FLAT TAX REVOLUTION?: POLICY CHANGE AND POLICY DIFFUSION IN EASTERN EUROPE

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Joseph Michael Ellis
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Examining Committee Members:
Dr. Richard Deeg, Committee Chair, Political Science
Dr. Sandra Suarez, Political Science
Dr. K. Orfeo Fioretos, Political Science
Dr. Mitchell Orenstein, External Reader, Johns Hopkins University

ABSTRACT

Why have Eastern European states adopted flat tax policies? That is what this dissertation answers. This is a curious development given that flat tax policies were noticeably absent from the landscape of most of the world, including Eastern Europe. Fives cases of adoption are examined, including Estonia, Latvia, Lithuania, Slovakia and the Czech Republic. I argue that two simultaneous processes occur in Eastern Europe that makes adoption viable. First, at the domestic level, the idea of the flat tax is held in esteem by a number of actors, specifically: elite carriers, tax and financial ministers, think tanks and right-wing political parties. They champion this idea to its adoption, or at the least, introduce the flat tax into the policy-making apparatus. Second, at the international level, policy diffusion of the flat tax is taking place. In other words, the experience of previous adopters impacts the decisions of future adopters. Examining both cognitive heuristics theory and rational learning I argue that there are "varieties of diffusion" during the diffusion of the flat tax. Additionally, though this dissertation concerns itself primarily with adoption, I also investigate two cases of non-adoption in Poland and Hungary. What is argued is "diffusion without adoption" occurs. The idea of the flat tax diffused, but the adoption was not politically, ideologically, and economically feasible.

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DEDICATION

To Don and Pauline Barnett.

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CHAPTER 1

INTRODUCTION

Research Question

In 1994 Estonian Prime Minister Mart Laar came to power behind a strict policy of liberalization of the economy and an adherence to the principles of neoliberalism. Laar's first order of business was to figure out a way to solve Estonia's tax revenue and collection problems (Smith 2002, 119). He answered by eliminating Estonia's gradual, or progressive, taxation structure in favor of a 26-percent flat rate on incomes, a rate that is now just 21-percent. Since the adoption of the flat tax the fortunes of Estonia have greatly changed. Estonia gained admission into the European Union and has become a showcase country for economic growth and acquiring foreign direct investment. This is not to argue that flat taxes caused the above events. In fact, it is beyond the scope of this dissertation to draw any kind of conclusions about the efficacy of the flat tax in relation to economic windfalls. However, straightening out its budget and revenue woes went a long way toward signaling to others that Estonia was at least serious about reforming their country. All told, thirteen countries in Eastern and Southeastern Europe have adopted flat taxes in the last fourteen years.[1] (See Table 1). This development is all the more surprising because only one country in the world – Hong Kong – had a flat tax prior to Estonia.

[1] The other twelve countries are: Albania, Montenegro, Macedonia, Georgia, Romania, Russia, Czech Republic, Bulgaria, Slovakia, Ukraine, Latvia, and Lithuania. See Table 1 for tax rates and adoption dates.

Table 1. Tax adoption and rates (personal and corporate)		
COUNTRY	ADOPTION YEAR	RATE (PERSONAL/CORPORATE)
Estonia	1994	21/21
Latvia	1995	25/15
Lithuania	1995	24/15
Russia	2001	13/24
Serbia	2003	14/14
Ukraine	2004	15/25
Slovakia	2004	19/19
Georgia	2005	12/15
Romania	2006	16/16
Macedonia	2006	10/10
Montenegro	2007	15/9
Albania	2007	10/10
Czech Republic	2008	15/21
Bulgaria	2008	10/10

The adoption of the flat tax was a surprising development that caught not only practitioners, but also scholars, off guard. It is surprising because the flat tax had little real world use, and also because Eastern Europe was in disarray and would be one of the last places to look for policy innovation. The problems were serious. “Postcommunist governments [in Eastern Europe] suffered from both tax evasion and weak control over the use of resources that were collected,” noted political scientist Linda Cook (2007, 21-22). What made it more difficult was the rapid switch to privatize formerly state-led economies. The tax bureaus had no way to track financial transactions and outflows. Governments lost revenue, could not fund basic social services and corruption was rampant. As Cook also stated, governments would go on to cut public sector salaries, increasing the incentive for bribery and under-the-table operations (Cook 2007, 22). One of the foremost experts on Eastern Europe’s transition, Anders Aslund, argued that the socialist economy had “no real tax system” to begin with. “At the end of each year, the state simply confiscated the remaining profits from state enterprises" (Aslund 2007, 116). Personal income tax – which is at the heart of this study – did not have a Soviet equivalent. Most of Eastern Europe, including the cases studied in this dissertation, adopted a model of progressive taxation which was unfamiliar to them.[2] Combine that with the problems of shock therapy, bureaucratic inefficiency, and corruption, and many in those states believed their tax system needed an overhaul.

This is a story about the flat tax. But this story reveals some important lessons to researchers in comparative public policy and comparative political economy along the way. My dissertation seeks to explain why democracies in Eastern Europe have adopted flat tax policies. In the course of answering this question I will engage many of the major questions of public policy scholars, namely: Why do states adopt new policies? Where do these new policies derive? And, why do other states adopt similar or the same policies? This dissertation also tries to add to the theoretical and academic debates about policy change.

First, it attempts to make sense of the flat tax as an *idea*, and not just as a policy. Ideas are mental constructs that both prescribe and prohibit political and economic choices. Whereas policies are made tangible by its introduction into the policy-making process, ideas exist in a less-tangible world – the mind for example – that only see the light of day when a policy crisis (e.g. the failure of progressive taxation) is revealed. Of course the flat tax is a policy with considerable consequences, but it is also wedded to

[2] Progressive taxation has sources in Adam Smith's *Wealth of Nations*, where he argues for taxation that is proportional to one's revenue (Smith as cited in Cahn 2004, 341). In Karl Marx's *The Communist Manifesto*, Marx argues that a "heavy progressive or graduated income tax" is a mechanism to redistribute wealth quickly (Marx 1978, 490). The vanguard for progressive tax was predominantly found in Western European governments and in the United States. The most graduated rates are seen in the Scandinavian countries of Norway and Sweden with top brackets reaching 60-percent. The rates are more moderate in the United States where the highest rate tops out at 35-percent.

certain ideological considerations and comes out of a specific neoliberal literature of the 1960s. By recognizing first its ideational qualities it helps to further understand why some countries opted for flat taxes when others did not. One can see these ideas in action by examining political discourse, whether that is in parliamentary debates, interviews with print or television media, or primary source texts like Milton Friedman's *Capitalism and Freedom* which actually introduce a new idea.

Second, the dissertation seeks to understand why innovations like the flat tax are adopted by other countries, what is called *policy diffusion* in the literature. The policy diffusion literature has been growing since at least the publication of Jack Walker's study of policy change and "adopter characteristics" throughout the American states in 1969, and Virginia Gray's 1973 study that examines "innovation attributes" across policy adopters (Clark 1985, 62). In the 1990s, Frances Berry and William Berry detailed the diffusion of such policies as state lotteries in the United States (Berry and Berry 1990). More recently scholars such as Kurt Weyland and Beth Simmons have been instrumental in taking policy diffusion research beyond the United States, applying their comparative techniques to Latin America and Western Europe respectively.

This dissertation details how the unfamiliar flat tax came to be accepted by others. Previous social scientists have observed how once unheralded policies like privatized pensions or monetarism, for example, were diffused and adopted to the point that those policies became the norm.[3] The flat tax went through a similar transition, a policy that was largely unused to a policy that became the norm in Eastern Europe. Where I depart with the traditional literature on policy diffusion is twofold. The dissertation recognizes

[3] For example, see Weyland's (1998) work on pensions in South America and Kathleen McNamara's (1998) book on the Western European shift to monetarist policies and away from Keynesianism.

that policies diffuse in a number of ways; what I term *varieties of diffusion*. I also argue that policies can diffuse without being adopted; that is, a policy idea can present itself to a state without a state having the political ability or opportunity to formally adopt it. This is what I call *diffusion without adoption*.

The *varieties of diffusion* concept contests the notion that policy diffusion is the result of one "pathway" to diffusion. In this dissertation I argue that the "timing" of the diffusion process is crucial to understanding the type of diffusion one will see take place. For example, the length of time from the first adoption (Estonia) to the very next diffusion (Latvia) – just one year -- details a very different adoption process than a diffusion that comes some ten years later, like Slovakia or the Czech Republic. Moreover, the political and economic landscape has changed considerably from 1994 to 2004, making policy change a more tedious and difficult process. A Weyland points out, diffusion processes over time become harder as reform costs and reform benefits come to fruition and the "initial enthusiasm [of a policy or idea]…fades away" (2006, 50).

Contrasting *cognitive heuristics* diffusion from *rational learning* diffusion, this dissertation argues that the more an actor, or group of actors, know about a given policy the harder it is to adopt that policy. Cognitive heuristics theory notes that actors are "bounded" and limited by the things they know, or can know, at a given time. Because Latvia and Lithuania only knew a few things about the flat tax, and those few things were predominantly favorable, they moved quickly fix the problems they were experiencing with their revenue stream. On the other hand, Slovakia and the Czech Republic knew considerably more – both plusses and the minuses of the policy – and in reality "learned" from prior adoptions, or what is described as rational learning.

Diffusion without adoption contests the notion that diffusion and adoption is the same process. First, the diffusion of *ideas* is a central force in shaping political discourse, dividing party lines and shaping public policy. The fact that the flat tax diffused throughout Eastern Europe is important in that respect – and changed politics in those countries – despite the fact that the flat tax policy might not have been adopted. Second, diffusion itself changes the prospects for adoption. For example, when Hungary found out that Slovakia adopted a flat tax it sent two distinct yet important signals to politicians. The signal meant that Hungary was either far behind a historically laggard Slovakia (a cause for embarrassment), or that Hungary wanted nothing to do with an experiment that was practiced in Slovakia, meaning Slovakia's political experiments were beneath them. Hungary's flat tax discourse was shaped around these diffused ideas and their sources.

Argument in Brief

In trying to understand why states adopt new policies I situate the research within three competing explanatory approaches: external pressures (or leverage), rationalist and ideational. (See Table 2). My argument is that the ideational framework helps to explain the adoption of the flat tax in Eastern Europe. My argument is predicated on the inability of power explanations or rationality alone to explain the adoption of new policies in Estonia, Latvia, et. al. This ideational argument takes into consideration arguments about external pressure and rationality, but suggests that those arguments alone cannot explain in entirety policy change in Eastern Europe. Those approaches also detail three important variables: coercion, interests, and ideas. (See Table 3). External pressure approaches highlight coercion (or power) as a central variable in policy change. That is, states are coerced into adopting public policies by powerful outsiders, in this case external institutions. Rationalist approaches highlight interests as a variable in policy change. Interests causes policy change when the actors involved in adoption do so to satisfy some sort of rationally expressed self-interest, whether that is collecting revenue, attracting the attention of foreign investors, or trying to get reelected. Ideational approaches privilege ideas as the most important factor in policy change. The ideas that actors hold at a given time are the most influential component part for the choices they end up making.

Table 2. Explanatory approaches

EXTERNAL PRESSURE	RATIONALIST	IDEATIONAL
Privileges role of external institutions in policy change (e.g. IMF, World Bank, European Union) Coercion is central to policy change Assumes states lack agency to resist change	Privileges rationality and self-interest as determinants in policy change Actors are goal-oriented and change policies to suit their political or economic outlooks Assumes actors (both domestic and external) have agency.	Privileges ideas as central to understanding policy change Actors bracket policies within an ideational framework that both prescribes and limits policy choice Assumes actors are agents and not coerced but also make decisions beyond self-interest

Table 3. Causal variables in relation to three explanatory approaches

EXPLANTORY APPROACHES	CAUSAL VARIABLE
External Pressure	Coercion
Rationalist	Interests
Ideational	Ideas

If ideas have causal significance, two sets of related questions must also be answered. First, what is the process by which ideas are translated into actual policy outcomes? Do elites determine the success of ideas, political parties, government bureaucracies, think tanks or epistemic communities? Second, how does one account then for its rather rapid acquisition in other countries? This will involve investigating the methods of 'policy diffusion' across the flat tax countries. As Simmons, Dobbin and Garrett note, policy diffusion "occurs when government policy decisions in a given country are systematically conditioned by prior policy choice made in other countries" (Simmons, Dobbin and Garrett 2008, 7). The flat tax is case in point. Every Eastern European country that examined tax reform after Estonia was conditioned to address the flat tax, whether that was by adopting it or bringing it up to only reject it.[4] What this dissertation does is establish a link between early adopters and late adopters. Additionally, it creates a distinction between "diffusion" and "adoption" that has not been satisfactorily addressed in the literature. Whereas diffusion addresses the processes by which ideas get from one place to the next, it takes for granted that once those ideas are in place it does not mean they will be adopted.

Only recently has anything been written extensively about the flat tax in the political science literature despite the fact the tax has been in action in Eastern Europe since 1994. (See Evans 2005, Aligica and Evans 2009, Baturo and Gray 2009). Like previously noted, my argument privileges the ideational framework that has been popularized over the last twenty-five years in the political science literature. I investigate where the flat tax idea originated, why it became so popular in Estonia, and further, why the idea spread to other countries in Eastern Europe. Along the way the *idea* of the flat

[4] Other than Hungary and Poland, most countries chose the former rather than the latter.

tax gave way to the *policy* of the flat tax. What is meant by this is the flat tax was once mainly an abstraction, written about in textbooks but rarely practiced. Over the course of the 1990s, the flat tax was realized as a policy option. In other words, the flat tax was made tangible.

Though the ideational framework is used, this dissertation does not argue that it is ideas "all the way down" (Wendt 2003, 92). Whereas the constructivist approach used by Alexander Wendt argues that ideas actually *constitute* the material basis of world politics, this dissertation argues that ideas are distinct causal variables that explain policy change where the leverage and rationalist approaches leave off. I argue that new ideas come into action after an initial crisis is revealed (McNamara 1998). The flat tax became a solution to a perceived crises, in this case the inability to collect taxes, the problem of shadow economies, or the belief that budget woes contributed to not being able to attract foreign direct investment. The leverage applied by international institutions and "external pressures" is also considered. There was little in the way of external pressure from groups like the IMF, World Bank or European Union to adopt a specific model of taxation, other than the Washington Consensus's edict to have taxes that are 'broad, moderate and marginal" (Williamson 1990).

Instead, the idea of the flat tax was transferred by those in the "trenches" of policy reform. Political parties, tax administrators, elites (or policy carriers, or "champions"), and think tanks were instrumental in relaying the flat tax idea to the public and to other political reformers. John Campbell's typology on the different types of ideational actors is helpful in understanding how ideas can translate into policy. In particular, he identifies "decision makers" and "theorists" as two important groups in any ideational change. He notes how decision makers are the crucial players in putting the flat tax into action. Parties and elites are two decision makers because they have the access to actually change public policies. But decision makers also have a close relationship with theorists. Theorists – housed in think tanks, universities, and sometimes in finance ministries – are engaged in actually creating and relaying the ideas to decision makers. There are cases where the two groups overlap, of course. Slovakia's Ivan Miklos not only helped found a Think Tank (MESA-10) where flat tax ideas were prominent, but he also served as Mikulas Dzurinda's finance minister and was the chief decision maker regarding taxation in Dzurinda's administration.

Once the flat tax is revealed in Estonia, the processes of diffusion were made more apparent in analyzing other adoptees in the Baltics, Slovakia, and the Czech Republic. These processes are also seen in Poland and Hungary, though the tax there has yet to be adopted. The investigation of these six cases also demonstrates varieties of diffusion. Using Kurt Weyland's four typologies of diffusion (external pressures, normative and symbolic appeal, rational learning, and cognitive heuristics) I address how diffusion proceeds differently from case to case. For example, in the case of Latvia and Lithuania, the cognitive heuristic model explains their decision to adopt a flat tax, whereas in the former Czechoslovakia "rational learning" appropriately explains flat tax adoption.

What is happening in Eastern Europe is a sort of two-level game, though I am using that term very liberally. Robert Putnam, in his classic article on two-level interactions, argued that foreign policy-making took place at "two levels". Domestic actors had to behave in such a way that accomplished their policy goals at the domestic level, but at the same time existed in an international context with goals at that "level" as well (Putnam 1988, 434). Once again, I am taking liberties with this concept. Putnam's argument was primarily about diplomacy and situated within the literature in international relations. This study investigates political economy by and large within the comparative context. There are similarities between these two studies, however. On the one hand, this dissertation strongly argues that flat tax adoption was a domestic political occurrence. It was adopted by domestic actors (policy elites and tax bureaucrats) without interference from international actors, or because someone on the outside coerced them to do it. They did so to accomplish a policy goal and solve a perceived political and economic crisis in their own country.

On the other hand, while the adoption itself is domestic the sources of these ideas are quite international. Starting with Estonia – where Laar learned of the flat tax from Milton Friedman -- the idea of the flat tax circulated through international and regional conferences, among cosmopolitan think tanks, and with determined policy champions. For example, Laar has been critical in relaying the idea of the flat tax not only in domestic circles but international ones as well. Laar's influence has extended to prime ministers in Slovakia, Georgia and Kazakhstan. Slovak's Mikulas Dzurinda and President Rudolf Schusterv met with Laar in 2000. During the meeting, then President Schuster "showed active interest toward the Estonian tax system," to which Laar briefed the President on the flat tax system point by point ("Estonian PM Mart Laar Said..." 2000). In the Czech Republic, Prime Minister Mirek Topolanek hosted a conference entitled "Flat Tax – the Basis of Tax Reform" in June 2005. The conference included politicians from nine European countries and became something of a "Who's Who" in the flat tax vanguard. Among others was Slovakia's finance minister Ivan Miklos, former Estonian Prime Minister Juhan Parts, the Czech Republic's own finance minister Vlastimil Tlusty and Daniel J. Mitchell, currently a policy analyst for the Cato Institute ("Mirek Topolanek Joined By ODS Foreign Partners…" 2005).

Though the domestic side engages in the actual adoption, the international arena becomes the space for ideas to travel. Additionally, while the domestic goals of the flat tax are to solve specific political or economic problems brought forth by the inability to collect revenue, the international goals are broader. The purposes of the conferences and international meetings are not only to advance the position of the flat tax as a policy, but also to engender an international discourse on the flat tax that furthers the idea across the Eastern European landscape. Undoubtedly, policy diffusion itself is a highly international process, and as this dissertation will show, a domestic-international interplay is at work for the flat tax to be a viable policy choice. Table 4 details a basic sketch of the causal process involved in taking an idea (like the flat tax) and translating it into a public policy. (See Table 4).

Table 4. Causal process

INITIAL CRISIS	CAUSAL MECHANISM	DOMESTIC DELIVERY MECHANISM	INTERNATIONAL DELIVERY MECHANISM
Tax evasion, black markets, inflation, inability to collect revenue	Ideas change	Tax bureaucrats, Think tanks, Policy champions, Political parties	Policy diffusion

Lastly, three other variables are addressed that are vital to understanding policy change and policy adoption. These can make or break whether a state can adopt a flat tax

(See Table 5). In fact, these variables taken together proved crucial in understanding Hungary and Poland's non-adoption of the flat tax. First, is the aforementioned variable of timing. It is argued here that as the flat tax process goes on it gets considerably more difficult to adopt a flat tax, even when the idea of the flat tax has diffused. This is because the flat tax is more of a known quantity than it was in early adoptions. While these "knowns" can bolster flat tax adoption – if actors see that it works for example – these knowns can also be debilitating, as critics find out it increases income inequality, or favors some interests over others. Second, public opinion can go a long way to advancing or halting the progress of a flat tax. Where public opinion is supportive, or at least indifferent to policy change, it makes adoption possible. If the constituents rally against a flat tax it makes it electorally dangerous for politicians to change from one policy to another. Thirdly, is something we might call "political environment" but it could be more broadly understood as having a political system conducive to adoption. This could mean the ability of parliamentarians to form a coalition stable enough to drive home a policy, or having a federal structure where competing branches are on the same page about a policy.

Table 5. Additional variables

VARIABLE	BEING TESTED
Public opinion	Whether public opinion favored flat tax and was conducive for adoption
Political environment	Whether political environment was conducive to adoption
Timing of adoption	Whether the timing of adoption (early or late) was conducive to adoption

Case Selection

A quick note must be made about the case selection before moving forward. This dissertation looks at seven cases, five of which adopted a flat tax, including Estonia, Latvia, Lithuania, Slovakia and the Czech Republic. Two cases of non-adoption are also investigated: Hungary and Poland. Though the study question investigates flat tax adoption, Gary King, Robert Keohane and Sidney Verba in their classic text on qualitative methods said that allowing for some variation on the dependent variable is a "basic and obvious rule" that actually helps to explain the research question at hand (1994, 129). For example, one cannot understand the conditions necessary for flat tax adoption if it does not include some discussion of the conditions necessary to prevent such an adoption.

However, as Table 1 indicates, a number of countries in Eastern, Central and Southern Europe have adopted flat taxes in the last fifteen years that were not studied in this dissertation. Included are those countries that make-up the former Yugoslavia (Serbia, Macedonia and Montenegro), several post-Soviet states (Russia, Georgia and Ukraine), and Romania, Bulgaria and Albania. These states were not included in the dissertation. Why? Once again, the work of King Keohane and Verba is instrumental. Advocating for what they call "unit homogeneity," the authors argue that research designed without controls will more likely than not create biased research, where omitted variables and measurement error are prominent. To avoid this problem, the authors argue that researchers should identify cases "alike in as many respects as possible," except for a key independent variable (King, Keohane and Verba 1994, 200). So ideas, a key independent variable in this work, might be different from actor to actor. However, their general political and economic environment would similar, approximating a more valid casual effect. King, Keohane and Verba admit that comparing across countries is always difficult because they “vary among innumerable dimensions”. Nevertheless, controls like democracy and economic openness are still valuable to prevent bias (King, Keohane and Verba 1994, 201).

First, the dissertation controlled for countries with solid democratic procedures, precluding Russia, Georgia, Albania, Macedonia and Montenegro.[5] (See Table 6). A key reason to analyze the flat tax in democratic countries is because the transparency of democracy brings to light the decision-making processes that go into policy change. The presence of a free press, the willingness of elected officials to talk to reporters and interviewers, the public accessibility of parliamentary records, and the overall availability of “public discourse” is more prevalent in a democratic country than a partly free, or pseudo-democratic one. This is not to argue that one cannot study policy change in an authoritarian state. Scholars such as Checkel have effectively studied policy change in the Soviet Union, not an epicenter for democracy (Checkel 1997, 18).

Table 6. Political system

COUNTRY	POLITICAL SYSTEM
Estonia	Parliamentary Republic
Latvia	Parliamentary Democracy
Lithuania	Parliamentary Democracy
Slovakia	Parliamentary Democracy
Czech Republic	Parliamentary Democracy
Hungary	Parliamentary Democracy
Poland	Republic

[5] Freedom House defines Russia as a “Not free” state, with Georgia, Albania, Macedonia and Montenegro being all “Partly free” states.

