began to reflect the three major economic policy challenges noted above, the policies implemented during 1998-2002 reflected a mixture of the particular political preferences and power within the coalition. After the initial austerity package was introduced, the government also started a program aimed at improving business conditions in the country, including a 2000 cut in the corporate income tax from 40 to 29 percent. Between 1998 and 2000, total tax revenues as a percent of GDP shrank from 36.5 to 33.7 percent, but this drop in government receipts was not accompanied by meaningful reductions of budgetary expenditures, which increased in part due to the costs of bank restructuring. Early on, the government was able to implement at least some restrictions of public expenditures (for example, a 50 percent reduction of social support for about half of those declaring income below the minimum subsistence level; see OECD, 2002). However, fiscal discipline loosened towards the end of the government term (with, for example a policy of higher wage tariffs for public-sector workers) and the left-oriented Cabinet members pushed through a Labor Code significantly reducing labor flexibility, which we discuss in detail in Section 4.1.

In the Czech Republic, on the other hand, there was no move towards containing the rise in budget deficits, even though they represented the main macroeconomic policy concern in the view of all advising international organizations (IMF, OECD, World Bank). The first Social-Democratic government (1998-2002) preferred to stimulate the economy by public spending and took advantage of the still low debt level. Netting out extraordinary budget items including privatization receipts and the costs of bank restructuring, the overall balance of the general government mushroomed to 4.8 percent of GDP in 2000 (World Bank, 2001a). Since then, the deficit grew on average approximately one percentage point a year. As a result, while both governments did not manage to contain fiscal deficits in the period following the 1997(8) crises, the Slovak deficits were due in part to tax reductions and the cost of bank restructuring, while the Czech deficits were primarily caused by uncontrolled increases in mandatory expenditures.

Accelerating Policy Divergence after 2002

The diverging reform trajectory was reinforced by the results of the 2002 parliamentary elections. Given that the first Dzurinda government did improve democracy and directed the country towards NATO and EU, a key election topic in Slovakia in 2002 was fighting high unemployment. After the surprising victory of the reform part of the 1998-2002 coalition, the post-2002 government coalition has been formed from center-right parties with key ministries held by conservative western-educated economists and lawyers. The new coalition has embarked on a bold reform program including a three-pillar pension reform, public finance reform, an overhaul of the social support scheme, a new Labor

Code featuring a high degree of flexibility, restructuring of the public administration, a flat corporate and personal income tax rate of 19 percent, and a rise in VAT on all products an services to the uniform level of 19 percent. The tax reductions that meant to stimulate business growth made the ratio of general government tax revenues to GDP fall by some 7.5 percentage points of GDP between 1996 and 2001. While the tax reduction in the first Dzurinda government was not accompanied by substantial expenditure reductions (the general government deficit in 2002 reached 7.2 percent of GDP), the public finance reform and deficit reduction under the current government is based on cuts in public expenditures, including the health and social sectors, wage bill and general services. As a result, the general government deficit was halved to 3.6 percent in 2003 and is likely to decrease further in 2004.

While in Slovakia a strong pro-reform government gained power in the 2002 elections, in the Czech Republic the elections were won by the incumbent Social Democrats who built a coalition with two smaller center-right parties. Initially, the coalition had no strong reform plan, but under fiscal pressures it started formulating a mild fiscal reform. The first set of legislative proposals was introduced in the Czech Parliament only in 2003 and major concessions to trade union political representatives further weakened the reform proposals. While the economy accelerated in 2003, the price of the moderate growth was high as the central government deficit skyrocketed from 46 bln. CZK in 2002 to 109 bln. CZK in 2003. The central government deficit alone thus constituted almost 5 percent of GDP, with little improvement projected for 2004.

Box 1: Pension Reforms Comparison

To illustrate the intensity of the recent Slovak reforms, let us describe the 2003 pension reform in some detail. Starting in 2004, the merit principle has been strengthened within the pay-as-you go system so that those employees who contribute more and for a longer time will also enjoy correspondingly higher pensions. Starting in 2005, the pay-as-you-go system (so called "first pillar") will coexist with a funded pension system (so called "second pillar"). Participation in the second pillar will be voluntary for all current workers; they will be able to opt for staying fully in the pay-as-you-go scheme. For all those entering the labor market for the first time in 2005, it will be mandatory to participate in the second pillar. The costs of the "two-pillar" system will be born by employers contributing 21.2 percent of employees' salary and by employees themselves with 7 percent of their labor income. The individual contributions to the second pillar will be 9 percent out of the overall 28.2 contribution package. The contributions will be collected by the state social insurance agency that will in turn transfer them to one of the private asset management companies. This is a high second-pillar contribution in international comparison.

It took both the first and the second Dzurinda governments to muster enough public support for this notoriously politically difficult reform, which also increases the age for retirement from the current 60 for men and 53-57 (depending on the number of children) for women to a uniform age of 62. The reform was initiated during the 1998-2002 government by conducting some preliminary studies and calculations but there was neither the political courage nor capacity in the Ministry of Labor, Social Affairs and Family (further "Ministry of Labor") to prepare such a complex reform at that time. Interestingly, however, the previous government did allocate to a special account approximately 65 billion SKK (roughly 2 billion USD) from the privatization of the Slovak gas utility for the purposes of funding the transition period between the pay-as-you-go system and the funded pillar. While a constitutional law that would have legally secured such a set-aside was not approved in 2001, the government did find the political will to set the money aside rather then use them for "development programs". At this time, no one seriously challenges the use of the allocated resources solely for the pension reform. The 2003 pension reform was passed in the Parliament with a comfortable majority, despite the protests of the opposition and the trade unions. The President of the country vetoed the reform due to the low valorization of the current pensions, but most of the public saw that as part of his pre-election campaign (Presidential elections will be held in April 2004) and the Parliament overturned the Presidential veto.

For comparison with Slovakia, consider the approved first step of a Czech pension reform, which consists of an increase in the retirement age to 63 for men and childless women that will be phased in until 2013; the introduction of "virtual" personal accounts within the continued pay-as-you-go system; an increase in pension contributions of self-employed so that the contributions correspond at least to the level of the minimum wage; and the introduction of actuarially fair early retirement conditions. In particular, the Czech policy of increasing pensions in tandem with both inflation and average wages is fiscally unsustainable (World Bank, 2001a). While Slovakia put privatization receipts from the sale of a major utility company into a pension-reform lock-box, Czech politicians used similar funds for various subsidy programs (transportation and housing, but not education). In a similar fashion, while the Slovak corporate tax rate has already been reduced, the Czech corporate income tax is supposed to decrease from its current 31 percent level to 24 percent only by 2006.

3. CZECH AND SLOVAK LABOR MARKETS

In this section we highlight the key policy issues of the Czech and Slovak labor markets, which are described in much detail in, for example, OECD (2001, 2002), World Bank (2001b), and INEKO (1999). In Section 4.4, we complement this description with the most recent data. We argue in this section that the higher degree of rigidity on the Slovak labor market with much lower employment rates than in the Czech Republic provides a strong motivation for reform. Reducing unemployment was perhaps the clearest mandate stemming from the 2002 Slovak elections and became a priority for the current Slovak government. Section 4 then describes the evolution of the Slovak labor market reforms since 1998 and comments on the lack of comparable reforms in the Czech lands.

3.1 Main Indicators

The key problem of the Slovak labor market is its very low employment rate. Table 3 presents an international comparison of employment and unemployment rates in 2001. The Czech employment rate is over 8 percentage points higher than the Slovak rate when considering population aged 15 to 64. Furthermore, Slovak employment rates are much lower than those of the EU even for younger workers who are less affected by years of communist labor market experience. During the late 1990s, the Slovak labor market failed to absorb a high annual inflow of about 50 thousand young labor market entrants. (The high inflows were due to the population boom that Slovakia experienced in the late 1970s and 1980s.) In contrast, the Czech population (and labor force) under 30 years of age has been stable. Education is key to labor market outcomes in both countries. While the Slovak employment rate is about 80 percent for college-educated population, it is only about 10 percent for Slovaks with only 8 to 9 years of education.

Table 3: Labor market indicators in 2001

	Czech Rep.	Slovak Rep.	Poland	Hungary	EU Candidates	EU-15
Employment rate						
15-24 years	34.4	27.7	21.4	31.4	27.0	40.4
25-54 years	82.0	74.6	69.5	73.1	73.8	77.0
55-64 years	36.9	22.5	30.5	23.7	34.6	38.2
15-64 years	65.0	56.7	53.8	56.3	57.8	63.9
Self-employed & family workers	15.3	8.6	28.0	14.6	27.1	15.7
Contract of limited duration	8.1	5	11.9	7.5	8.0	13.4
Unemployment rate						
15-24 years	16.3	38.9	41.5	10.5	28.8	14.0
25-64 years	6.9	15.9	15.6	5.0	11.3	6.5
15 + years	8.0	19.4	18.4	5.7	13.0	7.3
Unemployment over 12 months	52.9	58.3	50.1	44.8	52.4	44.0

Source: World Bank (2002). Note: Employment rate is the % of population employed. The self-employment and limited-duration indices are % shares out of total employment. The unemployment rates are % shares of unemployed in a given group on corresponding labor force. The long-term-unemployment index is the % share of those unemployed over 12 months out of the pool of all unemployed.

The Slovak labor market not only features low employment rates, but is also more rigid in terms of most relevant comparisons. First, there are more Czech workers employed under fixed-term contracts and there are almost twice as many self-employed workers in the Czech workforce compared to Slovakia (Table 3). Second, The Slovak labor market is also notorious for being much less dynamic than the Czech one. Consider the monthly outflow rate from unemployment registry in the last months of 1998 and 1999 when both countries faced economic slowdowns. The Czech outflow rate at the end of both years was 7.5 percent (two thirds of the outflow was due to a new job). In contrast, while Slovak GDP was never actually declining, the corresponding registry outflow rates were 4 and 3 percent.

Both labor markets share some unfortunate features. First, culturally and historically, population in both countries is not very mobile. The lack of territorial labor mobility across small districts facing dramatically different unemployment rates is uniquely low. In Slovakia, for example, even unemployment rate differences over 10 percentage points are not enough to motivate the labor force to move as little as 20-50 kilometers away. Second, while the level of unemployment is higher in Slovakia, the incidence of long-term unemployment (LTU) is similarly high in both countries. Over 50 percent of Czech unemployed in 2001 have been jobless for over one year (using the ILO definition of unemployment, which counts as unemployed only those actively searching for work). LTU incidence is lower in the unemployment registry data where the fraction of those Czechs registered for over one year grew from less than 20 percent in 1997 to almost 40 percent in 2001. In Slovakia, registered unemployment data show LTU incidence over 43 percent in both 1999 and 2000. The comparable incidence of Czech and Slovak LTU corresponds to a long-term Czech (Slovak) ILO unemployment rate of 4.3 (10.2) percent in 2001 (2000). In both countries, low educational attainment is the main culprit of LTU.

The wage structure is somewhat more dispersed in the Czech Republic than in Slovakia (Jurajda, 2003) and the Czech labor market features very high returns to education of about 10 percent (Jurajda, 2004). The Czech college/high-school wage gap is about twice higher than that observed in Germany and Austria that have similar structures of education with high shares of workers with vocational degrees. Not surprisingly, Czech public colleges, which are prevented from charging tuition and are funds starved by the governments facing large fiscal deficits, remain highly oversubscribed. While there is a similarly constrained access to higher education in Slovakia, the current government is preparing a reform of university financing, including the introduction of partial self-payments for tuition.

3.2 Institutions and Labor Market Policies

There are two key problems with labor market policies in both countries as of the end of the first transition decade. First, taxation of labor is very high. In the Czech Republic, "wage taxes bear down heavily on labor (at 47.5 percent of gross labor income, they are twice as high as the OECD average), and should be reduced instead to stimulate employment" (World Bank, 2001a). In Slovakia, "high payroll tax rates, which at 50.8 percent of gross wages are currently at the very top among regional economies, contributed to pricing less qualified workers out of the market" (World Bank, 2002).

Second, the extensive systems of social assistance, while alleviating poverty (World Bank, 2001b), also generate significant disincentive effects. The comparison of market wages with the total level of available social benefits discourages work, especially for families with children. Both of these problems impact the investment climate (see the discussion on page 3). Below, we first describe the standard investment-climate variables in each country and then discuss also the social support schemes.

Given the common institutional past, it is not surprising that the Czech and Slovak Labor Codes (as of early 2001) were quite similar. They featured significant legal mandates on maximum hours of work per week and onerous clauses concerning notifications and employee compensation (OECD, 2002, 2003). Both indefinite-duration and fixed-duration contracts were in use. Restrictions on labor market flexibility embedded in the Labor Codes were, however, rarely a topic of policy debate and did not feature as the key negotiation items on the list of employer associations. The Slovak Labor Code was significantly changed in 2001 (and yet again 2003, *see* section 4.2). A more detailed cross-country comparison of the current legal framework for labor relations is given in Sections 4.1 and 4.2, as part of the description of the recent reforms.

It is important to note that the level of sick-leave insurance is generous in both countries, and is often abused by both workers and firms (see OECD, 2003, for discussion of high Czech sickness incidence). It is not possible to fire an employee who is on sick leave. Hence, the high outlays of sickness insurance funds can partly be thought of as unemployment benefits or temporary layoff subsidy, depending on who is abusing the system.

Both countries honor a “tripartite dialogue” – discussions and negotiations between the government, trade unions and employer associations that are common in Continental Europe. The extent and content of the social dialogue have, however, varied substantially over the different reform periods, which we describe in Section 4. (In Slovakia, since 1999, such dialogue is sanctioned through a separate law which was adopted by the first Dzurinda government in return for the pre-1998 election support by the trade unions.) While every important piece of legislation is presented for discussion to the tripartite council, neither of the two social partners can veto a government decision to push through a certain reform measure. The centralized negotiations lead to “signals” about agreed aggregate wage growth. Firm-level collective agreements then often stipulate a set of minimum wage tariffs based on worker qualifications or job requirements. In both countries, trade union membership sharply declined during the 1990s and is now much weaker than in countries such as Austria or Germany. This was due, in part, to large-scale privatization and the rise of startup firms including green-field investments where owners often opposed the establishment of trade unions.

To complete the standard labor-market investment-climate description, we note an important feature of the Czech corporate income tax. Although the Czech rate is among the highest in Central Europe at 31 percent, its yield in terms of GDP share is among the lowest due to extensive exemptions. In 2003, the Czech rate was 6 percentage points higher than that of Slovakia, but the difference in effective tax rates after exemptions shrank to 2.4 percentage points according to the Czech Ministry of Finance. On the other hand, total social security contributions in both countries exceed by more than 10 percentage points the (un-weighted) average in the EU. These high contribution rates bear down heavily on labor and are also a likely barrier to growth of small enterprises. Very small firms are effectively able to avoid paying contributions by, e.g., using self-employed workers, but should they grow into medium size, their total tax burden skyrockets.