Second, the dissertation controlled for wealth, or GDP per capita. The seven countries studied in this dissertation are all in the top-40 of the World Bank's GDP-per capita list. In fact, all seven are currently within eleven places of each other, with the Czech Republic the 29th richest per capita country and Latvia the 40th richest.[6] At the time of Estonia's adoption of the flat tax in 1994, wealth was also fairly similar between states, save Hungary. (See Table 7). Controlling for wealth is important insofar as wealth has long been recognized as an important feature of states that can impact politics and ideology. This precludes Serbia, Romania and Bulgaria, each of which were outside the parameters to safely control for income, both presently and at the time of adoption.

Table 7. GDP per capita (in US dollars)		
COUNTRY	GDP 1994	GDP at time of adoption (or diffusion)
Estonia	$1530	$1530
Latvia	$1440	$1777
Lithuania	$1143	$1623
Slovakia	$2899	$13300
Czech Republic	$4117	$24400
Hungary	$8529	$19500
Poland	$2686	$16200

Finally, the dissertation adopts the approach of a "controlled-case comparison". In a controlled-case comparison the researcher tries to control, as much as possible, for anything that would fundamentally alter the conclusions of research if not held constant throughout (Van Evera 1997, 56). Drawing from Van Evera I have created three "controlled-case comparisons" within the project: the Baltics, the former Czechoslovakia, and Poland and Hungary. This "regional" perspective takes into account the differing

[6] The information can be found at http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP_PPP.pdf

historical, political, social and economic origins between the Baltics and Visegrad countries, while still controlling for regime-type and wealth. I am comparing both within the controlled-case comparisons and across the seven cases more generally. Estonia, Latvia and Lithuania make up what is collectively called the "Baltics" for their proximity to the Baltic Sea. A number of interviewees noted that all three countries closely monitored each other's political and economic decisions. Slovakia, the Czech Republic, Hungary and Poland make up the Visegrad countries, named for a town in Hungary where Central European emperors met in the Fourteenth Century to discuss international cooperation.[7]

Within the Visegrad group, two additional "controlled-case comparisons" are present. A perfect controlled-case comparison is the comparison of the Czech Republic and Slovakia, which at one time were the same country. Linguistic, cultural, political and economic patterns are historically similar, but the road to flat tax in both states was also markedly different at times. A final controlled-case comparison is the countries of Hungary and Poland. Hungary and Poland (along with the Czech Republic) are consistently paired in the literature as the "leaders" of Eastern European politics, though the countries are not geographically aligned the way the Baltics and the former Czechoslovakia are. (For example, the first NATO expansion after the Cold War included Hungary, Poland and the Czech Republic). In the latter chapters of the text I will go into more detail about the specifics of the chosen cases.

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[7] For further information on the Visegrad countries, a plethora of information is available on the Visegrad Group website, hosted by the European Union: http://www.visegradgroup.eu/main.php?folderID=925

Dissertation Outline

The dissertation is laid out in seven chapters (including this chapter). Beginning with Chapter 2, I open with an account of why investigating flat taxes in Eastern Europe is an important question, not only for scholars of post-communist transitions, but for scholars of public policy and policy diffusion more generally. I go on to investigate the literature on policy change and the three preeminent approaches that can be used to understand why a state might decide to change from one policy approach to another. The literature is drawn predominantly from the field of comparative political economy, with some investigation of international political economy as well. In this chapter my explanation of policy change is presented, as are the rival explanations. Lastly, the "thickly descriptive" methodology of process tracing is spelled out as well.

Chapter 3 details the case of Estonia in its march to the flat tax. Estonia is an important country because it was the first country to adopt the flat tax in Eastern Europe. This chapter does not explore specifically the process of policy diffusion as it is understood in the literature; i.e., where policy change occurs within a specific timeframe bounded by geographic considerations. It is true that a type of diffusion happens, that is, the flat tax idea was retrieved from "outside" sources in the United States, specifically Milton Friedman's 1964 *Capitalism and Freedom* – which he wrote while a faculty member at the University of Chicago – and Robert Hall and Alvin Rabushka's 1985 primer on the flat tax entitled *The Flat Tax*, which they wrote while on staff at the Hoover Institution, housed at Stanford University. This chapter argues that Estonia responded to the problem of tax collection and evasion by retrieving this idea from the 1960s and

1970s to help sort out their dilemma. It also details how domestic actors like political elites and nascent political parties rather than external interests navigated Estonia's problem and ultimate solution. In short, the flat tax seemed to solve a pressing problem of tax evasion and revenue shortfalls, like the rationalist approach would predict. However, the *idea* of the flat tax and what it meant to policy carriers also held considerable weight, making any policy change beholden to certain ideas and those that held them.

Chapter 4 introduces the early adopter cases of Latvia and Lithuania. This chapter assesses their decision to adopt a flat tax in 1995 in light of Estonia's decision to adopt the flat tax one year earlier. The chapter asks whether or not Latvia and Lithuania adopted the tax reform by studying or understanding Estonia's example. The answer is "yes", with some qualification. While Latvia and Lithuania "learned" — in a manner of speaking — from Estonia, they did not fully understand the implications of adopting a flat tax. This is what is called the *cognitive heuristic* model of policy diffusion. It was a rational solution to the problem of tax evasion, but unlike in Estonia tax discussions were not nearly as ideological or tied to right-wing parties or elites.

Chapter 5 discusses the late adopter countries of Slovakia and the Czech Republic. Slovakia and the Czech Republic did not adopt a flat tax until 2004 and 2008 respectively. This chapter assesses the flat tax in light of growing debate surrounding tax reforms in Eastern Europe. What Slovakia and the Czech Republic experienced was an institutional environment that was fundamentally different than the one faced by Estonia, Latvia and Lithuania. By the time Slovak and Czech elites were considering adopting a flat tax to solve fundamental issues of tax evasion and flourishing black market economies a wellspring of opposition parties and elites had come to the forefront. It took committed neoliberals to overcome the opposition, and in the case of the Czech Republic, several years to find a Prime Minister and parliament with the will to change the tax code. Slovakia and the Czech Republic also demonstrate what I call *varieties of diffusion* within the basic policy diffusion model. (See Table 8). Like Latvia and Lithuania, Slovakia and the Czech Republic adopted the flat tax, but it could not be considered an adoption based on cognitive heuristics. Instead, *rational learning* was a prominent part of policy diffusion. By 2008, almost everything there was to know about the successes and failures of the flat tax were available for public consumption, meaning those parties and elites for and against the flat tax knew full well what they were getting involved in.

Table 8. Varieties of diffusion

COGNITIVE HEURISTICS	RATIONAL LEARNING
Human rationality is bounded by innate limitations on information processing	Political action is goal-oriented and driven by interests
Use inferential shortcuts or heuristics to obtain information on policies	Learn policies by having access to information and knowledge of policy effects

Chapter 6 introduces the "non-adopters" of Hungary and Poland. Though both countries have had serious discussion about the flat tax, neither country adopted it. This is what I term *diffusion without adoption*. The idea of the flat tax diffused to both Poland and Hungary via the rational learning model. (See Table 9). Political elites and parties learned of the flat tax from the Baltics, Slovakia and the Czech Republic. However, both countries lacked either the political will (in the case of Hungary) or the appropriate political environment (in the case of Poland) to adopt the flat tax. In the Polish example, a center-right pro-flat tax party came to power in Parliament but could not bring the flat tax to fruition because then President Lech Kaczynski threatened to veto any legislation that changed from a progressive scale. In Hungary, the major center-right party promoting the flat tax was both highly unpopular and unable to form a stable coalition to get the flat tax passed. This chapter is important because it helps understand not only the ideational components required for the flat tax to be part of a policy agenda but also highlights how "political" policies can become over time. Of course, all public policies are by their very name "political". What is meant by this, however, is that by the time the flat tax reaches Hungary and Poland the flat tax is politicized in such a way that makes adoption more difficult. Whereas in the Baltics the flat tax evolved as a (relatively) non-controversial policy, the longer time went on and knowledge of the costs and benefits of the flat tax emerged, the harder it was to adopt the flat tax.

Table 9. Policy diffusion

COUNTRY	VARIETY OF DIFFUSION	ADOPTION
Latvia	Cognitive Heuristics	Yes
Lithuania	Cognitive Heuristics	Yes
Slovakia	Rational Learning	Yes
Czech Republic	Rational Learning	Yes
Hungary	Rational Learning	No
Poland	Rational Learning	No

Chapter 7 concludes the dissertation by summarizing the story of flat tax adoption, but also situating this narrative within the broader literature on policy reform in Eastern Europe. First, I recount which variables were validated and invalidated in the seven cases analyzed. Second, I address some of the component parts of flat tax adoption by looking at domestic elites or 'carriers', center-right political parties, and knowledge communities as they relate to the policy of the flat tax. I also turn my attention to the extent to which the flat tax idea became a vital policy instrument to solve the real problems associated with tax collection. Thirdly, the mechanism by which policy diffusion is made successful is deliberated. Lastly, the chapter places the flat tax debate within the context of Eastern European political economy. What does the flat tax mean for the discipline, and what does it say more generally about policy change in Eastern Europe? Furthermore, how is this debate trending and what are the pertinent issues for future study of the flat tax? I address these issues and also ask one last question: What makes the "flat tax revolution" all that revolutionary?

Conclusion

The dissertation takes ideas seriously, and takes seriously the flat tax itself as an idea with considerable effects. Of course, the flat tax idea is situated within an Eastern Europe of economic and political tumult, diversity and preexisting norms. At the end of the day, ideas are an important part, though only a part of the flat tax narrative. Domestic carriers of those ideas, the international diffusion of those principles and the timing of the adoption process further develop this thesis. The ultimate goal of this dissertation is to come to a more nuanced understanding of flat tax adoption in Eastern Europe. Like most research projects, not every explanation or conjecture is validated in the way I first imagined. Moreover, some things not conjectured at all reveal itself over the course of the research project. I vividly remember standing in the Bank of Latvia in Riga when a high-ranking employee told me he did not know what I was talking about when asked about Latvia's flat tax. It was at that point when I realized I made either a tragic error in flying to Latvia, or something was lost in translation.[8] Everything written within is done to represent the flat tax story are truthfully as possible. Hopefully the dissertation says something academically important while also developing a compelling narrative of policy change in Eastern Europe.

[8] I found out later that Latvia indeed had a flat tax but I misrepresented the tax in my questioning.

CHAPTER 2

LITERATURE REVIEW, METHOD AND THEORY

Introduction

With the collapse of the Soviet Union and the end of the Cold War the political and economic landscape of Eastern Europe fundamentally changed. "The communist economic system was [itself]…a tragedy of errors," Sharon Fisher noted (2008, 57). Of particular interest to this dissertation is the *transition* from the budget practices of Soviet-style economies to those of post-Soviet economies. Under communism, state subsidies protected inefficient and unprofitable businesses and states printed money or borrowed to maintain solvency (Fisher 2008, 57). But the collapse of such a system did not immediately resolve the problems of the former Soviet Union and Eastern Europe. For most, these "shock therapies" proceeded with devastating initial results.

A more specific problem also arose. How did the state collect revenue through taxation? Eastern European countries had to solve two related yet separate problems. On the one hand states had to cut budget deficits to maintain a balanced budget and provide government services. On the other hand, money to balance these budgets had to come from somewhere since personal income taxes were largely non-existent in the Soviet period (Fisher 2008, 61-62). During state socialism, taxation was managed automatically by the state bank system (Aslund 2002, 217). When these state banks collapsed, new tax agencies came about to replace them. Not only would new agencies have to be created but some methods would have to develop to collect these taxes in new market economies.

Three approaches came to light. The first approach was a highly progressive tax based on the social democratic model of Sweden. This model was seen especially in Hungary and Ukraine. Second, a moderately progressive scale as seen in Britain and the United States was mimicked by most of Eastern Europe including the Baltics, Czechoslovakia and Poland. These first two approaches gave way to a third – the flat tax (Fisher 2008, 62). The progressive methods were complicated and time-consuming for citizens adapting to already enormous change. Instead, starting with Estonia, several Eastern European countries adopted the flat tax, a far-simpler, less complicated form of taxation that taxes income with one flat rate instead of progressively (Grecu 2004, 10). The flat tax for those that implemented it was a pragmatic solution to a pressing problem. But the flat tax also was an *idea* — one of considerable controversy in some parts of the world. Understanding this third approach – the change to a flat tax in parts of Eastern Europe – is the pressing question of this dissertation.

This research project is important for three reasons. First, the dissertation seeks to understand the extent to which ideas can have causal significance in world politics. The idea literature is a growing one in some subfields of the discipline, but is it deserved of the attention it has recently received? If ideas are shown to have causal significance, this project will build on that research agenda. If they are shown to not have significance, this is also an important development and casts some doubt on this "cutting-edge" agenda. Second, understanding better the economic transitions of post-Communist countries is an ongoing project in Eastern European area studies and in the literature on transitions. How can flat taxes better contribute to our understanding of the various trajectories of these different economies?[9] A third implication of this research is its practical import for policy practitioners. Although progressive taxation schemes were the rule rather than the exception in Western industrial democracies, what can the experience of our Eastern European counterparts tell us? While this research project cannot address whether or not the flat tax brings about the economic recovery its proponents claim, it does provide some insights that policy practitioners might find valuable if searching for an alternative tax policy.

This chapter will proceed in three parts. First, I will investigate what public policies are, what makes them *public*, and why studying the flat tax specifically can yield insights into the public policy literature as a whole. Second, I will identify and discuss the three competing explanations of external pressure (or institutional pressure), rationalism, and ideas that are used to understand policy change in Eastern Europe. Included in this discussion is the role of policy diffusion in relation to the spread of the flat tax. Lastly, the third part of the chapter highlights the main explanations that will be tested in the proceeding chapters, elaborate on the case studies at hand and explain the methodologies used in this work.

What is Public Policy?

James Anderson's 1975 *Public Policy-Making* makes the case for why public policy is important to political scientists. In it, Anderson defines policy as a "purposive course of action followed by an actor or set of actors in dealing with a problem or matter of concern" (3). (Policies become "public" when government bodies or officials adopt

[9] Note, however, that this research project is not evaluating whether or not flat tax policies are successful at collecting taxes or attracting foreign direct investment. This is a question better left for economists.

them.) He further relates three important reasons that policy change should be studied: for scientific, professional or political reasons. First, understanding public policy "scientifically" enables political scientists to understand the political world "more generally" by isolating particular policies and studying them as either *dependent* or *independent* variables. *Dependent*, Anderson notes, if we wished to determine the political environment surrounding the adoption of a policy; *independent*, if we wish to make sense on how varying policies could in fact transform the policy environment. Second, policies can be understood for professional reasons. By professional, he means what Max Weber would have called politics *as a vocation*. In short, by knowing the consequences of policies it enables policy professionals and practitioners to know what to do. Lastly, Anderson suggests that public policy is studied for important political reasons. Rather than depending on politicians to change the political landscape, academics themselves could play a more prominent role by studying the "scientific" nature of policies while not refraining from making normative choices about the "right" policies (Anderson 1975, 7-8).

This dissertation will deal prominently with the "scientific" component of policy making. The goal of the dissertation is to understand why flat tax policy change happens and further, why and how it diffuses to other adopters. The dependent variable of this dissertation – flat tax adoption –will be understood in relation to three explanatory approaches: the external pressure approach, the rationalist approach, and the ideational approach. External pressure is one approach, highlighting whether strong, external institutions had any bearing on introducing the flat tax. Second, rationalists argue that policy change is a consequence of rationally-expressed self-interest. A third approach is an ideational one. Ideationalists stress the causal importance of ideas in policy change. Though ideas are an important variable in the flat tax decision, the dissertation also recognizes that ideas exist in relation to other key variables, such as right-wing political parties, supportive tax bureaucracies, and neoliberal think tanks. This dissertation will have achieved its goals if – by the conclusion – it can make a causal claim about how flat taxes adoption comes to be and why it was an available policy choice in Eastern Europe.

Research by Kraft and Furlong (2004) also highlights the controversies surrounding the study of public policy. They divide policy analysis into five models: elite, group, institutional, rational-choice, and political systems theory. Elite theory privileges the role of governing elites in shaping policy choice, rather than public pressure or diverse interests. Group, or pluralist theory, emphasizes the struggle for policy among diverse interests. Unlike elite theory, group models privileges the contested nature of the policy process.[10] Thirdly, institutional theory assesses the "rules of the game". Policy is shaped within the legal and formal restraints of governmental structure. Rational-choice theory singles out self-interest as the defining characteristic of policy choice. Knowing that all actors are rational, actors pursue those policies that serve their own interests (such as trying to get reelected) or the interests of others, which in turn, serve them as well. Lastly, systems theory takes into account the broad ranging environment in which policy is made, including public opinion, social movements, and interest group pressure. Anderson describes this as "input-output" studies, because the "inputs" into the political system (demands and supports) are analyzed in relation to the "outputs", or the final policy.

[10] Schattschneider's *Semi-sovereign People* typifies the elite model, while Dahl's *Who Governs?* typifies the group model.

Kraft and Furlong's models provide further insight into how policy change happens. For example, even if we can determine that ideas "cause" policy change, how are those ideas delivered, by particular elites, political parties, or vis-à-vis a preponderance of public opinion? Or, if the rationalists are right, who are the main actors involved in articulating the rationality of the flat tax policy? Additionally, one could note Suarez's approach in her book *Does Business Learn*? Though speaking of business and not specifically states, Suarez investigates how businesses "behave" or make decisions to change, preserve, or amend their policies. Her book adopts a "historical" perspective that combines structuralist, and interest group approaches. The structuralist approach, identified with the work of Charles Lindblom, suggests that business dominates politics. Businesses can understand the technicalities of a given policy better than politicians and thus steer the direction of a given policy. David Truman's interest-group model argues that interest groups naturally rally to their cause or to protect their own interests (Suarez 2000, 6).[11] The place of business and interest groups in Eastern Europe is an additional framework that can further refine a study of policy change. The next section will more specifically refine the three different "causes" explored in this research.

[11] Suarez understands policy change through what she calls "experiential learning". She argues that 'learning' affects states in three ways. First, policy learning takes place when states realize earlier successes and replicate those practices. This could mean learning from themselves or from others. Secondly, she notes, learning can work to hinder states. In some instances states learn bad practices and replicate those as well. Lastly, learning occurs after failures. States will learn or adopt new practices because old practices fail. (Suarez 2000, 10).

Three Explanatory Approaches

It should be noted that the flat tax has received short shrift in the political science literature, and as such there is a paucity of explanations to explain its adoption.[12] Study of the flat tax is important for both practitioners and political scientists. As a practical policy choice, the flat tax had rarely been used, save the case of Hong Kong and two small British islands Jersey and Guernsey. Practitioners wonder if the flat tax could solve whatever budget woes ail them or if the flat tax is a better alternative to progressive forms of income taxation. For political scientists, its rapid proliferation is an interesting academic question. It speaks to the literature on both policy change and policy diffusion, while at the same time introducing the policy innovation of the flat tax into the academic discussion. Moreover, whereas traditionally taxation studies have focused on industrialized states, this dissertation highlights tax reform in developing states and the challenges faced therein.

There are three ways, broadly speaking, the political science literature in international political economy might make sense of why states in Eastern Europe adopted policies like the flat tax. First, external pressure explanations argue that flat tax policies were adopted because institutions played an almost coercive role in forcing a states hand. Weyland summarizes the external pressure account as one where "powerful foreign influences" affect domestic policy-makers, by changing their original goals and inducing actors to behave in a way that they would not have otherwise (2006, 69). A common explanation with Eastern Europe is that external aid agencies like the World

[12] To my knowledge there have been only four published articles of flat tax adoption specifically: Arturo and Gray's (2009) article, Evans (2005) article, Evans and Aligica's (2009) chapter, and my own (2008) article. Also important is Per Nielsen's (2006) unpublished thesis on Estonian tax adoption.

Bank and the International Monetary Fund, and Western governments like the United States, coerced Eastern European governments to adopt certain policy choices (Vreeland 2003; Stone 2001).

One also hears of the dominating presence of the "Washington Consensus" throughout the developing world, and the role that Western economists played in reshaping the blank slate that was post-communist Eastern Europe. (Soros 1998, Stiglitz 2002, Beeson and Islam 2005, Rodrick 2006). Fjeldstad and Moore went so far as to say that the IMF was the "number one driver of the global tax reform agenda" (2008, 238). Davesh Kapur – one of the leading critics of the Bretton Woods institutions – argued that the institutions have acted with "hubris" and went far beyond their original mandates in giving both loans and advice that are then attached to strict conditions (1998, 123). This is especially apparent in less-developed economies and political systems, where populations are more vulnerable to the decisions of powerful elites. Additionally, Vreeland observed that domestic actors would sometimes bring in the IMF so as to gain political leverage "to help push through unpopular policies" (2003, 152). In this particular instance international institutions are not so much "pressuring" domestic governments but providing assurances to domestic populations weary of uncertain political or economic activity.

More recently, the dominance of the European Union has shifted the focus of scholars away from the IMF and World Bank with respect to Europe. For example, the strictures of the Copenhagen Criteria and acceptance of *acquis communautaire* have put countries in a double-bind. On the one hand, it is argued, states must accept free market strategies in order to gain access to free and open markets. On the other hand, if they do not accept the conditions they can be "left out" of the political and economic incentives that such an arrangement can bring.

Simmons, Dobbin and Garrett explain that many commentators have focused specifically on the exercise of American power as a critical component of relaying their "vision" to the world. The hegemonic United States – it is argued – acts through the Bretton Woods institutions offering up carrots and sticks to would be members, ready to offer incentives when it is advantageous to the institutions, but also willing to unleash sticks when needed. The goal of such institutions is to "impose" upon other states an image of how to appropriately behave (Simmons, Dobbin and Garrett 2008, 1). Additionally, Rachel Epstein investigates the extent to which leveraging by actors like NATO, the World Bank and the EU affect the change toward political and economic liberalism in Central and Eastern Europe. She argues yes, but only when prospective states face the three conditions of domestic *uncertainty*, subordinate *status* vis-à-vis other states, and the *credibility* of their policies is open for adoption is in question (Epstein 2008, 8-9).

A second explanation, and the conventional wisdom about why states adopt particular tax policies, usually has taken on a functional, or rationalist, logic. One, flat tax policies were said to be easier to collect and administer and therefore more desirable than gradual income policies. Two, flat taxes were viewed as a way to attract foreign investment into the countries and better develop the domestic economies of each state (Dilanian 2005). In Margaret Levi's classic *On Rule and Revenue*, she argues that policymakers adopt tax policies after judiciously weighing "the costs and benefits of proposed actions," and will settle on whichever policies extract the most revenue, or what she calls the theory of "predatory rule" (Levi 1989, 3-4). For Levi, moreover, policymakers are relatively autonomous in their decision-making, impervious to external or internal forces.