As we argue above, social security systems have important ramifications for investment climate reform in both countries. At the end of the first transition decade, the structure of passive and active labor market policies was similar in both economies. Unemployment benefits were not particularly generous in either country, but unemployment registry was the pre-requisite for collecting a wide array of social benefits. For instance, in 2002, only 85 thousand Slovak unemployed collected unemployment insurance benefits out of the pool of over 500 registered unemployed. Until recent changes in Slovakia took effect (see Section 4.2), both countries guaranteed families a so-called “minimum subsistence level of income” (also called the “minimum living standard”). This minimum level of income depends on the number of adults and the number and age of children living in the household. Until 2001, the minimum subsistence level was also tied to the consumer price index in both countries. Hence, if one’s unemployment benefits were below the subsistence level, social assistance benefits were paid (by district social offices) on top of the unemployment benefits (paid by district Labor Office) to bring the family to the minimum acceptable level of income.

To illustrate the work disincentive effect of these support schemes, consider the Czech social assistance benefits in early 2002, when the average gross monthly wage was over 15 thousand CZK and the pre-tax (net) minimum wage was 5,700 (4,715) CZK. During that time, the minimum living standard for a single individual was 4,100 CZK and a family of two adults and two children aged 11-15 was guaranteed the income of 12 thousand CZK, which is above the after-tax average monthly salary. In some cases, other forms of social support (child and parental allowances) are available on top of the guaranteed minimum subsistence level. These wage/welfare comparisons are at least as striking in Slovakia (see OECD, 2002 and 2003, which provide a detailed coverage of the two systems of social support). According to OECD (2002b), various replacement rates, minimum wages as well as social assistance benefits were even somewhat higher in Slovakia in the late 1990s. For example, a family with two jobless parents and 10 children received in monthly social assistance and various allowances 28,640 SKK, while the average monthly salary was 13,511 SKK as of 2002. These Czech/Slovak differences in social support generosity were minimized for long-term unemployed, who in both countries could count on similar support of almost 40 percent of average wage if they were single and 80 percent for a couple with two children.

Active labor market policies in both countries take the form of retraining and support for the youth and the disabled, but primarily they focus on two forms of subsidized employment. The Labor Offices provide support, typically for the less qualified workers, in the form of reimbursement to employers of a part of a worker’s salary. The program is known as “socially purposeful jobs”. It supports jobs in both existing firms and in self-employment. This form of support that aims at the creation of permanent jobs requires minimum 2-year job tenure. Further, the “public works program” which was recently expanded in Slovakia, creates short-term public-works jobs requiring few skills.

To summarize: Despite the high non-wage costs and structural unemployment problems (especially in Slovakia), labor markets were generally not seen as bottlenecks to reforms and growth during early transition; rather, they provided an efficient reallocation mechanism. It was the combination of weak restructuring policies and inadequate institutional frameworks that curbed investment and high-productivity employment growth in early transition (Section 2.1).

4. LABOR MARKET REFORMS

4.1 Slovak Reform Battle of 1998-2002

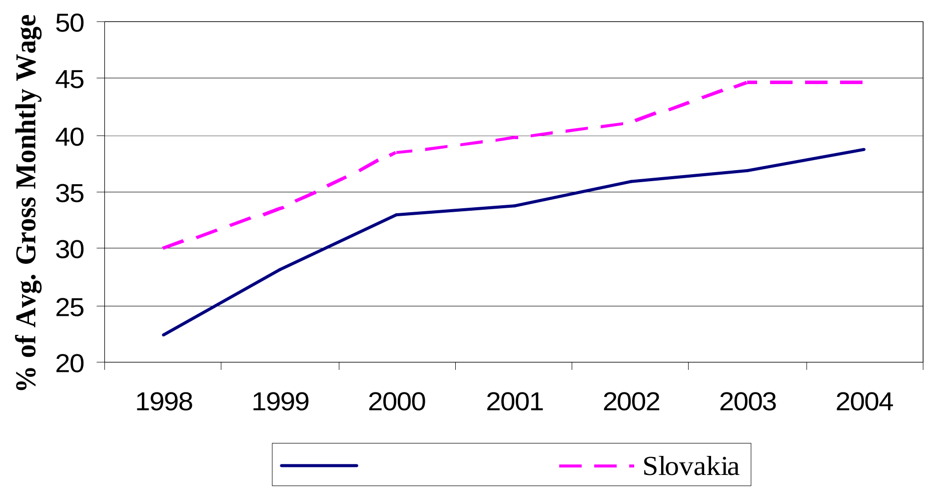
The complexities of governing in a left-right coalition are reflected in the mix of labor market policies adopted between 1998 and 2002. In this section, we discuss the coalition reform battle in some detail. We first outline a set of implemented policies and briefly illustrate one policy championed by each of the two opposing forces within the coalition. Second, we discuss the formation and capacity limits of the pro- and anti-reform groups. Third, we provide a detailed account of the Labor Code reform that then allows us to form some political economy lessons in Section 5.

When analyzing the labor market policies in any of the countries joining the European Union in May 2004, one must keep in mind the tremendous impact that the accession process has had on the policy makeup of these countries. Many legislative changes occurred within the EU harmonization process. The need to adopt the expansive *acquis communitaure* of the European Union provided both guidance as well as a straight jacket for transition policy makers and legislators. Under the cover of "harmonization", however, an intense struggle took place in Slovakia between the pro- and anti-reform groups over the content of the labor and social assistance legislation.

The labor market reforms of 1998-2002 consisted of two sets of policies: one initiated by the left-wing government party, the other championed by the pro-reform members of the coalition. The left-wing policies included: (i) increasing wage tariffs for public-sector workers in 2002; (ii) adoption of the low-flexibility Labor Code of 2001; (iii) introduction of universal child allowances in 2002; and (iv) repeated increases of minimum wage levels. The pro-reform policies included: (v) phasing out of early retirements in 2000; (vi) reduction of social assistance benefits in 2001; and (vii) the "quick-fix" of the 2001 Labor Code in early 2002.

Let us briefly illustrate the nature of these two sets of reforms by providing two examples: First, the increases in the level of minimum wages are depicted in Figure 1, which shows that the left-right Slovak coalition matched the speed of minimum wage increases of the trade-unionist Social-Democratic Czech government. The argument often used by those proposing minimum wage increases was that higher wages would make working preferable to the collection of benefits. In Slovakia, but not in the Czech Republic, the rise in minimum wages was accompanied by some reductions in the high level of social assistance benefits, which provided an effective wage floor (see Section 3.2). Second, in 2001, about 50 percent of the 324 thousand recipients of social assistance benefits in Slovakia (whose household income fell below the minimum subsistence level) were classified as being in this position for “subjective” reasons. Their level of social assistance was halved. This applied primarily to recent school graduates, those unemployed for over two years, those voluntarily leaving a job, refusing to co-operate with the Labor Office or refusing to participate in the public works programs. This policy was implemented to increase pro-work incentives (pro-reform view) and to reduce social support expenditures (coalition-wide view).

Figure 1: Minimum Wages



counterbalance the influence of the left-oriented part of the coalition. The striking fact is that the pro-reform "group" around Mikloš consisted of a small advisory team of 5 to 6 economists and lawyers and a network of external advisors. While the political backing in the Cabinet and the Parliament was, of course, wider, the analytical capacity of the reform grouping was that of this small team, which drafted and pushed through many of the reforms. His lack of a specific portfolio was a double-edged sword. On the one hand, the Deputy Prime Minister lacked specific authority in any of the economic areas and a large delivery apparatus of a ministry. On the other hand, his small team was not hampered by extensive bureaucratic procedures and could concentrate on strategic interventions in key policy areas and the preparation as well as lobbying for key policy reforms. Critically, his team was not connected to local vested interests and was able to mobilize some targeted international assistance, especially for institutional reforms in the financial and legal sectors (Mathernova, 2002).

Each of the two groups was able to propose some new legislation and occasionally block some of its opponents' initiatives. On some reform aspects, for example bank and enterprise restructuring, the two groups worked effectively together. Labor market and social assistance policies, however, presented an ideological challenge that made the two groups oppose each other rather frequently. When the pro-reform group was interested in certain positive aspects of new legislation proposed by the left-wing party, it was often able to negotiate a compromise. (For example, a compromise was reached on the adoption of the privatization law that allowed for full privatization of financial services, while capping the privatization of utilities at 49 percent.) The group was also able to prepare many reform proposals outside the relevant ministries and sometimes faced with their opposition (This applies, for example, to the new company law incorporating corporate governance rules and the collateral reform described in Mathernova, 2002, and the functional audit of central state administration).

Labor Code Battles

The small size and capacity of the pro-reform analytical group and the low quality of Slovak ministries, however, also led to some reform failures. A key example is the Labor Code of July 2001 that severely reduced labor market flexibility and unduly increased the powers of the trade unions. Even before the Labor Code was tightened in 2001, Slovakia's employment protection legislation was restrictive compared to an average OECD country. Table 4 presents three indices of labor market regulations for the Czech and Slovak Republics in 2002 and contrasts those with the OECD average. Slovakia scored particularly poorly in terms of firing clauses, where its level of regulation was more than two times that of an average OECD economy. Instead of fostering lower unemployment, the 2001 Labor Code further increased the cost of labor and decreased its flexibility by: setting maximum working hours per week at 40; mandating working time and rest periods in prescribed intervals; eliminating the most widely used form of part-time employment; setting a maximum 3 year period for fixed-term contracts; and by significantly strengthening the powers of trade unions, especially with respect to the firing of workers and any organizational changes in companies. Specifically, employers had to get trade unions' approval for firing of workers and the unions had virtual veto power over any organizational changes that implied any labor shedding. It was also not possible to fire a member of the trade union organization in a company. Finally, the 2001

Code allowed the automatic abolition of workers' councils (a popular replacement for the more rigid trade unions) in companies where trade unions were formed.

Table 4: Labor Market Regulation Indices of 2002

	Flexibility of Hiring	Conditions of Employment	Flexibility of Firing
Czech Republic	17	63	27
Slovak Republic	32	86	61
OECD Average	48	55	28

Note: Index values range from 0 to 100, with 100 representing the highest level of regulation. Source: rru.worldbank.org/DoingBusiness

Apart from its content, the Labor Code represents an interesting story from a political economy point of view. The Code spent almost two years in the legislative process, was presented several times in the Cabinet, discussed in the tripartite council and finally debated in three readings in the Parliament. Despite the full legislative procedure, everyone involved at the executive and legislative levels repeatedly underestimated the importance of the Code. Surprisingly, its impact was not fully appreciated also by the employers associations that were to suffer most from the new provisions of the Code. The collusion between the interests of the trade unions with the old-line bureaucrats in the Ministry of Labor, combined with the limited processing capacity of the pro-reform group and the lack of attention and action on the part of employer associations allowed the passage of a clearly anti-reform policy.

The Labor Code was adopted in early July 2001 and was not to enter into force until April 2002. This relatively long period of nine months allowed various groups of entrepreneurs and employers, as well as state institutions, to realize the full impact of the new legislation. If implemented, whole sectors of the economy would be paralyzed if for example health care provides, drivers, actors and teachers were not allowed a more flexible scheduling of their work hours and rest periods and more overtime. Many groups started calling for a postponement of the effectiveness date of the new Code. While the effective date was not postponed, in March 2002 a short amendment of the Labor Code was negotiated between the left and right parts of the coalition (the so-called "quick fix"). (The Ministry of Labor refused to admit any fault in drafting the original version. The Cabinet, therefore, was forced to present the short amendment as a "parliamentary initiative" through one of its deputies.) Curiously, the amendment of the Labor Code thus came into force on the same date as the Code itself. The main provisions in the short amendment extended the hours of overtime work and allowed for flexible scheduling of shifts. The price for agreeing to the amendment by the sponsor of the original Code, the ex-communist party, was twofold. First, the provisions on the increased powers of the trade unions were not subject to the amendment. Second, progressive amendments, such as differentiated pay based on performance, were excluded from the Civil Service Law that was part of the same labor-legislation package.

This reform failure provides a powerful example of the capacity constraints faced by reform movements in coalition governments during episodes of large legislative changes. The fact that the government coalition was able to agree on some improvements of the

Code in early 2002, once the paralyzing impact of some provisions was noticed, further highlights the impact of the capacity constraint. Faced with many other structural reforms to design and support, the reform group simply lacked the capacity to police the Labor Code and also did not consider it a priority vis-à-vis other items on the reform agenda. It, as it turned out mistakenly, relied on the employers association for whom the Code was of vital importance. The failure of the business groups and employers to pay sufficient attention to the potential detrimental impact of the new restrictive provisions of the Code on their own businesses is far more surprising. This inability to mount effective opposition to the 2001 Code demonstrates that the lack of analytical capacity and ability to mobilize to defend group interests applied not only to the public sphere but also private interest groups.

Mathernova (2002) further suggests that the key personnel capacity constraint of the pro-reform group had not only led to the approval of some anti-reform legislation, such as the Labor Code, but also limited the number of reform steps undertaken by the first Dzurinda government, given the distribution of political power. Hence pension, health care and education reform were left for the next government.

In sum, the public sector and the private interest groups, as well as the pro-reform government group were all affected by a human capital constraint. This constrains is likely the result of a combination of four key factors: (i) the slow reform process up to 1998; (ii) the democratic deficit under the previous Mečiar governments; (iii) the low Slovak wage level; and (iv) the ease of migration to the richer Czech Republic.

Brain drain from Slovakia to the Czech Republic is made easy by the close proximity of the two languages and cultures and their common history. After the January 1993 split of the Czechoslovak Federation, citizens had to choose either Slovak or Czech citizenship. As of the late 1990s, the number of short-term work permits for Slovaks issued by the Czech administration was low at about 40 thousand. However, the size of the ethnic Slovak community in the Czech Republic is estimated at 350,000, which would correspond to over 6 percent of Slovakia's population. According to recently unpublished research by V. Baláž of the Institute for Forecasting of the Slovak Academy of Sciences, over 10 thousand college graduates leave Slovakia every year. Between 1994 and 2002, this amounted to about 135 thousand college graduates lost in a country where the stock of all employed workers reaches only around 2.1 million.

4.2 Slovak Sweeping Reforms after 2002

After the 2002 elections, Slovakia became a true "laboratory of reforms." Rapid reforms were undertaken in several politically sensitive areas simultaneously (pensions, taxes, public finances, labor market, social benefits and health, *see* Section 2.4), despite the continued lack of experience and a deficit of skilled and trained people in the overall state administration. Under new pro-reform leaders, two ministries, namely finance and labor, were able to attract young and well educated people more than any other ministries. They are also the authors of most of the far-reaching reforms adopted in 2003.

Within one year of the establishment of the second Dzurinda government in November 2002, the Slovak Ministry of Labor, under a new pro-reform management produced 20 strategic documents and 10 major reform laws most of which are already approved in the Slovak Parliament. The reforms cover four areas: (i) social benefits such as child allowances and support for those below the minimal subsistence level of income, (ii) a new Labor Code, reversing the reform failure of the previous government, (iii) civil service reform; and (iv) the introduction of a new pension system.