Duane Swank also details the rational basis for tax reform. He argues that state finance ministers and economic advisers are acutely aware of the how tax reform affects tax collection, efficiency and government revenues. For example, when many OECD countries transitioned towards more market-oriented tax cuts and base broadening, they did so with the understanding that said changes would result in the outcomes they wanted. Stark also points out – contrary to the external pressure thesis – that tax reform moved at a pace that was suitable for the domestic actors involved. During the reform process France and the Netherlands cut rates fairly quickly, whereas Italy waited some ten years after in 1998 (Swank 2008, 67). What this means is that all countries approached tax reform with "rationalist" logic, but they did so without pressure from outsiders.

A third way to think about why states adopted flat tax policies concerns the extent to which ideas matter in politics.[13] Even though flat taxes might be adopted for functional reasons, and even if external aid agencies like the IMF support flat tax policies, it does not mean that certain *economic ideas* did not play a role in structuring what policy choices were available and which were not. Once again, the rationalist basis of flat tax policies is not in question in this research. Robert Hall and Alvin Rabushka, the architects of (failed) flat tax proposals in the United States, agree that flat taxes are attractive for the very reasons the rationalist approach details (Hall and Rabushka 1995,

[13] Rawi Abdelal's (2002) *National Purpose in the World Economy* and Andrew Savchenko's (2000) *Rationality, Nationalism and Post-Communist Market Transitions* have recently adopted the idea framework to cases in Eastern Europe.

52). [14] However, the flat tax had little real world applicability by 1994, and to suggest that the flat tax would be the panacea to a state's economic ills would only have been hazarding a guess. In short, the flat tax should not be seen as *only* a pragmatic policy choice that remedied the problems of tax collection, but a specific economic *idea* that trumped other ideas.

Lastly, a fourth literature has developed which seeks to integrate the approaches listed above. Jeffrey Checkel's work on policy reform highlights the influence of ideas in policy change. For Checkel, however, he explores the relationship between ideas and institutions arguing that though institutions themselves are relevant, the idea literature best makes sense of policy continuities and policy change *within* institutions (Checkel 1997, 3-4). In other words, institutions exist to do something organizationally specific, but also under a framework constructed by ideas. (Checkel 1997, 6-7). Another work by Epstein shows a similarly eclectic approach. Epstein describes how institutions like IMF and World Bank can influence states decision-making, but not per se through coercion and power. Instead, these institutions transfer a common "worldview" (in this case a liberal worldview) onto member states. She describes this as a combination of the "rationalist-constructivist" perspectives. It is rationalist in that it presumes the instrumentality of actors within politics, but constructivist in the sense that policy change also corresponds to norms, the appropriateness of ideas, or simply 'fitting-in' (Epstein 2008, 7-10).

[14] On the other hand, a recent research paper by the IMF has suggested that the flat tax does not guarantee the benefits its proponents claim (2006). Already in places like Latvia, a movement to abolish the flat tax is led by those who believe it did not provide the revenue stability once guaranteed (Johannson and Lannin 2009).

These three approaches cannot – on their own -- make sense of policy change in Eastern Europe. It can help us in the first case of Estonia because I am trying to understand why the flat tax was adopted there initially. What these approaches cannot explain are the exact avenues by which external pressure, rationality, or ideas lead to adoption and policy consolidation. Policy diffusion, for example, is not really a *cause* of the flat tax as much as it is a delivery mechanism. Policy diffusion brings with it then a whole host of questions regarding the uses of epistemic communities, policy carriers, political parties and federalism only to name a few. The proceeding section will tease out my preferred ideational approach, and then examine the literature on policy diffusion.

‘Ideas’ in Comparative Politics

Ideas can be defined simply as a ‘tools’ or a ‘repertoire’ of “related causal and normative assumptions that assign costs and benefits to possible action” (Parsons 2003, 7). One can understand ideas as certain programs or paradigms that define, or constrain, specific courses of action seeking to achieve certain outcomes (Campbell 2004, 94). Ideas can be seen to have causal significance given that certain actors in politics hold different ideas about a certain course of action, therefore if different ideas are chosen or win-out, different outcomes will persist (Berman 1998, 18; Blyth 2002, 33).

King, Keohane and Verba suggest that the “most difficult methodological task” with the ideational research program is showing ideas as causes (King, Keohane and Verba 1994, 191). Sherri Berman’s *The Social Democratic Moment* traces the absence of ideational research in political science back to Karl Marx, and his contention in *The German Ideology* that religion, ideology, law, the state, etc. were consequences of material interest and the rule of particular economic classes. Ideas were simply epiphenomenal and not worthy of analysis as independent causal variables (Berman 1998, 16). Moreover, she argues, the ideational literature has not been taken seriously because ideas "have never surrendered easily to empirical study or quantification" (Berman 1998, 18). Berman also identifies three broad problems ideational scholars have had in their own research designs. One, ideational theorists have had trouble identifying independent variables that can be clearly identified. Two, ideational scholars have argued with one another, failing to reach a consensus on the mechanisms by which ideas shape political behavior. Lastly, ideational theorists have failed to rigorously test their explanations against the backdrop of the real world (Berman 1998, 15).

In the field of comparative politics, a number of important works have addressed the role of ideas with respect to policy change. An early attempt at explaining how ideas affect international politics was Peter Hall's work on the spread of Keynesianism and subsequently monetarism across Western Europe. His work was a corrective on the various statist, bureaucratic and pluralist renderings on policymaking in comparative politics by exploring the processes of social learning.[15] Hall argued that the proliferation of Keynesian policies should be seen as an example of how certain economic ideas can 'influence' the public policy choices of states (Hall 1989, 4). Hall suggested that ideas acted as 'policy paradigms' much like the scientific paradigms in Thomas Kuhn's *Structure of Scientific Revolutions* (Hall 1993, 279). These "third order" changes reflected wholesale policy shifts that occur very rarely, produce a number of anomalies,

[15] Hall defines social learning as "a deliberate attempt to adjust the goals or techniques of policy in response to past experiences and new information. Learning is indicated when policy changes as the result of such a process" (278).

puzzles, and "experimentation with new forms of policy" (Hall 1993, 280). As Hall remarked:

> The principal contribution of a social learning perspective is to draw our attention to the role of ideas in politics. It reminds us that state-society relations cannot adequately be described entirely in terms of the 'pressures' that each exerts on the other, whether through parties, organized interests, administrative organs, or policy networks. The state is also linked to society by a flow of ideas between the two spheres (289).

Another important contribution to the idea literature has been Kathleen McNamara's (1998) *The Currency of Ideas*. McNamara argues that ideas and interests should not be separated as two competing variables but scholars should show the inherent "connection between the two" (McNamara 1998, 8). McNamara's book explores the reasons for the development of an Economic Monetary Union in Europe. She claims that the Economic Monetary Union is a result of: a) policy failure, that being the Keynesian economic policies that led to the oil crisis in the 1970s; b) policy paradigm innovation, that being Germany's insistence on a stable and strong monetarist policy; and c) policy emulation, that being the number of states that adopted this monetarist framework across Western Europe (McNamara 1998, 6).[16]

Put succinctly, the *idea* of monetarism was a response to the real-world problem of failed Keynesianism. McNamara's research program has particular import in the case of Eastern Europe and the flat tax. Eastern Europe experienced: a) policy failure, that being the inability to collect tax revenue via gradual income tax structures; b) policy paradigm innovation, that being Estonia's adoption of flat tax policies to solve the

[16] Also see Jeffrey Legro's (2000) "The Transformation of Policy Ideas". Legro argues, like McNamara, that ideational change is a consequence of two processes – *collapse* and *consolidation*. Collapse occurs when domestic actors determine that the old ideas are no longer valuable or effective. Consolidation occurs when new ideas are consolidated by societal and domestic actors.

revenue problem; and c) policy emulation, that being the fairly rapid adoption of flat tax policies across Eastern Europe in the last ten years.

McNamara's case is evidence of what Craig Parsons reveals in his book *A Certain Idea of Europe*:

> Battles of ideas are never separate from battles over the distribution of material gains. The former are important precisely because they can set the lines, dynamics, and results of the latter. Thus if I present my ideational argument as a competitor to structuralist or pure institutionalist approaches, this is not because these basic logics are mutually exclusive. Material reality, organizational arrangements, and ideas all play roles in politics. The interesting debate is not between them as incompatible concepts; it concerns how much we need ideational factors – ideas and their institutionalization – to explain how actors define their interests….to paraphrase Richard Biernacki, I show that ideas exercise and influence *of their own* but not completely *by themselves* (2003, 9).

The dissertation takes seriously the respective conclusions of both McNamara and Parsons about the relationship between ideas and material interest. One can take ideas seriously without forgetting that ideas are intertwined with the material needs of society. This does not negate the notion that ideas can act independently as causes; on the contrary, changes in material interest provide an opening for an evolution in ideas to take place. Additionally, like ideas, material interest itself can be subjective. In other words, though a "policy failure" might have objective attributes to describe the failure (the inability to balance a budget, for example) one person's perceived crisis might be another's short-term inconvenience. Parsons notes that we are far too quick to judge ideational claims more harshly because they all seem "subjective" (Parsons 2007, 114-115). But if a flat tax supporter "perceives" crises and assigns "meaning" to it, that is as objective claim as any other (2007, 115).

This dissertation also tries to provide an answer to Berman's concerns about the ideational program, and more generally, build on the literature that McNamara and Parsons develop. First, the dissertation suggests that ideas themselves are independent variables that cause a change from one policy to another. This does not mean that ideas come "out of nowhere". Ideas are relayed by elite carriers, political parties and epistemic communities to name only a few. John Campbell in fact critiques the ideational literature for side-stepping this very point (2004, 100). He breaks down ideational actors into five different categories: brokers, decision makers, theorists, framers and constituents (Campbell 2004, 101). Brokers are the most important, in that they draw from the other four groups in developing an idea, or making an ideational claim. Decision makers are responsible for turning an idea into policy by technically changing (through voting or ministerial decree) one public policy to another. Theorists develop the idea, through the publication or debate of said idea, or by relaying the idea to others, much the way think tanks operate. Framers set the terms of the debate if you will. These "spin doctors," as Campbell calls them, politicize an idea to give it meaning and then popularize it to a fifth group, constituents. Constituents obviously have a stake in any policy change. After all, these are the folks public policies are supposed to help. However, constituents also play a critical role in the consolidation of an idea. The simplest means is by talking to your neighbor about a given idea, convincing them of the wisdom of one idea over others. The constituent classification is more difficult to parse, however, when you consider that almost everyone involved in an ideational change is also a constituent[17] (Campbell 2004, 104).

Despite the fact that these actors matter, I still argue that ideas play a critical role in shaping their respective outlooks. Ideas have power when proponents of those ideas

[17] This might exclude transnational actors , who work between states, for instance.

hold them in greater priority than the alternatives, whether that is the coercion (or suggestion) by outsiders, or the functionality of alternative policies. This dissertation adopts an eclectic approach in terms of understanding the mechanisms by which ideas are transferred from one group to the next. By eclectic, I am emphasizing the domestic-international space where ideas exist and simultaneously interact. Domestic actors are the lifeblood of adoption, but we cannot understand the origin of those ideas by looking at the domestic realm alone. At the international level policy diffusion is the basic mechanism of idea origin. However, policy diffusion cannot explain adoption of a policy; that returns us to the domestic level.

The dissertation will also rigorously explain events “in the real world’. The flat tax is a policy change that swept through Eastern Europe and is now available in Asia and Africa. Its importance goes beyond the classroom and into the field, the “real world” as Berman describes it. In short, the dissertation is not only an academic exercise but details a policy decision that can greatly impact lives. Whether this impact is for the better (as Laar and neoliberals like him claim) or for the worse (as social democrats throughout Eastern Europe have argued) is not a question this dissertation can answer satisfactorily. It does provide a window into these policy debates that are, frankly, brand new to many observers and political scientists alike though.

The Flat Tax as an Idea

The flat tax could be seen as a specific economic *idea* with considerable *causal* significance. Milton Friedman first discussed the flat tax in the classic *Capitalism and*

Freedom and later in the book *Free to Choose* in the 1960s, although he was pessimistic about a flat tax ever being implemented in the United States. The flat tax idea was later developed in think tanks like the Hoover Institution and the Adam Smith Institute in 1980s and 1990s.[18] Though Friedman got the ball rolling, the most developed and rigorous flat tax blueprint to date was drawn up by Hoover Institution scholars Robert Hall and Alvin Rabushka. Hall and Rabushka argued that flat taxes could solve five problems that had plagued United States' revenue collectors: a) the problem of complexity; b) the problem of taxpayer cost; c) the problem of wasteful government investment; d) the problem of tax cheating and loopholes; and e) the problem of cronyism among the taxation bureaucracy (Hall and Rabushka 1995, 3). The flat tax would tax all incomes – with the exception of the poor, who would not be taxed at all – across the same 19-percent rate (Hall and Rabushka 1995, 58). The second major aspect of the flat tax is that it eradicates tax deductions because, for Hall and Rabushka, deductions are loopholes that can lead to massive tax cheating (Sease and Herman 1996, 27).

In the United States the flat tax was lauded by former presidential candidate Steve Forbes as a response to the "complex nightmare" of gradual income tax schemes (Forbes 2005, 3-4). Other United States politicians, namely former US representative Dick Armey and former presidential candidate and California governor Jerry Brown have supported the flat tax. In her then 2005 bid for election, German Chancellor Angela Merkel initially nominated Paul Kirchhof for a position as finance minister. Kirchhof was a flat tax devotee and stumped for a 25-percent flat tax throughout Germany. Of

[18] Laar, Estonia's Prime Minister, first learned about the flat tax by reading a book by Milton Freidman (Laar 2007). Slovakia's economic advisor Martin Bruncko learned about the flat tax while attending Harvard University, and flew home to his native Slovakia to implement it (Tzortis 2005).

course, in both the United States and Germany[19] flat tax policies have been derided by both the left[20] and the right[21], and have failed miserably when practitioners seek to implement them.

Conceptual Framework

In order to understand whether or not ideas played a part in Eastern Europe's adoption of flat tax policies, we would first have to analyze the other relevant explanations: external pressures-based explanations and rationalist-based explanations. While the ideational approach to international political economy is cutting-edge work in the field, might ideationalist explanations be insufficient to explain the developments in Eastern Europe? Moreover, the dissertation must deal with the possibility that ideas are simply epiphenomenal, and not the causes of policy change (King, Keohane and Verba 1994, 191). To answer the research question, this study will adopt a process-tracing approach in order to identify the "causal mechanisms" that led to the adoption of flat tax policies. A process-tracing approach investigates "the decision process by which various initial conditions are translated into outcomes" (George and McKeown 1985, 35). As Keohane, King and Verba acknowledge: "Process tracing will then involve searching for evidence – evidence consistent with the overall causal theory – about the decisional process by which the outcome was produced" (Keohane, King and Verba 1994, 227).

[19] Kirchhof's recommendation was chastised by many politicians and forced Merkel to distance herself from his ideas. Before the election Kirchhof dropped out of his presumed position to ensure Merkel's election.
[20] Flat tax policies are generally critiqued on the left as unfair to the poor, who are said to be overburdened by high taxes under such policies.
[21] Flat tax policies are criticized by some on the right because something of a cottage industry of accountants and tax specialists has developed because of progressive taxation schemes. When President Bush created his council to reexamine American tax policy, the flat tax was not examined in any real detail.

Keohane, King and Verba think process-tracing is particularly valuable when one has many potential explanatory variables as this project does.[22]

Lastly, Parsons – who has done a great deal of work with ideas – thinks process-tracing is a valuable method to use. He said the most effective way to validate ideational claims is to reexamine "earlier patterns of behavior, written and spoken utterances, and perhaps (with care) after-the-fact interviews to establish… beliefs and norms" (2007, 109). Parsons is quick to point out, however, that while not impossible, making explanations using ideas is considerably more difficult than say structuralist or institutional arguments. That does not mean you cannot make ideational claims, but the researcher must do so with care and attention (Parsons 2007, 109).

If ideas did matter in Eastern European cases, process tracing would be the best method to determine this. But there are two sets of related, and pertinent, questions that also need to be answered. First, if ideas did matter, then how? In other words, how are ideas brought into the policy-making process and by whom? Second, what is the process by which flat tax policies have been adopted in the various states? Are flat taxes the result of "policy diffusion", or has the flat tax developed independently in each country?

The literature on the causal linkages between the development of an idea and its implementation is robust and varied. Some have privileged the role played by civil servants — bureaucratic specialists — in shaping the policy process (Quaglia 2005, 556). In this instance, civil servants act as the "switchmen" of history. They are relatively insulated from politics, and proceed to act based on a constrained set of policy beliefs generated through years of technical practice. This understanding is particularly

[22] Although King, Keohane and Verba think process-tracing is good for identifying potential "causal mechanisms" in social science, they generally think that process-tracing is less rigorous methodological technique that cannot contribute to causal inference (Keohane, King and Verba 1994: 228).

attractive when politicians are faced with considerable resistance or societal pressures are negligible (Quaglia 2005, 556). A second understanding involves the role of "epistemic communities" in the formulation of policy change. Peter Haas defines epistemic communities as "networks of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue area" (Haas 1992, 3). This approach is different from the civil servant approach in that it broadens the scope of those who effect policy change to include those outside of the government, particularly by turning attention to the role academics, researchers, and think tanks play (See King 2005; Hasenclever, Mayer and Rittberger 2002). Thirdly, political parties could be instrumental in relating new, innovative ideas into the policy process. During times of uncertainty political parties are apt at rallying constituencies to their aid and advancing a new political agenda (See Szcerbiak and Hanley 2006).

A fourth understanding takes seriously the role elites play in policy change. Berman has called these political actors "carriers" because they "carry the load" of mobilizing support for one idea over another. It is political leadership that is the most crucial determinant in shaping history (Berman 1998, 25). Nicholas Jabko has also investigated the contribution of elites with respect to policy change. While Jabko does not accept the "simple constructivist explanations," he does accept that ideas can be used as "strategic resources". As he discusses the European Union's reforms: "The very notion of 'market reform' had a peculiar appeal within the context of the 1980s and 1990s. In the course of the European Union's quiet revolution, market ideas had an impact not so much because of a general conversion to neoliberal ideology but because they were incorporated into a well-crafted political strategy" (Jabko 2006, 5). Lastly, Rawi Abdelal's *Capital Rules* (2007) takes ideas and constitutive norms seriously by examining how such norms become embedded within transnational institutions. The "rules" of institutions "teach" members appropriate ways to behave. In doing so, "eager pupils" are willing to accept once controversial ideas (such as trade liberalization) because of the perceived benefits of membership in an institution (Abdelal 2007, 18).[23]

Policy Diffusion and Comparative Politics

A second series of questions involves the waves of policy change that swept across Eastern Europe, sometimes called "policy diffusion". (McNamara describes it as "policy emulation.") Kurt Weyland defines policy diffusion as a "bold reform adopted in one nation [that] soon attracts attention from other countries, which come to adopt the novel policy approach. As such a wave gets under way, innovations[24] often spread quickly to other countries following the trendsetter" (Weyland 2005, 262). Weyland argued that these "policy diffusions" also occur within a short time frame, and are bounded by geographic considerations. In Weyland's edited volume, *Learning From Foreign Models in Latin American Policy Reform*, he reveals some of the pressing questions of diffusion research. He states: "Does policy diffusion result from autonomous learning by the recipient countries or from the inducement or pressure

[23] Jabko's and Abdelal's work is important insofar as it shows that ideas can be "used" for rational purposes. For Jabko, ideas are "strategies" not necessarily deep-seeded beliefs. For Abdelal, states accept ideas, only because accepting such ideas bring with it great (or potential) benefits.
[24] The term innovation does not simply mean 'new'. As Jack Walker (1969) argued, innovation is simply 'new to you'. Moreover, policy diffusion scholars are not per se interested in the creation of innovation, but simply its 'adoption'.

exerted by foreign actors, such as powerful international lending agencies, especially the International Monetary Fund (IMF) or the World Bank?" In other words, is the spread of innovations the product of decentralized initiatives, or of central coordination, if not perhaps imposition (Weyland 2004, 2)?

In addition, Simmons, Dobbin and Garrett are quick to note that what theorists of diffusion explicitly reject is the idea that policy developments occur independent of cooperation between neighboring governments. That is, states adopt policies with some knowledge of the preceding decisions made by others (Simmons, Dobbin and Garrett 2008, 7). The reasons for that are varied, of course. Weyland argues that policy diffusion is the result of possibly four scenarios: via external pressures, via normative and symbolic appeal, via rational learning, and via cognitive heuristics. Simmons, Dobbin and Garrett identify four of their own that share a resemblance with Weyland's typology: coercion, competition, learning and emulation (Simmons, Dobbin and Garrett 2008, 2). Of special note is Simmons, Dobbin and Garrett's conclusions that policy diffusion is especially important to study in an age of globalization.

Estonia, Latvia and Lithuania all adopted the flat tax within the two-year frame of 1994-1995. Russia adopted the flat tax in 2000, and the remaining nine countries adopted the flat tax from 2004-2008. Moreover, while the flat tax has had success in Eastern Europe, no countries in Western Europe have a flat tax. Only one African country (Mauritius) and two Asian countries (Hong Kong and Malaysia) have a flat tax. Weyland (2005) and Simmons and Elkins (2006) have tried to understand the ways that policies diffuse, investigating external pressures, rational-actor models, culture, and even religious identity to understand why certain countries adopt similar policies within particular geographical constraint.

Explanations and Cases

"In an ideal scenario," says Berman, "the scholar would use cases where the outcomes to be explained vary and the relevant political actors are matched in everything except the ideas they hold. In such a situation everything would be held constant except the proposed independent variable (ideas), thereby ensuring that an analysis could provide us with unequivocal evidence of causality" (Berman 1998, 35). This is, of course, the ideal scenario. The varying outcomes occur in only two cases: Poland and Hungary, the only two states studied that did not adopt a flat tax. Berman's approach is the approach used in Chapter 6, for example. In the other chapters, it is shown that the outcomes did not vary, but the ideas themselves did. Estonia, Latvia, Lithuania, Slovakia and the Czech Republic all adopted the flat tax, but there is varying level of ideational support (and antagonism) in each country for the flat tax. In these cases everything is held constant, including the outcome. The way to detail if ideas mattered is to examine the political, economic, and social discourse that occurred during the time of adoption.

I am investigating whether or not 'ideas' matter by looking at five cases of adoption (both early and late adoption) and two cases of non-adoption. My explanations and rival explanations are as follows in Table 10:

Table 10. Explanations and rival explanations
EXPLANATIONS
Explanation 1: In states that have flat tax policies we would observe a shift in ideas that caused a shift in policy.
Explanation 2: In states that have flat tax policies we would observe discourse about the appropriateness of said idea which caused a shift in policy. Some actors would stump in favor of the idea and others would be opposed.
Explanation 3: In states that do not adopt the flat tax, we would observe that the flat tax idea conflicted with progressive ideas about economics, economic theory and good government. Ideas contrary to the flat tax prevented flat tax adoption in those countries.
Explanation 4: In states that adopted the flat tax after Estonia (the first adopter), we would observe that other states emulated the policy, or what is called policy diffusion. Previous adopters were instrumental in the adoption of the flat tax by other adoptees.
RIVAL EXLPANATION
Rival Explanation 1: In states that adopted the flat tax we would observe the power of external pressures (or institutions) caused adoption and not the power of ideas.
Rival Explanation 2: In states that adopted the flat tax we would observe the power of rationally-expressed self-interest caused adoption and not ideas.
Rival Explanation 3: In states that did not adopt the flat tax we would observe that external pressures or regard to self-interest prevented adoption, rather than actors being wedded to particular alternative ideas.
Rival Explanation 4: In states that adopted the flat tax after Estonia (the first adopter) we would observe that these states did so independently and without regard for the flat tax in other states.