Below, we focus on the labor market reforms under (i) and (ii). (Pension reform is described in Box 1.) We note that the new law on social insurance, which is part of the approved reforms for 2004, lowers the employer social security contribution rate by 3.6 percentage points and hence it addresses the high labor taxation highlighted in Section 3.2. The amendment to the Civil Service Law (iii) reverses the rigidity of the original piece of legislation adopted in 2001 by allowing competitive pay and performance monitoring and evaluation for an increasing number of civil servants. It also defines strict conflict of interest clauses for the public administration.

Social Benefits Reform

This labor market policy agenda affects investment climate through increasing labor supply, lowering labor costs at the low end of the labor market, and contributing to sound government finances. Furthermore, it turns out to be crucial from the political economy perspective (see Section 4.4). The group of those who fall below the minimum subsistence level of income and therefore receive social transfers constitutes over 10 percent of the Slovak population, including essentially the entire Roma minority. Since 2001, about half of these recipients collected only 50 percent of the subsistence level because they were classified to be in need for "subjective" reasons (see Section 4.1). Because the level of support was a steep function of the number of children, the work disincentives of the benefits were biggest for large families (see Section 3.2). In 2003, the government first introduced a one-family-benefits cap. Starting in 2004, a number of major changes in the system took place, most of which decrease the level of guaranteed support for low-income families while introducing a wide range of pro-work incentives.

First, starting in 2004, child allowances do not depend on income level and are not means tested. They consist of a universal SKK 500 payment amended with a SKK 400 labor income tax deduction. Compared to 2003, this raises (lowers) child allowances for high (low) income groups and provides a motivation for labor force participation.

Second, the subjective/objective distinction used to determine the level of social assistance benefits was abolished and a new structure of benefits is used, which is close to the "subjective" low level of benefits, but which offers various additional "activation" and/or "protection" bonuses. The "activation" bonus is offered to those actively seeking a job (the bonus is paid, if the job lasts a minimum of 10 hours a week), retraining, or who are engaged in short-term public works. Further, for long-term unemployed who find a job, an "activation" bonus of 1500 SKK is provided for 6 months into the job's duration and as much as 25 percent of a worker's salary can be deducted for the purpose of determining whether a household is below the minimum subsistence level (there are other deductions as well). While the new structure of benefits provides significant pro-work incentives, it also amounts to a major reduction in the level of benefits. To illustrate, a family with two jobless parents and 10 children that under the old scheme received in total 28,640 SKK, now receives 13,420 SKK without the "activation" bonuses.

Third, most social benefits are now paid by the district Labor Offices, instead of the separate social offices. Those have been merged with the Labor Offices. Registration at the unemployment bureau is a pre-requisite for collecting many types of social benefits. At least one personal visit every two weeks is required, but the frequency of visits raises to one per week for long-term unemployed. There is also a new benefit of up to 10 thousand SKK available for those moving at least 30 kilometers in order to acquire a job. Fourth, the valorization mechanism, which has been continuously increasing the level of the minimum subsistence level, is abolished, and the new administration also stopped increasing the minimum wage.

New Labor Legislation

One of the primary post-2002 election mandates of the new Ministry of Labor was an overhaul of the low-flexibility Labor Code of 2001 (described in the previous section). There was great public demand for such a step; the current minister's party (a junior partner to the party of Prime Minister Dzurinda) ran on a pro-business platform with an explicit commitment to make changes in the Labor Code. The new Code was approved in record time in May 2003. It took about two-dozen sessions with the trade unions to negotiate the final text, with unions staging frequent picketing in front of the Ministry. A factor that helped in withstanding the pressure was the popular demand for changes in the labor legislation. Fueled by the media, it was based on the widely perceived feeling that the 2001 Code "went too far" in setting too rigid rules and gave too much power to the trade unions that are otherwise playing an ever-decreasing role in the society. Once the unions saw the government was determined to push through the new Code and had the public support for it, they agreed to the language and the Parliament adopted it very rapidly thereafter.

The new Code of 2003 lowers the cost of labor and aims at motivating job reallocation and employment growth. It increases the regular working week to 48 hours on average calculated over a half a year or a full year; sets the maximum annual overtime to 400 hours (150 at the discretion of the employer and an additional 250 hour upon agreement with the employee); allows for a flexible setting of working hours and rest times; introduces flexible part time arrangements for students and retirees; allows for an indefinite repetition of fixed term contracts; limits the severance pay to two months (or three months for workers with tenures over five years); and makes the firing of workers considerably more liberal (e.g., the statutory notice period is reduced to two months).

The new Code also significantly constraints the powers of the trade unions. While under the 2001 regime they had an effective veto power over the organizational changes or firing of workers, under the 2003 Code they only need to get notified. The law puts the workers councils and trade unions on an equal footing (with the exception that the trade unions do collective bargaining and workers councils do not). Workers councils are found in an increasing number of businesses, especially with foreign investment, where trade unions do not exist. Essentially, under the new Code, trade unions need to bargain for all their powers and rights with the employers; very little is granted as a matter of law.

It is interesting to note the evolution of the relationship between the consecutive Dzurinda governments and the Slovak trade unions. In the 1998 elections, the trade unions supported the then opposition to the Mečiar government that later entered the government. In 1999, the first Dzurinda government adopted a Law on Tripartite Negotiations, in return for the trade union pre-election support. The unions supported the government (at least the measures proposed by its left-wing part) due to the reopening of the social dialogue that had been severed by the previous Mečiar's governments. Since the adoption of the unpopular reforms during the 1998-2002 period (mainly several macroeconomic adjustment packages), the relationship between the government and the trade unions has been progressively worsening. The second Dzurinda government is not feeling beholden to the trade unions, since they actively sided with the opposition in the 2002 elections.

As noted above, despite voicing their opposition to most of the 2003 reforms in the tripartite council, the Slovak trade unions have not proven until now to be a serious threat to reforms. All the reforms they opposed, including labor market, social benefits, health care and tax reforms ultimately succeeded in the Parliament. (Most of them even had to pass the Parliament twice, due to the frequent Presidential veto.) Possible explanations include a capacity constraint on their side as well as the lack of experience in dealing with reform governments in the 1990s that would have tested their organizational strength. In the 1998-2002 period, they concentrated their forces, with success, on labor legislation. After having to yield to the government on the 2003 Labor Code and virtually all other reform legislation, the trade unions are now mobilizing to stop further reforms. In late 2003, the Slovak Confederacy of Trade Unions with the support of opposition left-wing and populist parties and the tacit support of the current President, organized a petition proposing a nationwide referendum on early elections. The expectation on their part is that new elections would usher into power government of the young left-leaning law-and-order populist Robert Fico who is widely expected to stop or at least slow down the pace of reforms. The petition, supported by over 600 thousand individuals, easily surpassing the 350 thousand margin necessary, amounts to the first great success of the trade unions. The referendum will be held in early April, concurrently with the Presidential elections. The referendum may fail if less than 50 percent of eligible voters participate; but even if it succeeds, Slovak Constitution makes the results of a referendum only advisory for the Parliament.

In sum, it is clear that the second Dzurinda government has been able to pass a number of deep reforms in a short time period of one year. The rationale for concentrating reforms in the first year of the new government was twofold. First, early painful reforms may raise future growth so that by the end of the electoral cycle the public may again support the pro-reform parties. Second, the government was aware that the first painful reform steps would raise opposition to further reform (both within and outside the Parliament) making the continuation of reforms in the second half of the electoral period difficult. It is clear now that this political calculation was a correct one, since opposition to reforms started to mount at the end of the government's first year in office. It is, therefore, critical that the first positive effects of the Slovak reforms are already becoming apparent (see Section 4.4).

4.3 Lack of Reforms in the Czech Republic

In contrast to the situation in Slovakia, a key feature of the Czech labor market from 1998 through 2003 is the powerful role the trade unions play in influencing the government and the Parliament on labor policies. Not only are functionaries of the trade unions elected to the Parliament on the ballot of the Social Democrats, but they also have direct influence in the executive. Many governmental advisors are former associates of the trade union movement and the current Minister of Labor and one of his deputies are former officials of the trade unions. The close proximity between the trade unions and the leading political party, the Social Democrats, means that while the Czech labor market and fiscal reforms share some similar features with the Slovak reforms, they are invariably much softer and are usually postponed. The influence of the trade unions shows in several policy and institutional dimensions.

First, the social dialogue under the current Social Democratic government has been extended and institutionalized beyond the tripartite meetings. The government organizes so-called "social conferences" which are attended by representatives of the trade unions, employer associations, associations of pensioners, think tanks, etc. These conferences discuss forthcoming legislation (for example, the Social Conference on Pension Reform in 2000). Another illustration are the "round-table" meetings of powerful parliamentary committees with the social partners. The deeper social dialogue has made for more agreement between official government policy proposals and the trade unions' position so that one observes less overt struggle over proposed policies.

Second, since 1999, various Czech Ministers of Labor regularly extended the industry collective agreements, for example, in construction, textile or steel to firms that do not have trade union representation. Despite the wide use of the extension policy in 2001, the higher industry-level collective agreements still covered only about 19 percent of enterprise employment, in comparison to the 26 percent coverage of firm-level collective agreements. It is not clear how powerful the implementation and the monitoring of the extensions are in practice, but it does confirm the inclination of the Czech executive to work closely with the trade unions.

Third, the Social Democratic governments implemented a continuous rise of the minimum wage (Figure 1) on the argument that higher wages would increase labor supply (and not affect labor demand). Indeed, until recently, effective wage floors have been provided not by the minimum wage, but by the level of minimum subsistence income guaranteed by the state through social assistance benefits. Minimum subsistence level rises sharply with the number of children, but even the subsistence income for one childless adult surpassed the after-tax minimum wage until 2000 (by 2002, the ratio of after-tax minimum wage to one-adult subsistence level reached 1.15). Assuming a 3 percent nominal wage growth, the 2004 Czech minimum wage level will be over 38 percent of average gross monthly salary.

Fourth, the trade unions recently initiated some changes in the Labor Code that may limit labor flexibility. The amendments are currently being discussed in the Parliament and it is very likely they will pass due to the strong influence of the union representatives in the legislature. Most notably, the use of fixed-term contracts will be limited to 2 years.

Specifically, an employee whose fixed-term contract(s) will extend beyond 2 years will have the option to demand from the employer an indefinite-duration contract. If a given worker on a fixed-term contract is laid off prior to the 2-year threshold, and if this is followed by a break period of 6 months, the employer can again offer the worker another no-commitment fixed-term contract.

Do any forces work towards more reform on the Czech labor market? In particular, what is the role of Czech employer associations in the Czech social dialogue? Given that the current government's coalition agreement specifically guarantees that the protection of employees and the powers of trade unions cannot be diminished, the bargaining position of employers is rather weak. However, the Czech employer associations do take an active part in the social dialogue and are able to partially counterweight the power of the trade unions in the Parliament. They are not particularly concerned with wage bargaining being a constraint on wage differentiation or with the recent increases in minimum wages. The latter affect mainly service sector jobs where workers are more likely to be reported as receiving only the minimum wage even if they are actually paid more. There is, however, a potentially important effect of minimum wage hikes on the overall wage level as the firm-level collective agreements often increase the whole multi-tariff wage structure when the lowest tariff corresponding to the minimum wage is raised.

The key policy issue from the perspective of the employer associations is the high non-wage cost of labor in the Czech Republic resulting primarily from high social security contributions. Indeed, international competition in labor taxes, including that posed by the recent Slovak reforms, is now putting the Czech government under some pressure to lower the level of contributions. The employer associations would also like to see (i) selective tax incentives supporting high-value-added investment and research and development; and (ii) more government support for certain technical types of education at both secondary and tertiary level, which they view as being in short supply. Interestingly, the employer associations agree with the trade unions in urging the government to raise taxation of the self-employed that are currently able to avoid most forms of taxation. The first stage of fiscal reforms approved in 2003 institutes a minimum income tax and higher social security contributions for the approximately half a million Czech self-employed workers starting April 1, 2004. Such change is in part a result of the lack of political representation of the self-employed who are not involved in the social dialogue.

Just as Slovakia's reforms provide pressure for lowering non-wage costs, they are also used to inspire the Czech Ministry of Labor in its proposed reforms of the social benefit system. The motivation for reforms is similar to that we noted in Slovakia, namely fiscal pressures. The proposals are currently being debated in the Parliament. They include halving of social assistance benefits to those long-term unemployed who refuse to take part in short-term municipal public works.

4.4 Effects of Slovak Reforms

Slovak demand for labor is now undoubtedly stimulated by the economy-wide reductions in non-wage costs and by the new low flat corporate income tax (affecting demand for employees) and personal income tax (affecting self-employed). Social-benefits reform lowers labor costs at the low end of the labor market where the cost elasticity of labor is likely to be the highest. Simplified hiring and firing procedures, simplified legal framework for enterprise registration, and the reformed collateral rules easing access to credit for small and medium enterprises also improve Slovakia's investment climate.

Quantifying the effect of the whole reform process and identifying the impact of individual reforms is, however, made hard by two factors. First, a number of reforms took place at the same time. Second, most of them took place only very recently. While some of the new labor market policies were adopted prior to 2004 (including the 2000 first reduction in corporate income tax, the 2001 first major cut in social benefits or the high-flexibility Labor Code effective as of July 2003), the largest package of reforms (described in Section 4.2) took effect only at the beginning of 2004. A micro data analysis identifying the reform effects off variation in reform exposure of individual Slovak unemployed or firms is beyond the scope of this paper. Hence, we are left with considering the evolution of main Slovak labor market indicators before and after the reforms. We also use the Czech labor market evolution as a possible benchmark, under the strong assumption that the two markets would have evolved similarly in the absence of the large differences in the reform measures.

As we document below, Slovakia indeed recorded relatively high employment growth in the recent period. While the employment growth has been particularly strong among self-employed entrepreneurs, the number of employees also grew, thanks in part to the dramatically increasing FDI, which in turn reflects the improved investment climate in the country. Distinguishing the employment effects of the broad economic and social reforms from those of the very recent but far-reaching labor reforms is practically impossible at this time. In this paper, we intentionally described the overall reform scenario, including the labor market reforms, which led to the marked improvement in the investment climate in Slovakia. Our intuition is that while the labor market reforms have already had some positive impact, their largest effects will be felt in the medium-to-long run. Hence the bulk of the improvement on the labor market observed up to now (mainly in terms of short-term unemployed being pulled back into jobs) is probably due to the full comprehensive set of reforms and the overall economic expansion.

The recent dramatic increase in FDI inflows (in 2002, the net inflow of FDI was almost 17% of DGP, but this high number was due to the sale of 49% of the gas utility Company SPP. Not counting the SPP privatization, net inflows were in the order of 4 to 5% of GDP which is a sustainable figure over the medium term) is partly motivated by the looming EU accession and low labor costs, but in part it is also fueled by the introduction of the flat personal and corporate income tax; by fiscal consolidation reflected in the sharp narrowing of sovereign borrowing spreads and increased rating of the country; by strengthening of creditor rights and easing access to credit; and by the recent simplification of business registration; greater flexibility in labor regulations; and improved pro-work incentives in the labor market.