The seven cases studied in this research will be three 'early adopters' (Estonia, Latvia and Lithuania) two 'late adopters' (Slovakia and Czech Republic) and two countries that have not adopted the flat tax (Hungary and Poland). The case selection requires some explanation. First, these seven countries are similar enough politically and economically to make "well matched…controlled cross-case comparisons" (Van Evera 1997: 84). All seven countries rank in the World Bank's list of "upper middle income countries" and are members of the European Union. All seven have legacies of communist rule that ended around the same time in the early 1990s. And lastly, all seven countries have adopted parliamentary democratic procedures.

On the other hand, the seven cases have important differences that make each case unique to the other. First, the countries that adopted flat tax policies did so at different times. Estonia adopted the flat tax in 1994, and is an obvious case to study because it was the first country to do so in Eastern Europe. Latvia and Lithuania followed soon after in 1995. Slovakia approved the flat tax in 2004 and implemented it into practice in 2005, while Czech Republic waited until 2008. The timing of instituting a flat tax is important because an ideational approach would contend that, regardless of the incentives for adopting a flat tax at a given moment, ideas would still have causal significance over time. The second important difference is that all three countries went through tumultuous, albeit different, routes to the flat tax. Estonia's came about rather early, but was just one of many policies instituted by committed neoliberals in Estonia and all throughout the Baltics to break away from Russian domination and assert their independence (Aslund 2002, 385).[25] Slovakia was barely a country in 1994 when Estonia was adopting a flat tax[26] and much of the 1990s was spent solidifying a new political regime and searching for their identity as a state.

The last two cases investigated are Hungary and Poland. Unlike the Baltics, Slovakia, and the Czech Republic, Hungary and Poland did not adopt the flat tax. Although all seven countries are comparatively similar wealth-wise, politically democratic and post-Communist, Hungary and Poland have not adopted the flat tax.

[25] This is not to say that neoliberalism and "flat taxes" are synonymous. In fact, many committed neoliberals are not necessarily flat tax proponents. But neoliberalism does not preclude flat taxes either.
[26] Slovakia gained formal independence from the Czech Republic in 1993.

Why? If ideas do matter in the Hungarian and Polish case we would expect that they were not inspired by the same ideas regarding taxation that took hold in the Baltics, and eventually in Slovakia and the Czech Republic, but by different ideas about economic growth and social provision.[27] On the other hand, if Hungary and Poland have adopted the same general framework of neoliberalism as Estonia and Slovakia and still did not adopt the flat tax, this casts doubt on the ideational approach. Hungary and Poland are important cases because they provide variation on my dependent variable.

A criticism of this project needs to be addressed. The dissolution of the Soviet Union and the emergence of new states created what some would consider to be a "critical juncture," or political opening, for new policies. In the absence of mature political institutions, ideas are said to be 'hooks' to obtain and maintain support for a fledgling government. In this way ideas are simply a means to an end, and of little value except in the sense that they can exploit institutional weakness. In Mark Blyth's *Great Transformations*, he argues that, "in periods of economic crisis, ideas (not institutions) reduce uncertainty" (2002, 35). Robert Keohane and Judith Goldstein's *Ideas and Foreign Policy* argues that in times of uncertainty, ideas act as road maps to guide leaders. By traveling down a particular path ideas are then 'locked in' and mitigate against competing policy choices or rival ideas (1993, 12). Ideas are then "locked in" by institutionalization, or by being embedded within formal institutions (Berman 1998, 26-27).

This explanation would seem — prima facie — to have salience in the early adopter cases of Estonia, Latvia and Lithuania. In the Baltic States, elites were

[27] Anders Aslund's book *Building Capitalism* argues that Hungary was inspired more by social democratic models of economics rather than by liberal policies. This influenced, he argues, the different trajectories of tax policies across Eastern Europe (Aslund 2002, 228).

considered to have unrestrained access to mold and develop fragile institutions (Steen 1997, 2-5). However, even Blyth agrees that institutional weakness alone cannot explain why ideas are successful in a situation of unstable institutional equilibrium. New ideas do not immediately give way to institutionalization, but engenders a slow, prolonged process (Blyth 2002, 44-45). This argument would have less power with the group of 'late adopters,' in particular Slovakia (adopted in 2004) and Czech Republic (adopted in 2008). In both cases political and economic institutions were fairly consolidated, and yet the idea of the flat tax found its way into the policy making process. How can one explain this result? As Dimitrov, Goetz and Wollman have argued: "…[It] is still sometimes assumed that the implosion of communism left an institutional vacuum or tabula rasa from which a new set of institutional arrangements has grown. Yet as far as the executive is concerned, no such tabula rasa has ever existed" (2006, 17-18). In short, 'weak institution' arguments can only get one so far, and cannot explain the varied routes that led countries to adopt (or not) flat taxes.

Data Collection

Much of the data I collected comes from archival research, interviews with relevant policy actors and experts, information from government documents, and recent newspaper articles. The data was gathered on two separate research trips, one in 2007 to the University of Illinois Russian, East European and Eurasian Center, and a 2008 trip to Estonia, Latvia and Lithuania for fieldwork and interviews. The "process-tracing" method requires understanding the links between process and outcome, in which case a detailed descriptive analysis of that link must be highlighted. The most difficult part of this project was working through the potential language barriers that result from looking at seven countries that speak six different languages. In some cases relevant institutions like the Organization for Security and Cooperation in Europe, the World Bank and International Monetary Fund translate all of their work into English and the other official institutional languages. Moreover, several of the relevant policy actors were trained in the United States and speak fluent English.

CHAPTER 3

THE FIRST: ESTONIA ADOPTS A FLAT TAX

Introduction

By December 1991 the Soviet Union ceased to exist. Boris Yeltsin had defeated Mikhail Gorbachev's government, dissolved the Communist party, and appointed a transitional State Council of leaders from the surrounding republics. One of the first acts by the council was to recognize the independence movement of three Baltic states: Estonia, Latvia and Lithuania (Hesli 2007, 68). The act was the first "official" recognition by the former Soviet regime that they could no longer control their satellite states. The story of Baltic (and particularly Estonian) independence does not begin there, however.

In 1985, Estonians were struggling to cope with their own Communist leadership. Political scientist Andrus Park identified three broad changes in Estonian politics. The first phase was the initial resilience of the hard-line Communist leadership from 1985-June 1988 in the face of mounting pressure brought forth by Gorbachev's *glasnost* and *perestroika* movements. Second, the rise of liberal-minded, reformist-type Communists into the party brought forth macroeconomic changes, recognized Estonia's claim to sovereignty and "reassessed" the Soviet occupation of Estonia by Stalin in 1940. Like other parts of the Soviet Union, these reformists actually undermined the party itself, and by the Spring 1990 the Estonian Communist party "quickly disappeared from the center stage of Estonian political life" (Park 1994,148-149). Lastly, by April 1990 a host of "post-communist" leaders rose to the forefront holding new elections, creating new political parties and rejecting the old ways of the party (Park 1994, 150).[28]

The first Prime Minister in the newly sovereign Estonia was Edgar Savisaar, a leader of the political party Popular Front. Savisaar was an ex-Communist turned social democrat. While Savisaar and his party were popular among thirty-to-forty percent of the population his government was increasingly criticized by right-wing critics for his leftist economic views and by nationalist groups for his lenient stance on ethnic Russian minorities (Park 1994, 150). Savisaar was critical in leading Estonia to writing its first post-Soviet constitution that was approved by a wide 90-percent margin (Raun 2002, 246). The result of the Constitution was the creation of the Riigikogu, a unicameral parliament that has:

> …Ultimate authority on all key political decisions, including legislation, appointment of the prime minister and other leading officials, the longevity of governments, the state budget and treaties with foreign countries. Parliament also elects the president, who cannot serve more than two consecutive terms, by a two-thirds majority for a five-year term, aside from the one time compromise agreed upon for the first election, held in September 1992 (Raun, 247).

Because of the central authority of the parliament, the position of Prime Minister is instrumental in directing the country, including producing legislation and nominating cabinet ministers (Ruus 1999, 26). Additionally, the Riigikogu also had a symbolic presence among Estonians, as it was the pre-World War II institution that some where already familiar with (Eglitis 2008, 241).

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[28] In trying to make sense of these changes occurring years before the actual fall of the Soviet Union, Park comes to an interesting conclusion: "It would seem that the Estonian developments in 1985-1991 lend claim to the proposition that intellectuals form a substantial part of the new political leadership in the post-communist transitions" (Park 1994, 152).

Following the adoption of the new Constitution in 1991 Estonians went to the polls in 1992. They answered by evicting the left-leaning Savisaar in place of a bright 31-year old historian named Mart Laar. Laar and his Fatherland party were virulently anti-communist and pro free-market. They aligned with the Moderate party and the Estonian Independence Party to capture a slim ruling coalition in parliament. Lennart Meri was selected as President by a margin of 59-31 over Arnold Ruutel. Meri, who had been exiled to Siberia for five years under Stalin, combined with the youthful Laar, represented a true housecleaning for Estonia (O'Connor 2003, 174). Shortly after the Laar government began its political and economic program to free Estonia from its Communist heritage. Included in his program was the transition toward a flat tax on personal income.

This chapter is important insofar as it introduces the first flat tax adopter Estonia and tries to make sense of why Estonia adopted a tax reform that was relatively unheard of as a practical policy choice. Only Hong Kong adopted a flat tax prior. Tested in this chapter will be two explanations. The first explanation claims: In states that have flat tax policies we would observe a shift in ideas that caused a shift in policy. For this explanation to be validated it must be clear that Estonian actors were wedded to one set of ideas and then adopted a new set of ideas. Exemplifying this ideational shift is the adoption of the flat tax. The second explanation claims: In states that have flat tax policies we would observe discourse about the appropriateness of said idea which caused a shift in policy. Some actors would stump in favor of the idea and others would be opposed. This explanation would be validated by observation of these opposing debates. Acquiring the data requires archival research into political discourse, interviews with relevant policy actors, and secondary research into the ideational shift that occurred from the actors themselves.

The rival explanations call into question the above claims. The first rival explanation claims: In states that adopted the flat tax we would observe the power of external pressures (or institutions) caused adoption and not the power of ideas. For this explanation to be validated evidence of external pressure would need to be demonstrated, including, but not limited to, the coercive capacity of the IMF, World Bank, or European Union to shape policy change in Estonia. The second rival explanation claims: In states that adopted the flat tax we would observe the power of rationally-expressed self-interest caused adoption and not ideas. For this explanation to be validated evidence of self-interest would need to be observed, including the adoption of the flat tax for purely pragmatic and functional reasons that preclude ideas.

The case of Estonia demonstrates how ideas matter, thus validating the first explanation. The major progenitors of the flat tax ideas were elites who retrieved the tax reform from texts they read and agreed with and then presented those ideas to the brokers of tax reform in parliament and the economic ministries. The flat tax was also part of a broader ideology of neoliberal, free market ideas that some think made Estonia the "Baltic Tiger" it is today. In retrospect it made Estonia and Mart Laar household names among free marketers from the 1990s onward. However, the "debate" over ideas was not at all present in Estonia until *after* the passage of the new tax law in 1994, invalidating the second explanation.[29] These later debates reveal the tensions apparent in the flat tax debate – over issues of fairness and equality on the one hand, and issues of growth and

[29] The timing of the debate is important to note for later in the dissertation, as the tide began to turn against flat tax policies in places like the Czech Republic, Hungary and Poland in the 2000s, the same time these controversies arose in Estonia.

competitiveness on the other – but do not contribute in any way to the passage of the flat tax in 1994.

As to the rival explanations, both were invalidated. One could not understand the change from progressive taxation to flat taxation without taking into account ideas. External pressures were not present at all in the Estonia case, as the individuals interviewed in this chapter (and supported by secondary evidence) agreed this decision was made by domestic actors and not international actors. Moreover, rational self-interest alone could not explain why the flat tax *specifically* was chosen to reform the problem of progressive taxation. (Being the first to adopt a flat tax, remember, Estonia did not know if the plan would even work). That being said, the flat tax was advised and passed to solve a rational problem – budget deficits, tax evasion, and grey economies. This corresponds with both McNamara's and Parsons' insight into ideational change and how it is coupled with perceived economic or political crises.

But how was an *idea* like the flat tax made into realistic policy alternative, and from where did it come? What is argued here is that Estonia had a very prominent "carrier" of the flat tax named Mart Laar. Laar, a trained historian turned politician, was the chief domestic and international spokesperson for the flat tax. Laar and economists like Ardo Hansson, Heiki Kranich and Kalev Kukk stressed the flat tax at a time when few knew much about the tax reform. These men were informed by the works of Friedman, Hayek and Smith, and neoliberal ideas became a very important part of the early political and economic discourse in Estonia. Leading up to the flat tax there was very little debate about the reform, save a last minute change of heart from left-of-center

Edgar Savisaar. It has been after the adoption of the flat tax where most of the debate has become apparent.

The following chapter will first take a look at the problem of taxation specifically, analyzing the prior progressive system and the limitations of that system. It will also discuss the political and economic backdrop surrounding the shift from progressive to flat taxation. Second, the dissertation will "test" the explanation about ideas, culling information from archival research, secondary literature and personal interviews. A great deal of time is spent on the instrumental role played by Laar and those surrounding his ascension to Prime Minister. It also establishes a connection between the first promoters of the flat tax (Friedman, Hall and Rabushka) and its Estonian devotees. Lastly, the chapter turns its attention to the "rival" explanations, analyzing why rational self-interest and external pressures (or institutions) provide a satisfactory explanation for policy change in Estonia.

A quick note on method is necessary before proceeding. Used in this dissertation is the aforementioned process-tracing method. Process-tracing involves understanding the dependent variable – the policy change to a flat tax, in this case – by unpacking a series of events that lead to the ultimate outcome. By studying each decision in the sequence it helps to make sense of the question at hand. King Keohane and Verba suggest that the best way to get at this decisional process is by conducting interviews with relevant actors and reading the written record about the process (King, Keohane and Verba 1994: 227). As much as is possible, I try to trace this narrative chronologically, beginning with the initial problem of progressive taxation in 1991, the arrival of Mart

Laar in 1992, the passage of the flat tax in 1994, and then contemporary reflections on what those years were like in Estonia from 1991-1994.

The Problem of Taxation

In the classic study *Taxation and Democracy*, Sven Steinmo claimed: "Governments need money. Modern governments need lots of money. How they get this money and whom they take it from are two of the most difficult political issues faced in any modern political economy" (Steinmo 1993, 1). Estonia, and most post-communist states, had the same glaring problem. The Soviet tax system was based predominantly on turnover taxes from state-run enterprises. These turnover taxes — coupled with profits and personal income taxes — were transferred to the Soviet budget, which was in turn transferred back to Estonia's budget (Kukk 2003, 7). As the Soviet state began to whither (if not collapse) a major component of revenue disappeared. As privatization occurred and accounting schemes were not capable of taxing private enterprises, and in turn wage-earners, the state was left penniless (Norgaard, Johannsen, Skak and Sorensen 1999, 133). Rein Jarvelill, an adviser to the Minister of Finance and member of the Social Democratic Party, captured the essence of the time. "This was a rather difficult period in Estonia. They just got independence. We did not have our own experience on tax administration and how to collect taxes" (Jarvelill Personal Interview 2008). The presence of Soviet troops inside the country, the question of "ethnicity", and the need for strident land reforms summarized the numerous problems. Estonia faced another dilemma as well. The only way to have an operational state that could provide basic social services was to increase revenue. That revenue came from income tax.

The first income tax law in Estonia was put into force in 1991 and remained there until January 1994. The progressive tax rates for individuals were applied at rates of 16-percent, 24-percent and 33-percent ("Questions and Answers: Estonian Flat Tax System" 2009, 2). In the first quarter of 1993, Estonian revenues were at 880 million kroon, only one-fourth the projected income (EIU Country Report 1993, 14). A European Bank of Reconstruction and Development study warned of the problem that tax collection posed, the myriad of ways companies evaded taxes, and that if Estonia did not overhaul its tax administration a serious shortfall would arise. Estonia's problem was a classic case of failing to "penetrate territory" which does not allow states to "extract revenue" and "redistribute" (Cook 2007, 21). But few – even in the state – seemed to want to *increase* taxes. In surveys conducted in the early 1990s, more than 60-percent of Estonian 'elites' were opposed to raising taxes to increase revenue. It is not surprising, for example, that 83-percent of business owners were opposed to taxes. But 58-percent of state enterprises, 58-percent of intellectuals and 57-percent of political parties were also opposed. Compare these figures to Lithuania, where 36-percent of all 'elites', 22-percent of political parties, and 35-percent of intellectuals were opposed to tax increases (Steen 1997, 300). Estonia resolved the revenue shortage not by increasing taxes per se, but by changing the progressive tax-collection scheme altogether.

At the end of December 1993, the Estonian Riigikogu passed a budget to very little fanfare. Included in the budget was a new income tax law that set a 26-percent flat rate on incomes. This flat rate replaced the aforementioned progressive scale of 16-percent to 33-percent. The hope was that easier collection would make for higher revenues (EIU Country Report 1994, 15).[30] Fourteen years later, Estonia had become *the* Baltic Tiger, its former Prime Minister Mart Laar an international star, and the flat tax a policy star in its own right. But the flat tax cannot be understood one act alone, but through a culmination of happenings and ideas. This is the story of Estonia's flat tax.

Mart Laar and the Flat Tax

By Mart Laar's own account the transition from communist authoritarianism to capitalist democracy was a trying one. Estonia was heavily dependent on Russia as their major trading partner, inflation was at a rate of 1,000-percent, industry and farming were disasters, and in 1992 GDP dropped by over 30-percent (Laar 1996, 96). By 1996, Laar estimated, those problems were solved. GDP was up, rates of foreign direct investment were higher than had been seen in similar post-communist states, and unemployment was just two-percent. Estonia was also the first post-communist state to be on the European Union's radar, and was dubbed in 1997 'the shining star of the Baltics' (Norgaard 1999, 107). How did Laar explain this phenomenon?

Laar acknowledged he tried to make sense of the Estonian case in light of other post-communist transitions. Two themes emerged, he said. First, it was important to take politics seriously. By this he meant securing the institutional reforms needed to actually enact the proper economic reforms. The ratification of the aforementioned constitution and creation of the Riigikogu ensured political stability. Second, Laar

[30] Their intuition was not wrong. Revenue collection increased by 500,000 *kroon* in the years between 1993 and 1994. Revenue has increased every year since 1993, even as taxation as percentage of GDP steadily decreases. GDP real growth – which had negative growth from 1991-1994 -- has since experienced positive growth every year since 1995 ("Questions and Answers: Estonian Flat Tax System" 2009, 4).

claimed, Estonia had to adopt that “well-known advertising slogan”: *just do it* (1996, 97). He argued that economic reforms must be enacted and carried through regardless of the short-term headaches associated with the radical reforms. These radical reforms included the introduction of their own currency (the *kroon*), liberalization of economic life, abolishment of tariffs, and in time a flat tax on personal income.

Laar also acknowledged a more fundamental change occurring in Estonia. “The most basic and vital change of all,” Laar said, “had to take place in the hearts and minds of Estonia’s people. Without a major readjustment of attitudes, the post-communist predicament would become a trap, and the nation would never move forward to become a ‘normal’ country with free government and free markets under law” (1996, 98). The recognition of ‘ideas’ is critical to understand Laar’s (and thereby Estonia’s) political development. While he admitted his own political shortfalls – and the shortfalls of other conservative or neoliberal governments – the battle is really for the “ideas, values and dreams” of those governments to defeat socialist or planned ones. Laar himself was wedded to the idea of flat tax even though he misinterpreted its application. The *New York Times* reported in November 2006, that not only had Laar only read one text in economics – Milton Friedman’s *Capitalism and Freedom* – he errantly believed that the flat tax had been put into practice in the West (Stolberg 2006; Tierney 2006). Laar commented that Friedman’s basic insight – that people matter, not governments – guided his own thinking (Peach 2006).

In 2007, Laar presented a paper entitled “Milton Friedman’s Legacy Overseas” at Hillsdale College’s Free Market Forum. In the paper, he reflected on the meaning of Friedman to Eastern Europe, Estonia and himself. During the Soviet era, Laar recounted, Friedman's works were not possible to read and "the communist rulers hated this man, Milton Friedman. It became clear to me that he must be a really remarkable thinker" (Laar 2007: 1). For Laar, Friedman's importance can be seen in three areas: macroeconomics, privatization and foreign direct investment, and thirdly, in particular policies like the flat tax. The flat tax offers up the clearest threat to the Marxist legacy, Laar related, because it challenges the notion of a "heavy graduated income tax" as discussed in the *Communist Manifesto* (Laar 2007, 3). Laar's parting salvo summarized the meaning of Friedman in his personal life: "…We can clearly prove that the countries taking maximum advantage of Milton Friedman's ideas are developing faster than the countries which have used only part of them. We can say that Karl Marx has lost — and Milton Friedman has won" (2007, 6)![31]

Laar was also not shy about recommending his political and economic program to others. Taking on Strobe Talbott, U.S. Deputy Secretary of State under the Clinton adminstration, in an editorial for the *International Herald Tribune*, Laar charged that Russia (and the rest of Central and Eastern Europe) needed more, not less "shock therapy". The advice given by some Western advisors to soften reforms and increase aid will undoubtedly get those East and Central European countries in "serious trouble" (Laar 1994). Laar chided the European Union in an article that appeared in the *Wall Street Journal Europe* ten years later. In it he compared "new Europe" and "old Europe", claiming that if the "old" wanted to keep up with the "new" that they must adopt serious tax reforms. This would include doing away with the typical welfare state mentality.

[31] Laar criticized Marx in an interview with the Stanford Review, saying: "…I particularly don't understand why the world should so assiduously follow Karl Marx's teachings, whose first imperative — the confiscation of private property — paved the way for progressive taxation in the arena of history. Perhaps the time has come to leave behind the relic of communism" (Ilves 2006).

“The welfare state is considered a core part of European identity, despite its negative impact on European competitiveness, and its long-term unsustainability [sic]” (Laar 2004). Reiterating Laar’s concerns in 1994 for turning the “hearts and minds” of Estonians, he impressed upon old Europe to develop a new “vision” and “agenda” for the 21st-century.