Perhaps the clearest indicator of Slovakia's improved labor market performance is its *employment growth* (shown in the bottom panel of Table 2). Starting in 2001, Slovakia's employment growth has outperformed that of the Czech Republic. In 2003, Slovakia achieved a third quarter employment growth rate of 2.3 percent, representing the strongest employment increase on record. While the number of employees rose by less than 1 percent, the stock of self-employed entrepreneurs rose by over 15 percent. In comparison, during the same period, Czech employment shrank by over 1 percent. The Slovak employers association, which took an active part in designing the high-flexibility 2003 Labor Code, testified that the new firing clauses allowed them to create a much greater number of new jobs. Since the adoption of the Code, over 80,000 new jobs were created. Again, while the overall economic expansion in Slovakia is arguably the primary reason for the job creation, the new flexible rules have undoubtedly contributed to this positive trend.

A similar Czech/Slovak difference in differences comparison is offered by the *evolution of unemployment*: Between the third quarters of 2002 and 2003, the Czech ILO unemployment rate rose by 0.7 percentage points while Slovakia's ILO rate decreased by 1.5 percentage points. The contrast is even more favorable for Slovakia in comparing registered unemployment that rose by 1.1 points in the Czech lands (end of 2003 figure) but shrank by hefty 2.6 percentage points in Slovakia (November 2003 rate).

The Slovak/Czech difference in 2003/2002 differences is, therefore, plus 3.4 in terms of employment rate and minus 2.3 (3.4) in terms of ILO (registered) unemployment, amounting to a significant change in labor market trends on the background of similar macroeconomic evolution (current account and fiscal deficits in both countries were similarly large in 2003; the Czech third-quarter GDP growth was 3.4 percent while Slovakia grew by 4 percent in the same period). An important difference underlying the divergent evolution of employment occurred in terms of real wage growth: while the Czech real wage growth as of the third quarter of 2003 was strong at 6.4 percent, Slovakia's higher inflation and moderate nominal wage growth resulted in a drop in real wages of 1.7 percent. The lower wage growth in Slovakia may itself be a result of the lower level of social assistance providing an effective downward pressure on wages, but more research is needed to confirm this hypothesis.

Table 5: Slovak social transfers and unemployment during reforms

	1999-12	2000-12	2001-11	2002-11	2003-11
Social benefits recipients (thousands)	585	613	631	618	544
Idem, fraction of population (%)	10.8	11.3	11.7	11.5	10.1
Registered unemployed (thousands)	535	506	513	488	420
Registered unemployment rate (%)	17.3	18.2	18.2	17.8	14.2
Outflow rate (%)	3	4	6	7	6
Share of those unemployed >1 year	0.43	0.45	0.40	0.49	0.51

Source: Slovak Ministry of Labor and National Labor Office.

As Table 5, based on the unemployment registry data, documents, this favorable evolution of the Slovak labor market left behind its long-term unemployed whose share on registered unemployment continued to rise in 2003. The more employable short-term unemployed are obviously the first to leave the unemployment registry, so that "activating" the long-term unemployed will be one of the main challenges of the package of reforms introduced in 2004 and described in Section 4.2. The picture is brighter in terms of the number of recipients of all types of social benefits, which started to shrink in

2002 and continued to decrease in 2003, when the government froze the level of social assistance and introduced top coding of one-family benefits.

To the extent that the changes in social assistance benefits in 2001 affect different types of individuals differently, one may wish to study the dis-aggregated evolution of unemployment. A prime case of those classified as being in "subjective" material included recent school graduates. Unfortunately, the definition used to report recent school graduates in unemployment registry changed in 2002 making such analysis difficult. Workers under 30 years of age continued to form the largest group of registered unemployed (at 36 percent), but their total number dropped slightly between 2001 and 2002.

One powerful and unexpected effect of the 2004 reforms appeared in late February 2004. The socially excluded, predominantly jobless Roma minority, which relies heavily on social transfers, staged a number of protests against the new low level of social assistance benefits. In many instances, the protests turned into riots and resulted in looting of stores. The army and extended police forces were called to suppress the lootings. As a reaction to these events, the government amended some of the recently adopted legislation. For example, the "activation" bonus was raised from 1,000 to 1,500 SKK.

This recent social unrest presents the reform movement with a formidable political challenge. The Roma minority constitutes about 8 percent of the total Slovak population (though exact census data do not exist) but accounts for half of all long-term unemployed. The minority also represents the majority of the pockets of deep poverty in Slovakia (World Bank, 2001b). The social exclusion of the minority has been camouflaged by generous social support for decades, a tradition dating back to the Communist regime. While both Czech and Slovak Roma face (at least statistical) labor market discrimination and racially motivated violent attacks, their level of social support is now dramatically different. For example, in the Czech Republic, a family of two jobless adults and 5 children may qualify for up to 28 thousand CZK in total government support (starting with the minimum subsistence level of 19.5 thousand CZK and adding various other allowances). In contrast, a similar Slovak family now qualifies for only 7.6 thousand of SKK (about 6 thousand CZK at the current exchange rate), including the 1 thousand "activation" bonus. Meanwhile, the Slovak VAT on food increased from 10 to 19 percent.

While the recent vigorous employment growth in Slovakia will likely help many long-term unemployed find jobs, labor market discrimination and the concentration of uneducated Roma in areas of low growth may prevent them from benefiting from the improved economic conditions in the country, at least in the short run. In the absence of directed job support programs, the "push" of lower social assistance may not lead to higher Roma employment, but may exacerbate the existing social divide and increase poverty. Effectively addressing the social, educational and economic situation of the Romas remains one of the greatest policy challenges for several future Slovak and Czech governments, though Slovakia's challenge is far greater due to the larger share of the Roma minority on the total Slovak population.

5. CONCLUSIONS AND POLITICAL ECONOMY

By 1998, a full array of optimal technical solutions and reform policies tested in front-runner countries was available to guide the reform process in post-communist countries. At the time, both the Czech Republic and Slovakia faced fiscal pressures (resulting in part from the early costs of transition) providing a stimulus for public finance and labor reforms and faced the need to "harmonize" their legislation with that of the EU. Both countries were, therefore, in a good position to improve their institutional setup to deal with the dual challenges of rising unemployment and increasing international competition. We conclude that, so far, only Slovakia was able to take full advantage of the reform opportunities.

The Slovak labor market reforms first stimulated labor demand by cutting taxes and then addressed structural inactivity by making the Labor Code more flexible and by revamping the social support scheme to make work preferable to collecting benefits.

Slovakia's experience in the last four years, and particularly during 2003, illustrates how a large set of best practice solutions can be implemented in a short time span by even a very small reform team. While the lack of key personnel did lead to some unnecessary losses for the pro-reform movement and did leave most of the labor marker, social assistance and pension reforms for the post-2002 government, the lack of human capacity was generally overcome using few key advisors with access to key Cabinet members and taking advantage of targeted foreign assistance and advice of international financial institutions.

In contrast, the Czech experience of 1998 to 2003 shows how a richer economy can support the continuation of inefficient policies and how the political cycle can prevent a country from preparing for looming challenges, including the aging of the population and the likely outflow of assembly line FDI in future decades. The lack of genuine structural reforms is partly attributable to the close links between the ruling party and the trade unions and the general lack of political will and courage to undertake painful and unpopular reforms.

In conclusion, we pose several political economy questions and offer our answers as lessons from the comparison of the Czech and Slovak reform developments:

1. *How did the Slovak government of 1998-2002 manage to implement some painful reforms while key positions in the Cabinet (Ministries of Finance and Labor) were held by an anti-reform left-wing party?*

⇒ As argued in Section 4.1, the reforms were politically feasible due to the deep sense of economic and political failure of the previous Mečiar governments.