But Laar also noted the dangers of such a course of action: the changes will be disrupt society and would potentially make one a political pariah. “A government that implements such policy can become unpopular and be ousted from power,” Laar stated. “But this is not important. More important is that your country is changed beyond recognition. Looking back you can say: ‘This was a dirty job, but someone had to do it’” (Laar 2003, 37). Laar should know best. After he was ousted in 1994 as Prime Minister, he returned in 1999, then stepped down in 2002. Former Prime Minister Savisaar has been among Laar’s toughest critics. With Laar’s focus on efficiency and growth, Savisaar argues, he has ignored issues such as education, pensions, and social welfare. “What are the best societies to live in,” Heido Vitsur, Savisaar’s top advisor, asked. “The best societies to live in are the Nordic societies. We have to move in that direction” (Landler 2005).

Explanation 1: The Flat Tax as an Idea

The development of the flat tax in Estonia highlights in part the value of ideas. Laar admits himself, however, an obvious reason that the flat tax has been successful: “it is easy to collect and easy to control” (Laar 2003, 36). Moreover, the flat tax is hard to avoid. Unlike in industrial democracies where progressive taxation encourages wealthy people to shelter income, scour for deductions, and manipulate the system, the flat tax eliminates those possibilities according to Laar. In the course of the flat tax, Laar claims that income inequality has in fact *declined* because the traditional methods to avoid taxation under progressive schemes no longer exist (Tierney 2006). Furthermore, Laar argued that politicians like Savisaar used the flat tax (or at least opposition to the flat tax) to gain electoral support. The idea was wielded as a political tool. "The [Center Party] promised to remove the flat tax immediately after it was introduced," Laar stated in an interview with the English-language newspaper *The Baltic Times*. "But even when politicians promised this…they never saw it through, because the flat tax works. We must realize the difference between populist campaigns and real politics" (Alas 2006).

Erik Terk, Director for the Institute of Future Studies, a think tank in Estonia, argues the ideological – though not necessarily the mathematical or economic tenor of the debate – has mattered most. As an economist, Terk suggests that the flat tax is neither innovative nor really flat. "If you look at it as an economist it is not really flat. If you take all the income from zero to the maximum it is not proportional in some parts, it is actually progressive (Terk Personal Interview 2008). Terk's criticism of the flat tax centers mainly on his belief that it is an ideological game played by the various political parties. For example, though historically the flat tax has been supported by the aforementioned Fatherland, National Conservative and later, the Reform party, a fourth party has also played a role: the Social Democrats. Despite the fact that Social Democrats should be ideologically opposed to such a reform, they supported flat taxes for much of the 1990s. Why, Terk asks? Because it enabled them to be a third member of many ruling coalitions. A second political game also arose. During the late 1990s and 2000s when strange coalitions of seemingly disparate ideologies formed, Terk acknowledged that the exemption rate would rise after elections. The compromise from the conservatives was this: do not touch the flat tax (which protects our political base) and we will raise the exemption rate on who cannot be taxed (protecting your political base).[32]

Despite the "games" of politics, Terk admits that Laar and other conservatives were very committed to their ideas, even if they did not know what they were doing. "Let's just say from the beginning they [Laar and conservative parties] did not know a lot about economics. I had discussions with them when I was in the first government and it was awful. They started being very concerned with the ideas of Lady Thatcher and at first it was a very lonely economic understanding. But now we are even more conservative than Lady Thatcher" (Terk Personal interview 2008). Vitsur, former advisor to Savisaar, agreed:

> In my studies, there are possibly two explanations [to explain the flat tax]: one is the use of this textbook that you probably know, Milton Friedman's *Capitalism and Freedom*. It was this book that demonstrated that the best solution for every country was to have a tax as simple as possible and everyone have freedom of choice. And in Estonia there was this belief that everyone — well not everyone — that money problems are your own problems and the attitude is very individualistic (Vitsur Personal Interview 2008).

Vitsur also argued that Estonia was influenced by a Harvard-trained economist named Ardo Hansson who was an advocate for the flat tax and Reagan-style economics.[33] As

[32] The tax-exempt status on income has changed every year. The basic personal allowance will be reduced to 30 000 kroons (1917 euros) in 2010, 33 000 kroons (2109 euros) in 2011 and 36 000 kroons (2301 euros) as of 2012 ("Questions and Answers: Estonian Flat Tax System" 2009).

[33] Anders Aslund remarked: "Estonia was lucky to have Ardo Hansson, an American of Estonian extraction with a PhD in Economics from Harvard University and an associate of Jeffrey Sachs, as the leading economic advisor to the Estonian government and the Bank of Estonia for years (Aslund 2007, Footnote 7, 125)

Terk and Vitsur related, Laar was a historian, not an economist. So it would make sense that bright young economists were around the Riigikogu at the time. The extent to which Laar specifically advocated the flat tax without consultation is open to debate. Laar himself admitted that Hansson supported the flat tax as “entirely reasonable” (Ilves 2006).[34]

Kalek Kukk, an economist and current advisor to the Prime Minister Andrus Ansip, was also active in the early discussions involving the flat tax. “It was a common decision that we discussed for the future and the end of 1991 and after independence,” Kukk noted. “A bunch of us had a meeting about 50 kilometers from Tallinn and we discussed the different opportunities for a flat tax in Estonia” (Kukk Personal Interview 2008). Kukk drafted close to six proposals for income tax reform from 1992 through 1994. In every draft a flat tax was included. In the latter drafts they noticed something missing: the flat tax.

“In 1992 the Popular Front came into power. I can remember in every draft we wrote there was a mention of the flat tax. We wrote one draft, two drafts, three drafts, and then we get to the fifth or sixth draft and the flat tax was not in it. Edgar Saavisar thought he had to be different from Pro Patria and so he was against it” (Kukk Personal Interview 2008). For Kukk, anyone against the flat tax was playing a political game, not too different from Laar’s understanding or even Terk’s. All through the early 1990s the flat tax was a “common ideal” held by everyone in government. When Saavisar’s government rejected the flat tax it then required the support of Estonia’s political parties, groups like Fatherland and the Estonian Independence Party. It was at this point that the

[34] As Laar later said: “What he (Hansson) neglected to mention was that nobody in the world had yet successfully implemented it” (Ilves 2006).

ideology behind the flat tax became a more prominent issue. Though the flat tax was already an important idea held by elite carriers like Laar and Kukk, the parties themselves had yet to be central characters in the flat tax story. With Saavisar's rejection, the flat tax became something of a rallying point for these conservative parties. Not only could they act against the social democratic government of Saavisar, but they could now pronounce support for a flat tax policy that united several competing political parties.

Another prominent figure was highlighted in Per Nielsen's comparative study of tax reforms in Estonia and Norway — Heiki Kranich.[35] Kranich was named Finance Minister for the new government in 1994 after refusing the post a year earlier. Kranich was instrumental at setting the tax rate at 26-percent, and Laar admitted that Kranich was "very important when it came to the Parliament level, to really negotiate and get it done in Parliament" (Nielsen 2006, 69). But as Kranich admitted about the flat tax himself, "it would have been impossible without the personal part of Mart Laar" (Nielsen 2006, 69). And as Hansson said: "As for the flat income tax that was mostly the then Prime Minister Mart Laar who pushed it through — almost on his own" (Nielsen 2006, 69).

Terk and Vitsur argeed on one final aspect of Estonia's flat tax adoption: the seeming complicit role of the media. While analyzing the ideological nature of Estonia's media is outside the scope of this study, both acknowledged that newspapers and media were active in supporting the new government. Any policy or agenda that seemed socialist was castigated. Free market ideas were promoted and social democratic notions deemed irrelevant or Soviet (Terk and Vitsur Personal interview 2008). To Kukk's

[35] Kukk stated that Kranich was a "very important person," and was quickly moved to the Ministry of Finance following his work on the flat tax.

recollection, in the early 1990s there were very few articles that said anything against the flat tax.

Explanation 2: Discourse on the Flat Tax

The second explanation claims that ideational change would be revealed through an observable political discourse. The discourse itself was part of the causal story in the shift from progressive taxation to flat taxation. The problem with this explanation is that there was virtually no political and economic discourse until *after* the adoption of the flat tax. The passage of the tax law was one paragraph of a sidebar on the front page of the newspaper January 1, 1994. Not one author of the policy was interviewed and the vote total was not even published. As Kukk noted, the flat tax had support among economists but there was no public debate about its uses. Moreover, as far back as 1991, there was a "common ideal" that the flat tax would eventually replace the progressive tax. What does the lack of debate mean for the flat tax? If there is no debate does that mean that the flat tax was simply a rational policy decision that solved a pressing problem?

First, the major players in the flat tax decisions understood the ideological controversies surrounding the flat tax despite the fact that it was not yet controversial in Estonia. For example, Laar stated that because progressive taxation appeared in Marx's *Communist Manifesto* that such taxation would therefore violate the tenets of the free market. Also, because Friedman's books were banned in the Soviet Union that meant he must be a really "remarkable thinker". Marx's idea (progressive taxation) was held in contradistinction to Friedman's idea (flat tax). In one sense, Laar was battling an ideological ghost as Estonia was far from Marxist in the early 1990s. But Laar was also aware that Friedman's ideas could – and in time did – stir controversy in Estonia. Even economists like Hansson and Kukk knew that the flat tax was part of broader neoliberal package that squared with their ideology and was antagonistic to the social democratic model. Kukk spent his free time translating prominent free market texts into Estonian after all![36]

Second, there actually was considerable debate over the flat tax, but only *after* passage of the law. Why does this matter? Though it in no way validates the above explanation, it does provide a window into the ideational differences between flat tax supporters and progressive tax supporters. These debates highlight issues of fairness and equity on the one hand and issues of economic growth and revenue stability on the other. It demarcates the social democratic ideas from the neoliberal ideas. Unlike the closed door meetings outside of Tallinn that Kukk and others attended in 1991, the controversies of the late 1990s were open for all to see, in Estonia and elsewhere in Eastern Europe. This is also a preview of the debates that develop down the road in places like Slovakia, the Czech Republic, Poland and Hungary. In those cases, the debates took place before, during and after the adoption of the flat tax, or as in the case of Poland and Hungary, its rejection.

The main culprits in the Estonian debate were a case of back to the future. Savisaar and Laar picked up where they left off in 1992, this time with a more thorough understanding on the effects of the flat tax policy. Savisaar and his Center Party has consistently been a thorn in the side of Laar and other right-of-center politicians. In 1999, the Center party won 28 of the 101 seats Parliament. However, three rightist

[36] Most notable was his translation of Ludwig von Mises' *Liberalism* into Estonian.

parties – the Moderates, the Reform Party, and Laar's Pro Patria Union – won 53 seats combined, which made it hard for Savisaar to form a ruling coalition to govern. Moreover, the Estonian constitution allows the elected President (in this case Meri) to appoint whomever he wanted as Prime Minister ("Savisaar Scores Bittersweet Victory" 1999). Meri – no leftist – overlooked Savisaar, who he considered to be "an authoritarian" and "Communist", and appointed the familiar Laar to the post. But Laar's second term as Prime Minister was as tumultuous as his first. In this instance, the ruling block of the three right-of-center parties was fractured over inter-party distrust and backbiting. Laar announced his decision in 2002 to resign amid discussions between Savisaar's leftist Center Party and the pro-business Reform Party (Gunter 2002). To almost all political observers, this seemed to be a strange partnership.

One year later, the issue of taxation divided the coalition. The Center Party continued to champion a progressive tax and waged a campaign built upon ideas of social justice. But Prime Minister Siim Kallas of the Reform Party – who took over for Laar – butted heads with those inside Center Party. "A progressive income tax represents the very kind of economic thinking we don't support," Kallas said. "If we were to support it, we would really have trouble identifying our party's ideology" (Johnson 2003). By 2005, Savisaar was at it again. Criticizing new Prime Minister and flat tax supporter Andrus Ansip, Savisaar argued that increasing income inequality, caused by flat taxation, would increase crime throughout Estonia ("Savisaar Slams Economic Inequality" 2005). And in 2007, Savisaar and the Center Party threw their hat in the ring again, running once more on a platform to eliminate the flat tax, once more garnering a quarter of the vote, and once more failing to form a ruling coalition in parliament (Alas 2007). Ansip was elected for a second term.

The inability of Savisaar to regain power demonstrates not only the ideational struggles among elites but also the inherent problem with coalition-style governments. Terk stated earlier that once the flat tax was passed, unusual coalitions would form to protect the flat tax, leaving the Center Party on the outside looking in despite the fact that they have been the second largest party in Estonia for the last 15 years. It certainly speaks to Laar's conviction that *politics matters*, even if you can "change the hearts and minds" of the populace. Coalition-style politicking becomes a prominent reason – as will be shown later on – that Hungary has had a very difficult time adopting a flat tax despite the presence of flat tax ideas.

Rival Explanation 1: External Pressure in Estonia

Another explanatory variable with respect to Estonia's adoption of the flat tax is the pervasive role played by external actors like the European Union and lending institutions like the International Monetary Fund and World Bank. In particular, many have privileged "Europeanization" as an explanation, or the way in which EU states adopt EU rules (Schimmelfennig and Sedelmeir 2005, 7). Given that Estonia (along with Latvia, Lithuania, Slovakia, and Romania) joined the European Union following their adoption of the flat tax, it is worth considering the Europeanization literature as a jumping off point. As Heather Grabbe has suggested, the EU's role in Eastern Europe proceeded in two parts. First, was the economic development program known as

PHARE, or originally the 'Poland and Hungary Assistance for the Reconstruction of the Economy'.[37] PHARE provided grants, aid, and broadly neoliberal technical advice to Eastern Europe. The second part of the strategy was a political program that would further consider Eastern Europe for accession into the EU. The pre-accession criteria have sometimes been called the "Copenhagen conditions," because of the requirements laid out at the Copenhagen European Council in 1993 (Grabbe 2006, 7-10). Coupled with the requirements of the strict *acquis communautaire* -- the body of laws that makes-up the EU and structure the behavior of new and existing members – Eastern Europe seemed to have clear direction from Western Europe.

But the growing literature on Europeanization seems less than conclusive. As Grabbe herself pointed out, the EU's impact on Eastern Europe was not nearly as profound as it could have been because of the "diffuseness and uncertainty" regarding EU leadership (Grabbe 2006, 3). While the broad public policy agenda of the EU was followed by most of Eastern Europe, the peculiarities of domestic politics also mattered (Grabbe 2006, 201-2003). Hughes, Sasse and Gordon have been even more critical of the Europeanization thesis. In what they described as the "myth of conditionality," they argued that the pressures on Eastern Europe by EU conditionalities have been considered a given within the political science literature (Hughes, Sasse and Gordon 2004, 2-3). But the inconsistencies in the application of those conditions, the relative disconnect between EU elites and Eastern European elites, and the erratic dispensing of aid to Eastern Europe undermined the potential relationships between East and West (Hughes, Sasse and Gordon 2004, 8-9, 13).

[37] Although the program went on to include ten countries in Eastern Europe, including the Baltics.

Moreover, the International Monetary Fund has been linked to the flat tax. The IMF had five basic recommendations for developing countries with respect to taxation. One recommendation is particularly informative as it relates to the flat tax. The IMF Tax Policy Handbook recommends: “An administratively simple form of personal income tax, with limited deductions, a moderate top marginal rate, an exemption limit large enough to exclude persons with modest incomes, and a substantial reliance on withholding” (Shome 1995, 5). Two things are important to note. First, there is no discussion of the particular type of scheme of taxation that developing states should use whether that be progressive, flat or otherwise. Second, despite the absence of a specific tax scheme recommendation, the Estonian flat tax fulfilled two basic provisions: it was “simple” and there were “limited deductions”.

In Vahram Stepanyan’s IMF Working Paper on post-communist taxation, he notes that, “starting in the mid-1990s, [the Baltic states’] governments’ tax policies have been influenced by their medium-term objective of accession to European Union” (Stepanyan 2003, 13). But it is not clear the European Union had much to do with the flat tax specifically. For Stepanyan, VATs (or value-added taxes) and corporate taxation were more important to the European Union than personal income taxes (Stepanyan 2003, 14). Olev Raju of Estonia’s Tartu University related that given Western Europe’s own predilection for progressive taxation that there was virtually no pressure pushing for a flat tax specifically (Raju 2006, 43). Like Stepanyan, Raju admitted that corporate taxation was a more prominent concern for the EU. When Estonia lifted their corporate tax altogether on January 1st, 2000, it was aimed at promoting foreign investment in anticipation of future EU admission (Raju 2006, 44). [38] "By end-2000," Stepanyan said, "the Baltic countries had higher or similar levels of government revenues compared to the beginning of transition process and had largely achieved the tax reform objectives" (Stepanyan 2003, 19). It is also worth mentioning that the Baltic experience at tax policy reform was generally seen as more successful than their tax *administration*. Stepanyan blames this primarily on the politicized nature of the tax bureaucracy as well as its inability to cope with a growing taxpayer base (Stepanyan 2003, 22). But this could also speak to the fact that those implementing the new tax scheme were not necessarily accountants or bureaucrats, but in fact, ideologues.

Furthermore, almost everyone with knowledge of the Estonia case specifically seems to think that the IMF and World Bank had a very small role in domestic taxation issues. "To my knowledge they had nothing to say," Terk related. "They were neither for it nor against it. Usually these institutions have nothing to say about taxation. They like that it is collected, and that general taxation must be favorable for companies. But it is a domestic issue" (Terk Personal Interview 2008). Andres Saarnit, at the Bank of Estonia, says their influence was very "neutral" (Saarnit Personal Interview 2008). And Kukk argued definitively that the flat tax was the idea of Estonians, not outside influence. As he noted: "I can't say for sure that they were involved. But for me it was a very pragmatic decision. For me it was our very own idea. If you talk to some it was an idea from elsewhere. But I didn't need such ideas to know to do it. This was entirely Estonian" (Kukk Personal interview 2008). And as Hillar Lauri, a World Bank advisor in Estonia definitively said: "I ran the World Bank office from 1993-1995 (both years

[38] As Raju's research showed, however, eliminating the corporate tax actually did little in the way of increasing foreign direct investment (47).

inclusive) and I can tell you that we were not involved with the flat tax question" (Lauri Email Interview 2008).

Laar's view of the IMF, World Bank, et al has been less neutral. In his own discussions with the IMF and World Bank he found them to be very skeptical of the flat tax scheme. In particular they were concerned that cutting taxes would lead to budget deficits. As Laar told Per Nielsen, for the IMF "the most important thing was the financial stability, and they didn't believe very much in the theories that if you cut the tax, you'll get more money" (Laar as cited in Nielsen 2006, 56). But as already shown with monetary reform and the introduction of the kroon, Estonia has been known not to listen to IMF advice before. Daniel J. Mitchell, a fellow at the Cato Institute, believes that both the IMF and World Bank are even ideologically opposed to the flat tax. Despite talk of tax deficits, the real concern says Mitchell is tax competition. "The European Commission seems intent on protecting the interests of high-tax nations by hindering tax competition" (Mitchell Email Interview 2008). For example, when President Askar Akaev of Kyrgyzstan enacted a flat tax of 10-percent on personal income in 2004, the IMF prevented the change, warning that rate would not be high enough to meet the budget (Aslund 2007, 119).

While the European Union and International Monetary Fund pushed a neoliberal economic agenda and liberal democratic principles for Eastern Europe it is not clear the causal relationship between the two parties. Prior to 1989, Estonia in particular had already focused its sights on a non-communist economic and political program. Aforementioned elites, like Laar, were already wedded to liberal economic principles before coming to power. Domestic political elites – ‘carriers’ of ideas if you will – seemed to withstand the pressure of the external forces surrounding them.

Rival Explanation 2: The Explanatory Power of Rationality

The second rival explanation claims: In states that adopted the flat tax we would observe the power of rationally-expressed self-interest caused adoption and not ideas. According to the Estonian Finance Ministry in a report entitled “Questions and Answers: Estonian Flat Income Tax System”, it details three specific reasons for switching to the flat tax system. First, they highlighted its simplicity, second, its transparency and thirdly, that the flat tax had low compliance costs for both taxpayers and tax administrators (“Questions and Answers: Estonian Flat Income Tax System” 2009, 3). To elucidate on the first and third concern, the conventional wisdom concerning the flat tax was that it would be the best way to do taxation in a country that had very little experience otherwise. The finance report is typical of most writing on the flat tax change, particularly in news media reports.[39]

Without question, pragmatic concerns are central to explaining the flat tax change, but it can only explain so much. The development of the flat tax in Estonia speaks to McNamara’s aforementioned framework of *policy failure* followed by *policy innovation* (and eventually *policy emulation*). The failure of progressive schemes to collect and accrue taxes created an opening for a policy innovation. Laar capitalized – literally and figuratively no less – on this opening by introducing the flat tax as both a

[39] Ken Dilanian’s reporting on the flat tax for the *Philadelphia Inquirer* – the reporting that spurred this author to research the flat tax in Eastern Europe – stressed the pragmatic reasoning behind flat tax adoption (Dilanian 2005).

solution to the problem but also as an ideational shift from the 'old' way. But again the rational explanation cannot fully explain the arrival of the flat tax, if for no other reason than the fact that the flat tax had never been tried anywhere else in Eastern Europe or the Western world.[40] What I mean by this is that the first elites did not actually know the flat tax would work. Laar's decision was a hunch, if not a gamble, to accrue taxation.

The *idea* of the flat tax held considerable influence for Laar, despite not knowing for sure its considerable effects.[41] Moreover, all of Estonia's neighbors were still tinkering with progressive rates despite very similar problems concerning revenue collection and tax evasion. The best case of this is Poland, where over time the rates have been reduced and the tax brackets limited to only three, but the progressive form has remained. In short, the social democratic model of taxation still practiced in Hungary today was mimicked by almost all of Eastern Europe. From 1991-1994, Estonia followed the same model as everyone else. But in 1994, Laar's government offered up a "liberal alternative" to counter the progressive hegemony (Aslund 2007, 116).

Conclusion

This chapter assessed Estonia's adoption of the flat tax and the causes behind the adoption. Testing four explanations in this chapter, I learned that the ideational shift in Estonia facilitated the change from progressive to flat taxation. However, the shift did not occur for the reasons initially hypothesized. Rather than vigorous debate about the pros and cons of the respective taxes, the debate occurred primarily outside of the public

[40] Except for, of course, Hong Kong.
[41] In retrospect, the flat tax working seemed like an obvious result. But most Western observers like the IMF were very concerned that the tax could not recoup enough revenue to sustain a budget.

eye, among ideologues and economists. The ideas were derived from Western texts like Milton Friedman's *Capitalism and Freedom* and held up in opposition to the prevailing ideas of the Soviet period. The flat tax progenitors found an opening in the perceived failure of progressive taxation after the fall of the Soviet Union, uniting both a practical purpose and an ideational one. Lastly, contrary to the literature on the power of institutions, the IMF, World Bank and EU (at the time the European Community) held little sway over Estonia. As Aslund remarked, the "wave of tax reforms" came not from the institutions of the "West" but from the "East" (Aslund 2007, 118). Not only did Estonia not listen to the advice of these institutions concerning the flat tax, but Laar openly mocked those institutions after the adoption of the flat tax.

The next chapter highlights the second round of adoption of the flat tax in the Baltics: Latvia and Lithuania. Latvia and Lithuania draw attention to concept of policy diffusion and the extent to which those states adopted the flat tax because of Estonia's prior adoption. The chapter also looks at the interplay between institutional, rationality and ideational explanations in "early" adoption cases. Unlike Estonia, "ideas" were less compelling than what Latvia and Lithuania perceived as the rational advantages of the flat tax. But they also used Estonia as an inspiration – or model – for developing a flattax program. Though their knowledge of the Estonian case was limited, the first adoptervalidated what at one time was an unknown policy choice to future adoptees.

CHAPTER 4

LATVIA AND LITHUANIA: EARLY ADOPTION OF THE FLAT TAX

Introduction

The Estonian case showed how economic ideas interplayed with the problem of tax collection and revenue building in the nascent, post-Communist state. This chapter examines the extent to which economic ideas mattered in Latvia and Lithuania — the next two countries in Eastern Europe to go the way of the flat tax — but also the extent to which Estonia's decision to change their tax scheme influenced future adopters. In the literature this is known as "policy diffusion." This chapter will assess six of the explanations discussed in Chapter Two. Explanation one claims that in states with flat tax policies we would observe a shift in ideas that caused a shift in policy. Explanation two claims that in states that have flat tax policies we would observe discourse about the appropriateness of said idea which caused a shift in policy. Some actors would stump in favor of the idea and others would be opposed. The third explanation of the chapter (which is listed as explanation four in Chapter Two and later on in this chapter) claims that in states that adopted the flat tax after Estonia (the first adopter), we would observe that other states emulated the policy, or practiced what is called policy diffusion. Previous adopters were instrumental in showing off the flat tax to future adoptees.

Three rival explanations are tested in this chapter as well. Rival explanation one claims that in states that adopted the flat tax we would observe the power of external pressures (or institutions) caused adoption and not the power of ideas. Rival explanation two claims that in states that adopted the flat tax we would observe the power of rationally-expressed self-interest caused adoption and not ideas. The third rival explanation (which is listed as explanation four in Chapter Two and later on in this chapter) claims that in states that adopted the flat tax after Estonia (the first adopter) we would observe that these states did so independently and without regard for the flat tax in other states.

In the case of Latvia, this chapter shows that while there was significant political infighting over a post-Communist Latvia, the decision to turn towards the flat tax was relatively pragmatic in nature and void of ideological debate. In the case of Lithuania, there was a significant ideological force that disputed progressive taxation, but all told there was little political infighting about getting the new tax reforms approved. In both Latvia and Lithuania, the policy change was the culmination of wanting a tax code that was both efficient and pragmatic. Just like Estonia, though, external pressures were relatively insignificant. Latvia's and Lithuania's adoption of the flat tax was the result of the choices of domestic elites rather than international authorities.

Despite the "domestic" nature of the decision, however, Estonia was a flat tax model to look toward, or what the literature calls policy diffusion. Thus there is an international level to flat tax adoption as well. Using Kurt Weyland's four approaches to studying policy diffusion, I focus on the "cognitive heuristics" model. This means that actors mimic policy choices of a prior adopter (like Estonia) based on limited information and "bounded rationality". While Latvia and Lithuania essentially knew what Estonia was doing – abolishing a graduated tax for a more simple flat tax – they did not assiduously study the policy. Instead, policymakers established a mental shortcut: they had a model for a "new way" but largely designed their tax reforms with little input from Estonian advisors.

All told, only one of the explanations tested is validated, that being explanation three regarding policy diffusion. In neither case were ideas or public discourse a prominent part of the policy change. Instead, the flat tax was a solution to the problems exhibited by progressive tax schemes. As to the rival explanations, only one of those explanations was validated, that being the rival explanation of rationality. The rival explanation concerning external pressures held little sway in the Latvian and Lithuanian cases. Also, policy diffusion played an important role in delivering the flat tax to Latvia and Lithuania, invalidating the third rival explanation about the "independence" of their discovery of the flat tax.

This chapter will proceed by looking at both the Latvian cases and Lithuanian cases separately, and then analyze them comparatively at the end of the chapter. The first part of the chapter details Latvia, offering both a historical sketch and a contemporary analysis of their political and economic situation. It then situates Latvia within the context of the flat tax change, analyzing how and why that change took place. The second part of the chapter highlights Lithuania, once again looking at their situation both historically and contemporarily before moving on to their adoption of the flat tax. The last section of the chapter assesses the extent to which Latvia and Lithuania learned from the predecessor Estonia. This is what McNamara called "emulation", or what Weyland and Simmons define as "diffusion".

Latvia: A (Short) History

Lativa and Lithuania, two countries just to the south of Estonia along the Baltic Sea, adopted the flat tax one year later in 1995. Like Estonia, both Latvia and Lithuania had a Communist heritage that shaped political and economic developments. As Juris Dreifelds has noted, the Baltic experience was unique even to the rest of Europe. Unlike other Soviet Republics (like Ukraine or Georgia) the Baltic states possessed a long period of independence from 1920-1940 where nascent democratic procedures existed. The three had managed to establish a democratic order during what Huntington has called the "first wave of democratization" (Krupavicius and Algis 2005, 122). Second, all three were subject to the central planning of Moscow and had no economic or political autonomy, like Poland or Hungary (Dreifields 1996, 110). After the fall of the Soviet Union, the three turned their sights toward democratic reform and economic liberalization. Their goals were threefold: turn away from Russia, integrate with the West and establish a political and economic system based in Western ideals (Aslund 2007, 25).

In Latvia the transition proceeded at a piecemeal rate. Latvia's transition — not unlike Estonia's — included a number of reform-minded Communists. In fact, Latvia's transition was very much predicated on something of a "dual government" within the Latvian Soviet Socialist Republic (SSR) Supreme Soviet. On the one hand was the Latvian Communist Party, and on the other was the reformist People's Front political party. As Dainis Ivans highlighted in 1989, Latvia's government was composed of "the nominal power of the Communist Party…and the real power of the People's Front"

(Dreifelds 1996, 73-74). Beginning in 1990, the Soviet government allowed for the first time open elections, and these elections gave rise to the first serious opposition candidates (Eglitis 2008, 238). By April 1990, Latvian citizens spoke with their votes on the government they preferred. The People's Front won a clear majority of seats in the Supreme Council (Dreifelds 1996, 74). However, Latvia did not declare independence immediately after the success of People's Front. A type of power-sharing arrangement occurred. Anatolijs Gorbunovs, a high-ranking Communist reformer was elected chair of the Supreme Council. Ivars Godmanis, a Popular Front leader, was tapped to be the Prime Minister. In one case, Aldis Purs pointed out, Latvia had two attorney's generals: one who was loyal to Moscow and another who was loyal to Riga (Purs 2005, 136).

But the dual government — like Russia's many years before it — was doomed to fail. Lithuania had passed a Declaration of Independence on March 11th, 1990, and Moscow responded with an economic blockade (Pabriks and Purs 2001, 60). Sensing Soviet frustrations, Latvia chose a conciliatory approach, passing instead a "Declaration about the Renewal of the Independence of the Republic of Latvia," which declared independence of a sort. It placed a transitional period of time on when Latvia would be a fully functional and sovereign state (Purs 2005: 136). But by the Fall 1990, Latvia was already establishing its own customs offices and other public offices to establish their sovereignty (Dreifelds 1996: 77). Even more damaging to the Soviet cause was the failure of the "Black Beret" insurgent movement composed of pro-Moscow Latvian forces. After attempting to occupy the Ministry of the Interior in Riga on January 20th, 1991, five people were killed including a well-known Latvian cameraman (Dreifelds 1996: 77). By March, an overwhelming majority of all Latvians — including those considered ethnically “Russian” — were for an independent and democratic Latvia. When Russia’s own coup failed in August 1991, Latvia was an independent, sovereign state.

Politically, Latvia was a transitioning, parliamentary democracy. Though Latvia (like Estonia and Lithuania) had what is called a “restorationist” political system – they restored the pre-World War II Constitution, for example – it had been roughly sixty years since anyone had used the preexisting governmental structures (Eglitis 2008, 241). While the People’s Front had soundly defeated the Latvian Communists, early Latvian independence saw harsh times and a lack of cohesion by the party. By 1993, over twenty-three different political groups were vying for seats in Parliament, called the *Saeima* (Dreifelds 199, 87). These elections were for the *fifth* Saeima in particular, the first parliamentary elections of their kind since 1931. When voters went to the polls on June 5th-6th, the newly formed Latvia’s Way party — a moderate, some might even say right-of-center party — won 36 seats of the 100 seat parliament. They combined with the conservative Agrarian Union party (12 seats) to form a ruling coalition in the first democratically elected government in over sixty years (O’Connor 2003, 169).

The victory of right-of center parties in 1993 was sign of things to come in Latvia. In the sixth and seventh *Saeima* respectively, right parties outnumbered left parties four and three to one. The success of right parties could possibly be attributed to the inability of the left-of-center Popular Front to provide basic services in a post-independence Latvia. It could also be attributed to the absence of a social democratic discourse in the 1990s. Although social democracy was very popular at the end of the 1980s, in the 1990s right-wing parties likened social democracy as a successor to communism, painting it in such a way that made it hard for social democrats to compete in elections (Runcis 2005, 177). However, coupled with right-of-center dominance has also been the relative instability of government. From 1993-2000, eight different prime ministers were in place, six right-of-center, and two centrist. As Artis Pabriks and Aldis Purs noted: “This characteristic of Latvian politics seriously undermined the electorate’s trust in the parliament, parties and democracy…” (Pabriks and Purs 2001, 83).

The formation of political parties in Latvia has essentially depended on two issues: nationality and economic development. On the nationality question, parties contest for how “Latvian” or “Russian” the school curriculum, language, or culture should be. On the economic development question, parties had to answer one question: What role does the state play (Pabriks and Stokenberga 2006, 54)? Because all political parties have answered with various shades of gray to these questions, the ideological purity of the parties have come into question. In other words, what exactly is a “right” or left” party? Some scholars have answered by arguing that Latvia’s party system has become overtly “personalized” and “short-lived”. In the end, the agenda of the various parties has been directed by particular individuals whose agendas are very much their own. “In the making of the lists of parties,” political scientist Andris Runcis argued, “special attention was paid to popular public figures…This approach to making election lists was characteristic of most of the lists because it was expected that the voters would choose between politicians rather than parties” (Runcis 2005, 174).

Latvia’s political transition and its economic transition share a few similarities that are important to note. First, the effort of post-Communist reformers in both states is similar. The People’s Front in Latvia acted as a conduit to the people and both a symbolic and realistic alternative from the previous system. This is similar to Estonia's Popular Front, a social democratic alternative to the hardline communists. The quick rejection of the "old way" enabled one of the more peaceful and successful transitions of the post- Soviet states. Second, in both cases, their governments quickly shifted to moderate, or right-of-center governments – the Latvia's Way Party in Latvia and the Fatherland Party in Estonia. This moved those governments not only farther away from their communist past, but also hardened the distinctions between social democratic and neoliberal parties. Thirdly, there was a dual priority placed on economic *and* political reform. This necessitated the need for both a political and economic message on the part of political elites and parties. So while on the one hand the flat tax speaks to the politics of state-building and revenue collection it also speaks to a specific economic discourse contrary to progressive taxation.

Explanations and Rival Explanations 1 and 2: Ideas, Rationality and Discourse In Latvia

Coupled with tenuous political development has also been a rocky economic development. Prior to the fall of the Soviet Union, Latvia was simply one piece of the USSR's command economy. Russia was its largest trading partner and Latvia had no experience with free markets or privatization. Even after independence, Latvia was dependent on Russia as its major trading partner. Like Estonia before it, Latvia's tax system was wedded to a Soviet system where local administrators had very little influence. When Latvia became independent it had to find a means to generate revenue and balance budgets (Dreifelds 1996, 117). Interestingly, one of the major sources of discontent about tax revenue has not been the state in Latvia, but regular citizens.

As Dreifelds stated:

> Tax evasion by firms and claims of billions of diverted dollars abroad have created a populistic backlash for ordinary people who believe that all their demands for increased pensions, family allowances, farm subsidies and other services could be easily satisfied by more rigorous and determined tax collection practices. Indeed, in 1993 the government created a large new layer of bureaucracy, including 1500 finance inspectors, to verify the accounts of enterprises. Much effort was also applied to collect arrears of taxes although many of the delinquents turned out to be state firms on the edge of bankruptcy (1996, 118).

By 1994, the Latvian government sought to counteract personal income tax evasion by giving every employee a work book that they had to turn in to be employed. Penalties were also applied for those who tried to evade taxes in the business sector. Prior to those new laws, only the "fools" would be above board, pay taxes, and respect the law (Dreifelds 1996, 119). It encouraged tax avoidance so as to stay competitive with other businesses that also dragged their collective feet on the tax issue. In 1995, moreover, Latvia faced a serious budget deficit caused in part by the banking crisis of the same year. Whatever the major impetus for the revenue shortfall – tax evasion, banking crisis, or neither – tax reforms took place in 1995 that broadened the tax base and cut rates. The tax law was simple and straightforward: "The rate of tax to be paid from the annual taxable income shall be 25 percent. The payer of the payroll tax shall pay a rate of tax, which amounts to 25%, from the monthly taxable income."[42] These tax reforms included not only income taxes, but also corporate and VAT taxes (Nissinen 1999, 70-71). In a study performed by the World Bank in 2004, they found that starting in 1998, Latvia increased budget revenues by 42-percent, compliance costs were greatly lessened, and they found a reduction in tax evasion ("State Revenue Service Modernization Project" 2004, 24).

[42] *Latvian Tax Law* (last amended January 2006).

Janis Platais, currently an adviser for the IMF, was very supportive of Latvia's turn toward a flat income tax in the mid-1990s. For Platais, the flat income tax was a logical solution to the problem of tax collection. The tax administration was overly burdened by trying to enforce a progressive scale that consisted of multiple brackets. OECD tax policy experts suggested a flat income tax in the early 1990s and put a single rate on both individual income and corporate income to avoid a "grey area" in the tax regime for hiding income. Those within the tax bureau and the OECD were confident in their decision. "There were no major doubts as the flat rates were adopted as a measure to depart from multiple rates taxation," Platais noted. "We viewed this as simplification" (Platais Personal Interview 2008). Those same experts were surprised when they assessed revenue a year later. "The calculations for fiscal impact estimated that the measure initially would be revenue neutral. However, later we experienced fast surge in revenues from individual income tax, while corporate income tax was slightly lagging earlier projections" (Platais Personal Interview 2008).

The Latvian flat tax experience was unique from the Estonia experience because of the relative absence of ideological debate on the issue. Though some experts believed that a progressive tax might raise more revenue — which in turn could be redistributed — their influence was small and the group "did not have a very strong say" (Platais Personal Interview 2008). Two points can be drawn from the Latvian case. First, there was almost no leftist discourse to speak of which championed a progressive tax. Unlike Estonia, there was not any political party that defined itself in support of, or in contradistinction to, the flat tax. Political parties lacked the ideological cohesion that had defined Estonia. Second, Latvia's lack of an ideological tenor can also be explained by the absence of what Aligica and Evans called a “policy champion” (Aligica and Evans 2009, 200-201). There was no Mart Laar in the Latvian experience, no one who assiduously read the text and trumpeted the cause to others. Ultimately, economic ideas did not have the same cache they seemed to have with Estonia.

On the other hand, the lack of ideas is not just a consequence of party politics or elite champions but the recognition that policy change is more pragmatic than ideational. The group of flat tax pioneers in the Estonian case understood the symbolism of the flat tax as much as they understood its practical application. The Latvians understood the flat tax problem as *specifically* a tax problem and nothing more. For example, Allister Heath claims that Latvia set their tax rate at 25-percent simply to undercut Estonia’s initial 26-percent, introducing the variable of tax competition as an additional reason to adopt a flat tax (Heath as cited in Aligica and Evans 2009, 194). Edwards and Mitchell’s work on tax competition notes the same trend, as they argue that successive flat tax adopters have lower rates than their predecessors. Furthermore, flat tax countries have cut their tax rates in time (including Estonia, Latvia and Lithuania) in response to cuts, or lower rates, by neighbors (Edwards and Mitchell 2008, 62). It is not clear whether or not this type of competition produces the results the states that engage in it claim. It is clear, however, that they find the competition to be rational. This invalidates explanation one about ideas and validates rival explanation two concerning rationality. There is no causal relationship – or information for the matter – that speaks to the power of ideas in the Latvian case.

Like in Estonia, there was no public discourse on the flat tax until after the fact.[43] In 2009 facing a budget crisis, the Latvian government decided to reduce old age pensions and cut public sector salaries. Up on the chopping block as well was the flat tax (Johannson and Lannin 2009). On June 9th, Latvian Prime Minister Valdis Dombrovskis announced that Latvia would move towards a progressive tax to keep the budget in line and also acquire a loan from the IMF ("Economic Crises Forces Latvia to Ditch Flat Tax System" 2009). But on June 11th, the flat tax was preserved and the budget was trimmed.[44] This does not help in any way explain the 1995 adoption; however, it does provide a glimpse of the future. Not only will adopters like Slovakia and the Czech Republic go through a similar struggle on the road to policy change, but non-adopters like Poland and Hungary have to make sense of the flat tax in light of shrinking budgets at a time of economic trauma.

Lastly, the rival explanation of "external pressures" is examined. In Estonia, the idea of the flat tax was retrieved from external sources; that is, the flat tax was not an Estonian idea specifically. It was derived from texts like Milton Friedman's *Capitalism and Freedom* or Hall and Rabushka's textbook on the theory. Similarly, it is important to note the role that the Organization for Economic Cooperation and Development (OECD) played in the Latvian decision to go the way of the flat tax. Though the OECD (which is headquartered in France) provided technical advice according to Platais, their role was more passive than the role played by domestic elites. While there is some discussion that

[43] Once again, the timing of these debates may not mean much for flat tax adoption in Latvia but helps to make sense of the 'late adopters" in Chapter Five.
[44] The international reaction to this decision was intriguing. Daniel J. Mitchell of the Cato Institute said in preserving the flat tax that it greatly disappointed the "class warfare advocates" and "economic Luddites" (Mitchell 2009). Richard Murphy's taxation blog Taxresearch.Org approvingly proclaimed that the anti-poor "flat tax bites the dust" (Murphy 2009).

the IMF and World Bank offered "advice" during this period, external forces like the major aid organizations and the European Union did not play a major role in the decision, according to Platais.[45] Similar to the Estonian experience, taxation reform was not handled by the predominant lending institutions. But unlike Estonia, "outsiders" were more significant players in Latvia's tax reform.

Lithuania: A (Short) Political History

Lithuania offers an interesting case in relation to both Estonia and Latvia. Culturally, Lithuania's religious practice is dominated by Catholicism -- as opposed to Estonia's and Latvia's Christian Orthodoxy. Historically, Lithuania has aligned itself more towards Poland and Western Europe, than Russia or Northern Europe. Politically, Lithuania's dual PR/Majoritarian contrasts the very basic PR-list system that exists in Estonia and Latvia (Pettai and Kreuzer 2001, 108). And economically "Lithuania never opted for the same sort of economic 'shock therapy' as Estonia" (Aalto 2006, 100). Instead, Lithuania opted for a more gradual pace due in large part to the left-right divisions that prevented the government from rapid ideological swings, but also due to a Catholic heritage that "helped maintain ideas of collective solidarity and to resist liberal economic ideas" (Aalto 2006, 100). This "gradual" pace, according to Kevin O'Connor, is responsible for Lithuania being such an economic laggard by comparison to the other Baltic states (O'Connor 2003, 179).

Lithuania experienced something else unlike Latvia and Estonia. Whereas Latvian and Estonian independence movements began with reform leftists (like Savisaar)

[45] As Pami Aalto has noted, in the European Union's eyes Latvia was a relatively small, and in economic terms an "insignificant" potential member (Aalto 2006: 95).

and led to conservatives (like Laar), Lithuania's trajectory started with rightists (like intellectual Vytautas Landsbergis) and the transition period was dominated by left-of center politicians like President Aligirdas Brazauskas (Park 1994, 155). Lithuania's political parties are also indicative of the oscillation between left and right. "More than a decade after the restoration of Lithuania's independence in 1990," Algis Krupavicius wrote, "Lithuanian party politics is often described as a political pendulum in constant fluctuation between left and right" (Krupavicius 2005, 183).

Though ideological distinctions were less obvious during the late-1980s, the Lithuanian movement for independence cannot be understood without reference to the reformist, and in time, right-of-center Lithuanian Movement for Restructuring, known as the *Sajudis* movement.[46] The *Sajudis* were a political movement that united nationalists, intellectuals, liberals, and communist reformers (O'Connor 2003, 150). Like in Estonia and Latvia, where pro-reform deputies were sent to Moscow, Lithuania's *Sajudis* were well represented in the 1989 USSR Congress of People's Deputies. And also like Estonia and Latvia, communists within Lithuania broke with Moscow. By 1990, *Sajudis* in the Lithuanian Supreme Soviet possessed 89 of the 141 seats. The Sajudis were the essence of a Lithuanian "perestroika" movement.

Rawi Abdelal in his *National Purpose in the World Economy* stressed the significance of the *Sajudis* (later the Homeland Union Party). For Abdelal, the *Sajudis* recognized the threat posed by close economic links to the Soviet Union. In order to gain true "independence" from the USSR it demanded closer ties to Western Europe and a rejection of the East (Abdelal 2001, 93). "Almost all Lithuanians accepted the arguments of these nationalists, and there were no influential organized groups that contested them,"

[46] *Sajudis* in Lithuanian literally means "movement".

Abdelal says. "Lithuanians agreed largely on what it meant to be Lithuanian, what the governments should do in its relations with other governments, and what were the purposes of the state" (Abdelal 2001, 94). In short, the *Sajudis* movement, and the broader nationalist sentiment, pushed Lithuania in a direction that embraced economic reform. This reform was expressly anti-Soviet and pro-Western. As the numbers indicate, more than half of trade went to Russia in 1991, and by 1999, more than half their trade went westward.

As Krupavicius noted, in 1988 the Lithuania party structure lacked the type of ideological cohesion that would typify the 1990s and 2000s. For example, though the trajectory of the Sajudis movement was to become a conservative to moderate conservative political movement, the Sajudis in their early years had cross-ideological support. It was not until the 1992 – when the new constitution was written and the political institutions were set in stone – was ideological purity more apparent. Issues concerned the relationship between inflation and unemployment (the Hayek versus Keynes debate), greater social protections, and the respective political parties tackled the issue of minorities (Krupavicius 2005, 201). In the parliamentary elections of the same year, the ex-communist Lithuanian Democratic Labor Party took 43-percent of the votes in Parliament and held serve until the Sajudis (now called the Lithuanian Conservatives) won 70 seats in 1996 (Ramonaite 2006, 71).