⇒ Fiscal pressure provided the second most powerful stimulus for reforms. While the pro-reform team consisted of only a handful of advisors to the Deputy Prime Minister, his political power (and that of the team) grew during the first two years in office as the dismal fiscal state of the government was becoming apparent. (We note that early transition in Poland displayed a similar feature. The Polish economy was in such a grave state when Communism collapsed that it was not possible to adopt gradual reforms. Radical reforms were applied, deflecting the demands of reform's likely losers; *see* Balcerowicz, 1995.)

2. *How could the center-right parties, lead by the incumbent Slovak Prime Minister Mikuláš Dzurinda, achieve an election victory in 2002 given that they already implemented a number of painful reforms and were likely to carry out many more? Why were they not defeated by votes of the unemployed whose social support were to be lowered or the low earners worried that the advertised flat income tax would primarily benefit high-income groups?*

⇒ We note that the first government of Mikuláš Dzurinda did fulfill the integration ambitions of the Slovak population (OECD, NATO and the EU) and the expectations of improving the democratic deficit of the previous Mečiar governments. Consequently, there was a comprehensive change in the mood of the public, as evidenced by public opinion polls (conducted by the Institute for Public Affairs, Inštitút pre verejné otázky). While in 1997, the Slovak public cared mostly about improving politics and anchoring democracy, by 2001 the most important topic was fighting unemployment, which was an important agenda of the center-right parties.

⇒ A second factor contributing to the center-right victory in 2002 may have been the turn-out-the-vote campaign organized by many NGOs and financed in part by Freedom House Slovakia, which received US$ 1 million from the U.S. government and distributed these and other funds to individual NGOs. While in February of 2002, the expected turnout was only 50 percent, it reached 70 percent at the time of the elections so that Slovakia tied with Hungary for the highest voter turnout in the 2001-2002 elections in the Visegrad region. According to Freedom House Slovakia, the main target group of the campaign consisted of well-informed, urban, educated, and pro-democratic voters. Indeed, for the first time, the turnout of urban voters was higher than that of rural voters and these voters supported pro-market reforms, and a pro-NATO, pro-EU political agenda.

⇒ Equally important was the partial disintegration and splintering of the anti-reform Mečiar's party and of the ultra-nationalist party shortly before the elections. The big surprise of the elections, however, was the failure of the new party of a young left-wing law-and-order populist Robert Fico who led in the pre-elections opinion polls. It is likely that due to the integration achievements of the first Dzurinda government, splintering of the opposition, together with the generally conservative nature of the Slovak voters, people voted for the "devil they knew" and re-elected most of the same center-right parties.

⇒ One could cast the 2002 Slovak elections in a simple voter decision model where the public would prefer milder reforms, but was offered a choice of either a complete lack of reforms (represented by the Fico and Mečiar's parties) and extensive reforms (represented by the group of center-right parties in the current coalition). Because the

Fico and Mečiar's parties were potentially standing for unsustainable anti-reform policies, the center-right parties could afford to offer a bolder reform agenda.

3. *A related question is why potential losers from the new Slovak policies did not manage to prevent or thwart the labor market reforms once the new government proposed them. In particular, the trade unions stood to lose from a flexible Labor Code and a more dynamic labor market. Why, in contrast, are the Czech trade unions more successful in pursuing their agenda?*

⇒ The post-2002 Slovak government, in contrast to the post-1998 one, does not feel restrained by trade unions in pursuing its policy. Most of the policy reform measures adopted in 2003 was opposed by the trade unions in the tripartite council, but the government managed to get enough support for them in the Parliament. Apart from not being successful in the official social dialogue, Slovak trade unions were not able to organize large-scale strikes. (One exception was the strike of railway workers in early 2003 protesting the closure of certain railway routes. The strike ended without the trade unions prevailing.) Slovak trade unions also have little presence in the Parliament, which is in sharp contrast to the Czech case. One possible explanation for the lack of the power of Slovak trade unions is the higher unemployment rate that may make its members more worried about losing their jobs in case of a strike. Another possible explanation is that the capacity constraint problem described in Section 4.1 applies also to trade unions. The management abilities of Slovak trade union leaders were too low until now to mount an effective anti-reform campaign. While the Czech trade unions faced right-wing governments until 1997 and learned how to effectively fight the governments in the media, mount strikes, and negotiate concessions, the Slovak trade unions are in a position to acquire some of these skills only after the 2002 elections.

4. *Why are the Slovak reforms of 2003 so deep and wide reaching? How was it possible to design and adopt such far-reaching reforms in a record time of one year?*

⇒ The current relatively homogenous coalition of four center-right parties views this government's term as *the* opportunity to revamp the country and put a lasting mark on the reform landscape of Slovakia. This opportunity must be seized before populist parties regain hold of the country that is likely to happen after the next general elections. Further, the majority of far-reaching reforms (tax, pension, public finances, social security and social benefits, and Labor Code) have been concentrated in the first year of the election term while the reform consensus lasts and so that their positive effects may be felt before the next general elections.

⇒ The capacity constraint in the new administration, while still large compared to other countries, is substantially smaller in the second Dzurinda government. As a result of bringing Slovakia into the fold of democratic nations and with the prospect of EU entry in May 2004, some young graduates from Western universities have returned to Slovakia and took up positions in the state administration. Such teams are particularly visible in the Ministries of Finance (headed by Ivan Mikloš) and Labor.

⇒ After the 2002 elections, the Cabinet also wanted to accelerate reforms prior to joining the EU. While most of the 2003 reforms are in the jurisdiction of national governments, it might be harder to get them adopted faced with the peer pressure from other states worried about competition in terms of low taxes, funded pensions, or greater labor mobility.

⇒ Some commentators argue that the level of maturity of the Slovak political system and society is still lagging behind its neighboring countries. Therefore, the public discussion and scrutiny of the reform proposals was not as strict as it would be, for example, in the Czech Republic. Hence, all that is required for deep structural reforms is a majority in the Cabinet and Parliament, not necessarily a society-wide consensus. While this has enabled the adoption of the 2003 reform program, it also made the government more exposed to the upcoming social and political challenges, such as the recent Roma riots or the upcoming April 2004 referendum on early elections.

5. *Why are the Czech reforms only mild? Are any interest groups blocking reforms?*

⇒ The Czech Social Democrats are pushed into undertaking fiscal reforms by the unsustainable evolution of government finances. Cutting down government expenditures, however, is against their political agenda and conviction. Furthermore, the current Czech government has only a small majority in the Parliament that makes the ruling party vulnerable to capture by lobbyist groups often composed of a handful of its own MPs.

⇒ Further, the Czech Confederacy of Trade Unions (CMKOS) is closely tied to the ruling party and well organized. Historically, trade unions have recorded some victories even under the right-wing Klaus' governments and are able to organize nation-wide "warning strikes" of symbolic duration. The Czech Minister of Labor is a former trade union official. Representatives of the trade unions were elected into the Parliament on the Social-Democratic candidate list. They are able to use this power to directly affect the Czech fiscal and other reforms. For example, they managed recently to lower the higher retirement age for women with children from the one originally proposed by the government.

In sum, the political pendulum propelled by the 1997(8) economic crises installed an anti-reform Social Democratic government in the Czech Republic and a left-right coalition in Slovakia, which was forced into some labor market reforms by strong fiscal pressures. While trade unions opposing reforms have gathered political power under the Czech Social Democratic governments, Slovak trade unions remained weak until recently and were not able to thwart a sweeping reform agenda of the post-2002 center-right government. The painful character of the most recent far-reaching Slovak reforms now helps the groups of reform opponents mobilize and mount political opposition. The next several weeks and months will show whether the political representation that pushed through the far-reaching reforms in 2003 will survive in its current form the rising social unrests (especially among the Roma community in Eastern Slovakia) and the planned April referendum on early Parliamentary elections.

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