Explanations and Rival Explanations 1 and 2: Ideas, Rationality and Discourse in Lithuania

On the periphery of the conference room at the Lithuanian Free Market Institute (LFMI) is a library of books by Friedrich Hayek, Milton Friedman, Mart Laar, Ludwig von Mises, and even an autobiography of Lee Iacocca. Their slogan, "If you don't create a free market, a black market will emerge," has guided the group since its beginning in 1990. Founded by six Lithuanian economists, the scholars believed that Lithuanian growth could only be achieved by free market policies. The group has not only been active in recommending pro-growth policies to whomever asks, but has also become something of an intellectual vanguard for classical economics throughout Eastern Europe. LFMI also supported extensive changes to income taxes. LFMI President Elena Leontjeva went so far as to call for the abolition of all taxes, except for a VAT tax of 33-percent (Frierson 1996, 6). When Lithuania abolished progressive taxation in 1995, "it was abandoned owing to LFMI's concerted efforts."[47]

Think tanks like LFMI are important insofar as they create, promote and steer public policies.[48] The creation of public policy is a central feature of think tanks. They are paid to "think" after all. A contemporary example might be the power the American Enterprise Institute had in articulating a vision of the Second Iraq War and the congressionally-appointed Iraq Study Group seeking out their advice (Kagan 2006). An

[47] http://www.freema.org/index.php/menu/about_lfmi/history/activities_and_ahcievements/646

[48] Aligica and Evans stated that while LFMI has only "responded to the post-Soviet institutional environment rather than created it," the think tank has been influential in liberalizing the banking sector and "flattening" tax policy (Aligica and Evans 2009, 152).

example closely related to this project is Hall's and Rabushka's detailed creation of a modern flat tax, which they worked on as analysts at the Hoover Institute in Palo Alto, California. Second, think tanks promote previously created policies and ideas. For example, the Ludwig von Mises Institute in Auburn, Alabama does not "create" von Mises ideas though they disseminate them to others. This enables future generations to be exposed to the ideas of von Mises or other historical figures. Thirdly, think tanks possess the ability to steer policy, not only by disseminating and creating ideas, but also by aligning themselves with the proper organs of power. In Washington, DC – perhaps the epicenter of the think tank universe – it is not uncommon for an analyst to move seamlessly from the think tank, to the classroom, to the institutions of government.[49] This is how a think tank like LFMI has its most impact. For example, Ramunas Vilpisauskas, the chief economic advisor to Lithuanian President Valdas Adamkus, was a Senior Policy Analyst at LFMI from 1997-2004. These webs of networks (commonly called epistemic communities) allow for the promulgation of ideas throughout various sectors society (Aligica and Evans 2009, 93).

Lastly, think tanks serve to discredit certain public policies and ideas. As Senior Policy Analyst at LFMI Zilvinas Silenas noted: "We [LFMI] are not an academic institution. We are concerned with the spreading of ideas and spreading influence. We don't even ask to be cited" (Silenas Personal Interview 2008). In the case of Lithuania, social democratic ideas and progressive taxation already "weren't that popular, and even among socialists there wasn't a consensus that flat taxes were bad" (Kaetana Leontjeva

[49] Paul Wolfowitz might be the epitome of such a transition. He was the dean of the Paul Nitze School of International Studies at Johns Hopkins University, served as an advisor to the American Enterprise Institute, was George W. Bush's Deputy Secretary of Defense, and World Bank President before settling back into a role with AEI.

Personal Interview 2008). Or, to quote Silenas further: “I simply think that socialist ideas were no longer valid” (Silenas Personal Interview 2008).

The first few examples would seen to validate the explanation that flat tax adoption was a consequence of having the right ideas at the right time. LFMI and its analysts came to fruition at a time when social democratic ideas were discredited and the population was looking for new direction. The flat tax seemed to offer that direction. However, there are two problems with such a claim. The first is that Lithuania, like Latvia, lacked the sort of policy champion or elite carrier that ideas need to get into the policy arena. There is no discernible figure who led the charge for the flat tax in Lithuania. Second, even those who most persistently believe in the power of ideas (LFMI analysts) noted that there was not an ideational struggle over the flat tax. Social democrats were not per se antagonistic to the flat tax. Moreover, the Lithuanian party system had yet to have the sort of right-left ideological divide which typified Estonia, and to some extent, Latvia. As in the case of Latvia, both explanations one and two were invalidated. Ideas were not the cause of the flat tax and discourse was noticeably absent in Lithuania.

What can explain the presence of the flat tax then? Though analysts at LFMI were unapologetic free marketers, they still believed the initial discussion regarding taxation was not really ideological — it was rooted more in notions of efficiency. Ruta Vainiene, who specializes in tax competition at LFMI, noted the problem of high inflation during the mid-1990s in Lithuania. Because of rampant inflation, virtually all Lithuanians were in the same tax bracket. Since almost all people were taxed around 33-percent, it made a progressive scale largely meaningless anyway. Reported inflation rates in April 1993 were around 20-percent, the highest in the Baltics. During this period in time wages could rarely keep pace with the cost of basic goods, like food (EIU Country Report 1993, 41). And despite steady growth through the summer, by September of the same year inflation had increased to over 30-percent. Part of the problem was Lithuania's commitment to protecting living standards by increasing pensions, the salaries of state employees and student grants. Prime Minister Adolfas Slezevicius supported government spending for these services in the wake of rampant inflation (EIU Country Report 1994, 37). Thus when calls came forward to lower the rate to a 27- or 24-percent flat rate almost all Lithuanians jumped on board.[50] Moreover, tax boards and administrators preferred the simplicity of the new system. The flat tax was common sense for many, while for others, there was "a hidden argument, and that was the abolition of the progressive tax" (Vainiene Personal Interview 2008).

Mindaugas Lukas, Chief Specialist of Direct Taxes and International Division for the Lithuanian Finance Ministry, highlighted the role of the Ministry in the adoption of the flat tax and the relevant changes the income tax laws have went through. According to Lukas, tax changes in Lithuania have occurred for one main reason: simplifying tax administration. "The law was prepared by specialists in the Ministry of Finance, and a big part of it was to simplify it for administrators" (Lukas Personal interview 2008). The law of 1994 (and later amended in 1997) set the initial flat rate at 33-percent for most income. There were, however, over eight different rates that dealt with the differences between say, royalties (which were taxed at 13-percent) or the sale or transfer of property

[50] Another reason for the popularity of the flat tax is that it established a non-taxable allowance like the tax codes in Estonia and Latvia. Thus, the poorest were not taxed on their income at all.

over the tax-exempt minimum (which was taxed at 10-percent). [51] In the amended income tax law of 2003, the flat rate was reduced to 27-percent, and income received from things like athletics, performance art, royalties, property transfer or copyright was taxed at 15-percent.[52]

"Well, I can say as far as I know, there was no public debate at all regarding the law of 2003. It is natural for the public not to be interested if taxes don't increase" (Lukas Personal Interview 2008). Lukas related a story about the Netherlands and their progressive taxation scheme. He cited an article describing how the adoption of the flat tax in the Netherlands would keep revenue at the same rate and simplify the administration for the tax bureaucracy. However, the political capital spent to change the system would be overwhelming. "Tax administrators would rather abolish [progressive taxes], but politicians won't allow it" (Lukas Personal interview 2008). Even in Lithuania, the flat tax is frequently challenged. "As elections are coming [in Lithuania] we have lots of proposals for progressive income taxes" (Lukas Personal interview 2008).

The story Lukas tells is not terribly different from the story of Estonia. Lithuania faced a revenue crunch, taxes were hard to collect, and the flat income tax rate simplified the previous progressive scheme. The new tax regime – and its evolution from 1994 until the present day – followed a rational logic, validating a rival explanation. Moreover, while politicians may have steered the political trajectory of tax laws -- such as setting rates, he notes – economists and specialists within the Ministry of Finance argued about the nuts and bolts of the tax policy. Even those at LFMI who believe that ideas matter argued that the flat tax was efficient and made sense. Like Latvia, the flat tax was a

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[51] See *Provisional Law on Income Tax of Natural Persons* as amended 27 March 1997. English language translation.
[52] See *Republic of Lithuania Law on Personal Income Tax* 2002. Last amended 15 May 2008.

rational solution to a pressing problem. Unlike Estonia, there was little political intrigue or infighting over the decision. There was also no considerations about where the flat tax fit in ideologically: no discussion of Marx, much less Friedman. Vainene explained it succinctly: “Estonia did it consciously…Lithuania, less so” (Vainene Personal Interview 2008).

Or, as Jonas Cicinskas, Professor of European Studies at Vilnius University, explained it:

> To my view, it was not ideology which led to a flat tax, but pragmatism. There were no conditions (no established fiscal system, just the inherited one), no professionals (with the knowledge of alternative taxation), no expertise to think about more sophisticated though more exact (more fair) taxation system. The social structure of society (almost every person was the former communist state employee; very small differences in wealth and income) also pushed to favourize [sic] flat tax. The ideology comes much later (in our case – after approximately 10 years of systemic changes), and with it the debate about flat tax (Cicinskas Email Interview 2008).

Cicinskas’ argument, in its brevity, brings to light some additional considerations which to this point have not been addressed. First, Lithuania had to actually create the original progressive system out of nothing and they did so poorly because no one was trained to do it the right way to begin with. It was not just that the progressive tax system was a failure but that from its implementation was doomed to fail. Second, the flat tax was the result, not of serious discourse, but of *no* discourse whatsoever. The needs of acquiring revenue were so great that not a lot of time was spent on other options. Cicinskas implies, for example, that with more consideration a fairer policy might have been developed. (This verifies Vainiene’s claim that Lithuania’s flat tax was not consciously thought through). Thirdly, because class distinctions were minimal in 1995, tax changes did not affect many people.

As to rival explanation two concerning external pressures, what role did they play in Lithuania? Little, if any, according to most observers. Cicinskas stated that only more recently has the IMF been involved in tax discussions, and these talks have by and large questioned the wisdom of flat taxes.[53] Even more blunt, LFMI's Kaetana Leontjeva stated that they played no role. "They didn't shape Lithuania vis-à-vis the flat tax. (Kaetana Leontjeva Personal Interview 2008). Lukas thought the IMF and World Bank might have been important, but only as to "validate the system" (Lukas Personal Interview 2008). In other words, Lithuanians wanted the flat tax, while external actors rubber-stamped it.

Michael Camdessus, then Managing Director of the IMF, suggested two years later what many Lithuanians already knew. Camdessus praised "simple and broad-based" tax reforms with "limited exemptions and uniform rates" (Camdessus 1997, 5). Camdessus also noted that systems should be designed in such a way that they could be "easily enforced" to collect the revenues needed to sustain a functioning state. By 2004, IMF mission head to Lithuania Ashoka Mody argued that taxes should be cut so as to stimulate economic growth. In no case, Mody stated, should taxes (and revenues from those taxes) be used "as a tool to implement social objectives" ("IMF to Lithuania: Cut

[53] A 2006 IMF Working Paper enumerated several concerns with the policy. In the paper several conclusions were reached. First, the paper claims that the flat tax is not entirely flat. If one takes into account social insurance contributions, the effective labor tax is far from flat (Kenn, Kim and Varsano 2006: 5). Second, the enthusiasm for flat taxes have less to do with "fairness" of the tax and more to do with the tax cuts it has created. Although the Baltic states started their tax with very high rates, they have cut those rates over time. Moreover, the late adopters have set considerably lower rates than their predecessors. Their last two points, however, are especially worth noting. Except in the case of Russia, after the adoption of the flat tax, personal income revenue actually decreased (Kenn, Kim and Varsano 2006: 13). Lastly, the claim that the flat tax has increased compliance — which therefore made it easier to collect — was treated with suspicion. While they agree that the tax has simplified administration of taxes, they argue that individuals still weigh the costs and benefits of avoiding taxes to determine whether or not evade. If a country does not possess a thoroughgoing program to combat tax cheats, regardless of the type of tax, there will be cheaters (Kenn, Kim and Varsano 2006: 29).

Income Tax Rate" 2004: 1). In neither case did the IMF concern itself with what *type* of taxation was more valid.

Explanation 4: Diffusion and the Flat Tax

The previous sections on Latvia and Lithuania assessed why domestic actors rejected one kind of tax system (progressivism) in favor of a new tax system (flat taxation). Rather than an interplay between the ideational and rationalist explanations as witnessed by the Estonian case, both Latvian and Lithuanian elites commented on the pragmatic (or rationalist) nature surrounding the decision to change tax policies. A host of practical reasons were detailed, including the inability to collect taxes, the problem of tax evasion, the rise of black markets, the high rates of inflation and the lack of expertise and knowledge to successfully implement a complex progressive system. Moreover, neither Latvia nor Lithuania had the sort of policy champion (elite carrier) that held the banner for the flat tax. But though the previous section might tell us *why* they switched to a flat tax, it cannot really tell us *how* they came to the policy to begin with. By 1995, only two countries (Hong Kong and Estonia) were flat tax states. This means one of two things: either Latvia or Lithuania knew of Estonia's adoption, or they adopted the flat tax by sheer coincidence, independent of Estonia's choice.

If this first part is true it begs the question: is the adoption of the flat tax in Latvia and Lithuania a product of policy diffusion? In other words, was Estonia's flat tax innovation influential in the "emulation" of the early adopters of Latvia and Lithuania? This takes into account explanation four and rival explanation four as related in Chapter

Two and at the beginning of this chapter. Explanation four claims that adoption of the flat tax post-Estonian adoption is attributable to Estonia's prior adoption. Rival explanation four claims that flat tax adoption was entirely independent of Estonia's (or prior states) adoption. Once again, policy diffusion itself should not be seen as a *cause* of the flat tax, but a delivery mechanism that brings forth the ideas (or policy) of the flat tax.

Kurt Weyland's research on Latin America has been incredibly influential in understanding the relationship between policy change and diffusion. Weyland suggests that policies diffuse in four different ways: via external pressures, via normative and symbolic appeal, via rational learning, and via cognitive heuristics. In the external pressure framework, it attributes policy change "to central coordination and vertical imposition emanating from the core of the international system" (Weyland 2006, 32). This is the type of diffusion one might see in dependency theory or world systems theory, for example. Second, diffusion can take place via normative and symbolic appeal. In this framework, leaders and politicians adopt certain policies so as to conform to various norms or standards of behavior within a given community. For example, a reform "leader" shows the "backward" state the proper modicum of behavior, on something like human rights or environmental standards. Thirdly, rational learning assumes that states and their leaders are predominantly rational and "learn" new policies by systematically studying previous adopters. Politicians embark on new policies by creating a balance sheet of successes and failures of old policies, before deciding whether or not to change. Lastly, the cognitive heuristics model presumes that politicians are essentially rational, though they use "cognitive shortcuts" — the privileging of some information but the discounting of other relevant information — in their decision-making. Thus, leaders possess “bounded rationality”. (Weyland 2006, 34-36). [54]

The case of Latvia is a good test for policy diffusion. It is in geographic proximity to Estonia and shared common features of a post-communist, transition experience. Platais did not recall any extensive discussion of Estonia at the time of Latvia’s adoption, other than to note that “it was probably mentioned.” Overall, “[Estonia] was not considered the main reason for Latvia” (Platais Personal Interview 2008).

So did Estonia’s decision to adopt a flat tax “diffuse” to Lithuania? “Well, I don’t think you can say it did not effect the decision,” Lithuania’s Lukas argued. “The decision of neighboring countries had an effect on the decision, certainly” (Lukas Personal Interview 2008). LFMI’s Silenas agreed. “From my subjective opinion Estonia was always a leader in the reforms. If Estonia advocated it was very good, then everyone else got on board” (Silenas Personal Interview 2008). Vainiene suggested in her experiences Estonia was frequently used “as an example” (Vainiene Personal Interview 2008). And as Ramunas Vilpisauskas, Chief Economic adviser to Lithuanian President Valdas Adamkus, noted: “Yes, other countries’ examples have been discussed. Estonia in general has often been used as a good practice example in the area of taxation, together with Slovakia” (Vilpisauskas 2008 email interview). Even Estonian analysts recognized

[54] A preliminary investigation of this question was undertaken by Alexander Baturo and Julia Gray (Baturo and Gray 2005). Their working paper analyzed the extent to which “rational learning” took place as other flat tax countries slowly adopted Estonia’s flat tax. Barturo and Gray designed a predictive, statistical model to determine the likelihood of adoption in twenty Eastern European and EU countries. While Baturo and Gray’s work uses similar independent variables as this project — like ideology and external pressures — their work relied on a statistical account of diffusion whereas this paper addresses the issues from a more “thickly descriptive” approach. This paper also distinguishes between “early” adoption of the flat tax and “late” adoption.

their own importance. Vitsur — Savisaar's adviser and no fan of flat taxes — asserted that Estonia was praised in the economics literature for their decision to abolish graduated taxes (Vitsur Personal Interview 2008).

Weyland's framework is helpful in teasing out exactly what went on in Latvia and Lithuania, and whether or not diffusion of some sort occurred. First, the external pressures model seems to have little bearing on either case. Every actor interviewed for this research – from Estonia, Latvia, or Lithuania – suggested that these tax reforms were by and large *internal* decisions. Not one group, person, or organization "centrally coordinated" any policy decision. Party leaders, local bureaucrats, and experts were intimately involved in public policy change. To suggest that Estonia was powerful enough – or committed enough – to impose flat tax policies on others is folly.

Second, Weyland speculates that policies can be put into place for symbolic or normative appeal. This might carry some weight had the media and lending institutions universally praised flat taxes prior, and if being a member of the flat tax club distinguished a country as being non-backward. Neither happened. In Latvia and Lithuania, the flat tax was received with no publicity. There was little to no public discussion of the policy reform, and certainly no international fanfare. Estonia, Latvia and Lithuania were three Baltic countries that changed their tax system. This was the long and short of it.

Third, Weyland argues that policy diffusion comes from "rational learning," i.e., new adopters learn from old adopters. This explanation would make sense had Latvia and Lithuania learned two things: one being that the flat tax was working in Estonia, and two, the Estonian case inside and out. They knew neither of these things. Latvia and

Lithuania just one year after Estonia made the same general assumptions that a flat tax would be easier to administer and collect, as well as prevent tax cheats. But they did not know for certain this was the case. A great deal of rational learning depends on time – an actor can see for himself or herself whether policies work. Within a 14-month period, Estonia, Latvia, and Lithuania all pursued the same policy, crossing their fingers that it might work.

Lastly, Weyland proffers what he calls the “cognitive heuristics” model. This model assumes the essential rationality of actors, but argues that they are bounded by an absence of information that forces them to take “mental shortcuts.” This model helps to explain what seems to be happening in Latvia and Lithuania. Both Latvia and Lithuania knew *about* Estonia. Estonia was the leader of many new policies, being the first to privatize and also being the first to introduce a new currency. Most tax experts knew of the Estonian plan.[55] Most believed the plan would work. But no one with certainty had the relevant information before them to say, “It worked for Estonia. It must work for us.” Instead, both countries could point to someone else who had done it first, thus validating the model.

The rival explanation of “independent” decision-making rings hollow in the case of Latvia and Lithuania. The “big three” of the Baltics had a history of cooperation, from their rejection of the communist system in the late 1980s to their reformist and dissident struggles in the early 1990s, all the way to their transition to democratic and free market states. Estonia – who had been something of a leader in all these processes – had the attention of Latvia and Lithuania at all times. It does not mean per se that Latvians or

[55] Cicinskas said it was quite common for experts from the various Baltic countries to talk to each other, especially in the early days (Cicinskas Personal Interview 2008).

Lithuanians were devotees of Estonia, or ardent students of their politics and economics. But there was always an awareness of what was happening to the north. Were Latvian and Lithuanian bureaucrats, politicians, academics and analysts aware of what was happening in Estonia? They absolutely did. But did they have full knowledge of the considerable effects of the flat tax? No, or at least, not yet. As Cicinskas implied, had Lithuania had more time to think through their flat tax or know what they know now, it might have looked very different.

Conclusion

This chapter tested six different explanations. One set of explanations and rival explanations tried to understand Latvia and Lithuania in relation to the three causes of external pressures, rational self-interest, and ideas. Discovered was that Latvia's and Lithuania's adoption of the flat tax was less controversial and less ideological than the struggle in Estonia. Thus, the adoption of the flat tax followed a more pragmatic course than its predecessor. Like Estonia, however, external pressures were not significant as an explanatory variable. A second set of explanations investigated the extent to which policy diffusion occurred in Latvia and Lithuania. I argued that there was diffusion, or what McNamara called emulation. Following the cognitive heuristic model, I argue that policy diffusion occurred in Latvia and Lithuania. This is to say that both countries drew inspiration from the policy innovator (Estonia), but did so without knowing the full scope of the policy reform. This is particularly apparent in early adoption cases where facts and information are not fully known.

The following chapter will examine two cases of “late adoption”: Slovakia and the Czech Republic. Those cases for the first time show an active and deliberate debate over the flat tax prior to its adoption. The “idea” as well as the policy are exhausted at length by policy champions, and for the first time, political parties design entire political programs in support of and reaction to the flat tax. Moreover, these two countries could actually “learn” from the previous three adoptions discussed in this dissertation, demonstrating what I call the “varieties of diffusion”. The flat tax had noticeable “effects” by the time we arrive at 2004, the year of Slovakia’s adoption. The timing of the adoption greatly affects the circumstances surrounding the adoption.

CHAPTER 5

LATE ADOPTION: THE FLAT TAX IN SLOVAKIA AND THE CZECH REPUBLIC

Introduction

Estonia introduced Eastern Europe to the flat tax in 1994, and by the end of 1995 Latvia and Lithuania had adopted the same policy. It would not be until 2004 – when Slovakia joined the club – that the flat tax had spread to other parts of a democratic Eastern Europe.[56] By the time the Czech Republic adopted a flat tax in 2008, the list had grown to ten countries in Eastern Europe. Two questions need answering in this chapter. First, how did flat tax adoption come to be in both Slovakia and the Czech Republic? Second, was Slovakia's adoption – and later the Czech Republic's – a product of policy diffusion? In other words, did the decisions of Estonia, Latvia and Lithuania impact the policy choices made by Slovakia and the Czech Republic?

Like the previous chapter on Latvia and Lithuania, this chapter assesses three different explanations, and three different rival explanations. One set of explanations will examine the flat tax in light of the debate about external pressures, rational self-interest and ideas. Explanation one claims that in states with flat tax policies we would observe a shift in ideas that caused a shift in policy. Explanation two claims that in states that have flat tax policies we would observe discourse about the appropriateness of said idea which caused a shift in policy. Some actors would stump in favor of the idea and others would be opposed. Rival explanation one claims that in states that adopted the flat tax we would observe the power of external pressures (or institutions) caused adoption and not

[56] Russia adopted the flat tax in 2001, but the absence of liberal democracy there precluded them from discussion in this controlled case comparison.

the power of ideas. Rival explanation two claims that in states that adopted the flat tax we would observe the power of rationally-expressed self-interest caused adoption and not ideas.

A second set of explanations will deal specifically with policy diffusion and whether or not Slovakia and the Czech Republic emulated prior adopters or acted independently. The third explanation of the chapter (which is listed as explanation four in Chapter Two and later on in this chapter) claims that in states that adopted the flat tax after Estonia, we would observe that other states emulated the policy, or practiced what is called policy diffusion. Previous adopters were instrumental in showing off the flat tax to future adoptees. The third rival explanation (which is listed as explanation four in Chapter Two and later on in this chapter) claims that in states that adopted the flat tax after Estonia (the first adopter) we would observe that these states did so independently and without regard for the flat tax in other states.

I argue that support by right-wing politicians and their parties help to explain why the flat tax was adopted in both Slovakia and the Czech Republic. The "idea" of the flat tax solved the pressing issues of tax evasion, attracting foreign direct investment, and making it easier to collect taxes. But the "idea" of the flat tax also was wedded to certain ideological considerations, which made its adoption only possible by those center-right groups. For the first time in the dissertation, both explanation one and explanation two are validated. Not only did ideas matter but there is also considerable discourse and deliberation on the flat tax in both Slovakia and the Czech Republic. Like in Estonia – and following McNamara's model, however – the flat tax comes to fruition by replacing a perceived "policy failure". The "policy innovation" of the flat tax is the rational response to the breakdown that preceded it. Once again ideas and interests are intertwined. External pressures – as in Estonia, Latvia and Lithuania – were not the cause of the flat taxes in either country. However, in the case of Slovakia, the timing of joining the European Union and NATO coincided with their decision to adopt the flat tax. The significance of this is developed in the rival explanations section.

Explanation four is also validated as the idea of the flat tax diffused to Slovakia and the Czech Republic. It must be restated that policy diffusion is not a *causal* explanation of the flat tax. Diffusion does not *cause* anything but merely acts as a *delivery mechanism* for policies or ideas. In this chapter I argue that rational learning – rather than cognitive heuristics -- helps to explain Slovakia's and the Czech Republic's introduction to the flat tax via an international (or transnational) delivery of the flat tax idea. I term this *varieties of diffusion*, where the same policy is diffused in all cases under consideration (i.e., the flat tax) but the manner in which it diffused is different from case to case. This chapter also tries to separate the process of policy diffusion from policy adoption. The policy itself diffused, but the *timing* of such an adoption came much later. In both Slovakia and the Czech Republic, the political environments were not hospitable to the adoption of the flat tax. For Slovakia, the unseating of the Meciar regime and the rise of the neoliberal prime minister Mikulas Dzurinda changed the political climate significantly. In the Czech Republic, Mirek Topolanek took control of the center-right from Vaclav Klaus and surrounded himself with flat tax advocates. Only when those political actors changed was flat tax adoption a real possibility.

Perhaps more than any other two cases in this research project, Slovakia and Czech Republic make for an ideal controlled-case comparison. Slovakia and the Czech

Republic made up one country – Czechoslovakia -- until their peaceful breakup in 1993. John Stuart Mill argued controlled case comparisons fell into two categories: method of difference and method of agreement. Method of difference comparisons find cases with similar general characteristics and variation on the dependent variable. Method of agreement comparisons find cases with dissimilar general characteristics but agreement on the study variable (Van Evera 1997, 57). It is true — as in the method of difference approach — that Slovakia and the Czech Republic share "general characteristics" like a history of socialism and a non-violent post-communist transition. But as this chapter will show, there were also marked differences, including the illiberal nature of Slovakia in comparison to the Czech Republic and the relative absence of a free market discourse in Slovakia as well.[57] In this sense, the controlled comparison is more of a method of agreement model given that both countries adopted the flat tax despite contrasting political trajectories.

This chapter will proceed in three parts. First, the case of Slovakia will be detailed, both politically and economically, before proceeding to understand their decision to adopt a flat tax. A crucial part of the Slovakian narrative is the transition from a semi-authoritarian government to functioning parliamentary democracy. Second, the case of the Czech Republic is examined in a similar fashion, highlighting the political and economic transition that in time enabled the adoption of the flat tax. Lastly, the explanation of policy diffusion in addressed in both cases, identifying how "rational learning" took place during the diffusion process.

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[57] From 1997-2004, for example, Slovakia had consistently worse Freedom House scores than the Czech Republic.

Slovakia: A (Short) History

Czechoslovakia proper split into two sovereign states, Slovakia and the Czech Republic, on January 1, 1993. With the help of Czech leader Vaclav Klaus, Vladimir Meciar, a Slovak politician who championed himself as father of the Slovak Republic, "negotiated Czechoslovakia out of existence" (Haughton and Rybar 2006,118). From 1993 through 1998, Meciar led Slovakia as its Prime Minister. The book on the Meciar-era is complex. On the one hand, he led Slovakia during its critical post-Communist experience, and privileged the cause of Slovak independence. On the other hand, Meciar led Slovakia into political and economic isolation. As Sharon Fisher comments: "During much of the 1990s, nationalist elites in Slovakia…largely ignored the recommendation of Western governments and international institutions, preferring to continue their relatively free rein in forging domestic policies" (2006, 19). Nor did it make it any easier when the Czech Republic was included in all of the talks surrounding NATO and EU enlargement in the late-1990s and Slovakia was not. Politically, debates in Slovakia went from being "right versus left" to "pro-Meciar versus anti-Meciar" (Toma and Kovac 2001, 341).

In 1998, Slovak citizens went to the polls to decide on the Meciar issue and the future of Slovakia. In a close election, Meciar's Movement for a Democratic Slovakia party (MDS) won over the rival Slovak Democratic Coalition (SDK). Unfortunately for Meciar, his party was unable to form a majority coalition to rule. After three days of tension, Meciar appeared on television to announce that he could not form a government and would resign as Prime Minister effective October 29, 1998 (Tom and Kovac 2001, 343). Stepping into the position was a 43-year old former transport secretary named

Mikulas Dzurinda, the leader of the SDK. In time, Dzurinda would couch his politics as fundamentally “anti-Meciar.” Six years and one reelection later, Slovakia was a member of the European Union, the North Atlantic Treaty Organization, and the flat tax club.

Dzurinda’s legacy as a prime minister in Slovakia is threefold. First, Dzurinda is recognized with restoring – one might even say creating -- democratic principles in Slovakia. As Kevin Krause acknowledged, Meciar proceeded on a “systematic demolition of horizontal accountability” (Krause as cited in Kirschbaum 2005, 279). The most harrowing tale involved Meciar’s confrontation with President Michal Kovac. In May 1995, Meciar’s government tried to force Kovac out with a vote of no confidence, and though it failed to get the required ninety votes, the next three years involved Meciar and Kovac fighting back and forth for who “actually” controlled the political process (Kirschbaum 2005, 280). When Dzurinda came into power he opened up the door for a direct election of the presidency, thus disentangling the President from parliamentary control by the National Council of the Slovak Republic, or NC SR (Kirschbaum 2005, 299).

Second, Dzurinda’s government went on an aggressive campaign to cure the economic ills of Slovakia. The country had serious fiscal problems, revenue shortfalls, and disagreements about the necessity of privatization and ownership (Toma and Kovac 2001, 346). In two years, Dzurinda’s government succeeded in attracting foreign direct investment and by 2001, the European Commission commented that Slovakia was a “functioning market economy” (Henderson 2002, 123). At the same time, both unemployment and inflation rose from 1998-2000, leaving some critical of Dzurinda’s free market policies, and hesitant of reelecting him in 2002 (Kirschbaum 2005, 303-306).

Lastly, Dzurinda's legacy was defined by his desire to work with outsiders – in particular international institutions – a fundamentally new direction in Slovak politics. Dzurinda's ability (or willingness) to grapple with the political and economic problems of Slovakia endeared him to Westerners, who actively "played an important role in moving the [country] toward liberal democracy" (Fisher 2006,19). In 2000, Slovakia became the thirtieth member of the Organization for Economic Cooperation and Development (Kirschbaum 2005, 300). The first term also saw Dzurinda's government move towards admission in NATO and the EU, something that seemed like a distant possibility when Meciar was in power. The run-up to Dzurinda's 2002 election was confirmation that the public was – by and large – behind this new orientation. As Kirschbaum argued: "Dzurinda's unexpected success was seen as a confirmation of the population's desire to see Slovakia join both NATO and the EU, giving him thereby a mandate to proceed. It was not seen as an approval of his government's or his party's economic and social policies" (2005, 306). On November 2002, Slovakia was invited into NATO at the Prague Summit. And on May 2004, they navigated their way through the complex *acquis communautaire* to gain admission into the EU.

Explanation 1 and Explanation 2: The Flat Tax and Ideas

The shift away from Meciar and toward Dzurinda made flat personal income taxes a real possibility. One of Dzurinda's more telling decisions was his nomination of Ivan Miklos to the post of deputy economic minister. Miklos was a member of the Democratic Party, a right-wing party that was most amenable to free market policies (Henderson 2002, 126). During communist rule, Miklos taught at the University of

Economics in Bratislava and became known for describing how planned economies absent features of private property were doomed. He is credited with leading the People Against Violence movement, the first anti-communist movement of its kind in the former Czechoslovakia. Miklos also helped establish the think tank MESA-10, an institution devoted to neoliberal economic reforms in post-communist Slovakia (Evans 2004).[58]

As typified most center-right parties in Slovakia, there was broad electoral support for both neoliberal policies of privatization, modernization and Europeanization balanced with conservative "historical identities and ideologies" (Haughton and Rybar 2006: 115). Miklos was not universally beloved as cuts in public spending and pension reform were unpopular among portions of the population (Haughton and Rybar 2006, 129). But he was crucial in shepherding through tax reforms that would radically alter Slovakia. In November 2003, 85 of 130 members of the NC SR voted through a new bill that would abolish Slovakia's graduated scheme in favor of a 19-percent flat tax on incomes and corporations. As Miklos told the *Slovak Spectator*: "The tax reform is directed towards creation of a fair, simple and investment-oriented environment in the Slovak Republic" ("Flat Income Tax Makes It" 2003). The bill also shored up tax avoidance and the "grey economy," which economists estimated at 12 to 15-percent of GDP.

Also important to this story is a man named Martin Bruncko, a Harvard-educated Slovakian who learned more about the mechanics of the flat tax while at the Kennedy School of Government. He then returned to Slovakia hoping to convince others of the flat tax plan. "In theory it was interesting," Bruncko told the Christian Science Monitor,

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[58] As is made clear on their website: "Since its formation in 1992 MESA 10 defends the values of [the] market economy" (www.mesa10.sk)

“but we never thought we could do it in practice. So it was fun to see that you could actually do it” (Tzortis 2005). When Bruncko returned to Slovakia from Harvard in 2003, he took up a post as Finance Minister Miklos’ chief economic advisor. “We did heavy marketing of [the flat tax] and explained it to business people,” Bruncko said (Tzortis 2005).

Explanation one in the Slovakian case stated that the shift to a flat tax was caused by a shift in ideas. In Slovakia, the ideational shift is present as the country tried to redefine itself from a softly authoritarian, social democratic state to a democratic, capitalist one. Slovakia also had three similarities with its predecessor Estonia. As in Estonia, Slovakia possessed several policy champions (or elite carriers) that were purveyors of the flat tax idea. Miklos was the most important one, but Bruncko, his Harvard-trained understudy, and Dzurinda all stood-up for the flat tax. Second, the Slovak Democratic Coalition (SDK) party became a central organizing force for the flat tax and its supporters. Though Estonia’s parties were nascent and just being consolidated, there were still two parties, Laar’s Fatherland Party (or Pro Patria) and the Reform Party that kept the flat tax on their policy platform. Thirdly, Bruncko played a role akin to Estonia’s Hansson, as he was an educated intellectual who studied the flat tax in school before applying it in practice. As he said himself, the “theory” itself was interesting and he was curious to see it operate in practice. Lastly, like Lithuania, a think tank was key to elaborating flat tax ideas. Miklos’ MESA-10 did just that.

Explanation two about the presence of significant flat tax discourse is not quite validated in the Slovakian case. There is significant discourse about the rejection of the Meciar political regime in favor of Dzurinda’s regime. In a sense it could be argued that the discourse was the first step in introducing a flat tax. Without Dzurinda's commitment to democracy and an open economic system the flat tax would never have been up for discussion. But like in Estonia, Latvia and Lithuania before, the flat tax was not seriously debated in an open forum.

Rival Explanation 1 and 2: Rationality and External Pressures in Slovakia

Like Estonia before it, Slovakia's flat tax cannot be understood by rational considerations alone. Dzurinda, Miklos and Bruncko were committed to free market policies and, in particular, wedded to their new tax policy. Their commitment ultimately led to their defeat in 2006, when the Smer Social Democratic Party's Robert Fico came to power promising social welfare reforms in light of the "inequalities" produced by the Dzurinda government ("European Press Not United on Slovak Election Result" 2006). The flat tax was left largely untouched when Fico took office but the debates following his election depict the ideological struggles of the country. "Tax relief by way of lower or more tax-deductible items will not help the lower-earning classes," Richard Sulik, the author of Dzurinda's tax reform, said. "They hardly pay taxes anyway" (Jancik 2006).

On the other hand, the flat tax solved a pressing economic and political problem. Elites like Bruncko and Miklos were convinced the elimination of progressive taxation created an environment more conducive to investors. Slovakia was used as a model for growth:

> Slovakia is case in point. The country has been intent on building an investor-friendly climate. So in 2004 it swept away 21 categories of personal income taxes, five tax brackets, and scores of exemptions and reductions, replacing them with a flat 19% rate, Slovak officials say their tax reform was crucial in securing a

> 1.3 billion investment last year by Korean automaker Hyundai Corp., which is building a factory for its Kia brand cars in the city of Zilina ("Europe Circles the Flat Tax" 2005).

How does a tax aimed at domestic revenue collection engender foreign direct investment? Mitchell and Edwards argued that flat taxes created a tax competition among investors to find the most transparent and cheapest place to do business. For example, in a flat tax system, source of income is only taxed once, there is no capital gains tax or double taxation of dividends (Edwards and Mitchell 2008, 59). Also, at 19-percent, Slovakia had the lowest tax among developed countries. Others have noted that the flat tax has done wonders for revenue collection and efficiency. Budget revenues for 2004 not only met expectations but also exceeded them. Moreover, a simplified tax system mitigated against tax evasion and reduced the budget deficit. Coupled with the fact that Slovakia's corporate tax and personal income tax are the same rate, it prohibits against individuals being able to "hide" taxes in one entity or another (Burak 2005, 17-18).

While the rival explanation states that rationally-expressed self interest alone explains flat tax adoption does not make complete sense of the Slovak case, the rationalist thesis cannot be altogether discarded. The Slovakian case demonstrates again McNamara's model of policy failure followed by a policy innovation. The "idea" of the flat tax coupled with general neoliberal thinking instigated a change from what was considered to be a failed system. The interplay between ideas and rational self-interest played out again.

Lastly, the power of external pressures is assessed. Like in the cases prior, the dominant international institutions had little to do with Slovakia's decision. As has been discussed elsewhere, the IMF and World Bank were not just disinterested in the flat tax but in some case vehemently opposed. Aslund remarked that the IMF has long resisted tax cuts because of the fear of budget deficits (Aslund 2007, 118). Slovakia had the lowest tax rate of the developed democracies and for that reason was always on the IMF's radar. But Slovakia's decision to adopt a flat tax coincided with their acceptance into the European Union (most importantly) and NATO in the same year. The switch to a flat tax was not caused by the EU or NATO specifically; however, the flat tax was part of a broad package of reforms that turned Slovakia westward. Dzurinda was after all, the anti-Meciar, interested in integrating Slovakia with the Western world and the flat tax itself was a Western idea. Unlike the Baltic states, whose flat tax adoption preceded their admittance into the EU by ten years, the flat tax and EU went hand in hand in Slovakia.

Czech Republic: A (Short) History

The Czech Republic's early years as an independent state was very different from Slovakia's. First, the Czech Republic aligned itself with two fairly committed – though controversial – democratic reformers, President Vaclav Havel and Prime Minister Vaclav Klaus. Second, unlike Slovakia, the Czech Republic had a politically mature and meaningful center-right party. Neoliberal and free market ideas were as active in the Czech Republic as they were in almost any other Eastern European country. This makes their "lateness" to the flat tax game both an interesting and puzzling phenomenon. Who were the main proponents of this reform and why did it take so long before those proposals became reality?

Klaus is a first place to start because he gave voice to ideas of free market and privatization in the Czech Republic following the collapse of the Soviet Union. As a Finance Minster from 1990-1992, Klaus was the progenitor of the economic reform package that brought forth policies of privatization and neoliberalism. Opinion surveys in 1991 revealed that 89-percent of Czechs were supportive of a market economy and most believed it was necessary for economic growth (Innes 2001, 85). Klaus also shepherded the Czech Civic Reform (OF) into the Civic Democratic Party (ODS), the longest standing right-of-center party in the Czech Republic.[59] Ideologically, Klaus fashioned himself as a "Thatcherite Conservative" who possessed the "idea that uninhibited markets alone would liberate the Czechs' innate economic genius…it was, after all, an heroic and inspiring vision" (Innes 2001, 86). Klaus was considered by many (even his detractors) to be the most important politician in all of the Czech Republic (Eyal 2003, 150).

From 1994-1996, the Czech Republic was becoming the international darling of the Central and Eastern European transition countries. The US Agency for International Development stamped its approval at the Czech Republic's privatization, low unemployment, and macroeconomic programs (Weiner 2007, 53-54). But by 1997, economic crisis struck the country. Unemployment increased, exchange rates and the financial markets were in crisis, and the capital market was rife with corruption (Weiner 2007: 63). Despite Klaus' strident neoliberalism, the Czech Republic did not fulfill the promises laid out in his "Guide to the Economic Goulash". The state neither shrunk during his rule nor were markets terribly transparent (Innes 2001, 220). "By the late

[59] The ODS describes itself as a "liberal conservative center right party of a modern European structure, building on the traditions of the European Chrisitan civilization, humanitarian and democratic traditions of the First Czechoslovak Republic, and on the experience of today's Western democracies" (www.ods.cz).

1990s," wrote Elaine Wiener, "the political landscape of the Czech Republic had changed dramatically. Dissent emerged within existing parties, resulting in fragmentation and volatility in interparty coalitions in the Czech Parliament" (2007, 66).

Sean Hanley's text on the rise of the Czech right also offers interesting insights on Klaus' conservatism. Hanley found Klaus' ODS success to be remarkable given that Czechoslovakia had perhaps the "strongest social democratic traditions" (Hanley 2008, IX). In comparison to Poland and Hungary, Hanley noted, Czechoslovakia lacked the populist, religious, and nationalist sentiments that made conservatism viable. And although the ODS and other right-wing parties never mounted majorities (hovering around 25-35 percent) their influence was significant. "After the split of Czechoslovakia in 1992," Hanley wrote, "the independent Czech Republic thus appeared to be an island of conservatism and free market radicalism in a sea of nationalism, populism and post-communism" (2008, 12-13).

Explanation 1 and 2: Ideas and Discourse in the Czech Republic

By 1998, the ODS met to consider four new themes to campaign on: privacy, an efficient state, an absence of debt, and solidarity between citizens. This document came to be known as the Podebrady Articles, and it laid out a new economic plan of attack. Included in the articles was a little known tax reform that experienced mild success in the Baltics. It called for "flatter" taxation. The ODS election program suggested a "flat tax" in the range of 20-percent of that year but to no avail (Hanley 2008, 141-142). The Czech Social Democratic Party took 32-percent of the vote, enough to maneuver their

Prime Minister Milos Zeman into power. Social democrats would control Parliament from 1998-2006.[60]

The success of the Social Democrats belies the seeming conservative, free market island that Hanley articulates. He admits as much, when he speculates that incumbency was little help to right-wing parties in the late-1990s (Hanley 2008, 13). What the Czech right required was a new voice, and they found that in Senator Mirek Topolanek. Topolanek, an ODS party member since 1994, was tapped to lead the party in 2003, ending thirteen years of leadership under Klaus. Topolanek pushed the party in the direction of a number of domestic policies, including welfare reform and most importantly flat taxation. Klaus – in the same year -- was closely elected President of the Czech parliament and embarked on a more "detached relationship" with ODS (Hanley 2008: 14, 152). Hanley notes:

> In substantially addressing areas such as education, welfare, the environment and family policy, the program represented a move in the direction long advocated by critics of Klaus. Its centerpiece was fiscal and tax reform along the lines advocated in the 1998 Podebrady Articles: a 15-percent flat tax combined with a universal basic income payment to all adults… (2008, 153).

Topolanek's influence was apparent within the ODS as he became the presumptive candidate for the prime minister post in 2006. In the run-up to the election, the ODS presented their Blue Chance Program, identifying the introduction of the flat tax as their major domestic policy proposal (Hanley 2008, 154). On the third of June, 2006, the Czech Republic went to the polls to decide on a new Parliament (or Chamber of Deputies). The ODS won 35-percent of the vote but the results produced a deadlock. One-hundred delegates aligned to form a coalition of ODS, Greens, and Christian Democrats. One-hundred delegates aligned with the Social Democrats and Communists.

[60] The flat tax also was discussed in 2000 by Klaus's think tank, the Center for Economics and Politics.

For the next seven months both groups fought to gain control before two Social Democrats abstained from voting, giving ODS the necessary members to rule in January 2007.

In the meantime, political fights were rampant, especially over the issue of the flat tax. Social Democrat lower house chairman Miloslav Vlcek told journalists in August 2006 that they would in no way allow a flat tax to be introduced ("Social Democrats Not to Allow Flat Tax, Changes to Labor Code" 2006). By December, Social Democrat Chairman and former Prime Minister Jiri Paroubek told a Czech journalist that he would never recognize the "media fetish" of the flat tax. He also likened Topolanek to Slovakia's Dzurinda, calling him a "conference tourist" whose reforms exist simply to please free market elites. Writer Lenka Zlamalova summarized Paroubek's and her own position like so: "[The] flat tax is an elegant, catchy slogan for the election campaign. But it is by no means an indispensable reform…" ("Paroubek has Retreated Towards Reforms" 2006).

But by late December 2006, the ODS and their agenda was coming to fruition. Martin Riman, an ODS politician who went on to become Minister of Industry and Trade, and Miroslav Kalousek, a Christian Democrat later tapped to be Finance Minister, introduced a proposal for a 17-19-percent flat tax that would take effect in 2008. This would abolish the four-tiered system of rates ranging between 12-32-percent ("Coalition Government to Introduce 17-19% Flat Tax 2006). In April 2007, Topolanek and his coalition in Parliament formally introduced a 15-percent flat tax. The tax – a fulfillment of campaign promises made by Topolanek in June 2006 – still faced the challenge of the bill being passed through Parliament, given the "fragile majority" the coalition government possessed ("Czech Center-Right Coalition Agrees on Flat 15% Personal Income Tax Rate" 2007).

In May of that year, Topolanek's former finance minister Vlastimil Tlusty introduced another proposal. Tlusty promoted a 12-percent flat tax on both corporate and income rates and had warned Topolanek that his proposal could be jettisoned if he did not seriously consider this alternative. Tlusty argued that Topolanek's reforms were weaker than what he had promised in the run-up to elections in 2006 ("Former Finance Minister Presented Alternative Tax Reform Plan" 2007). Indeed, Topolanek's position had softened some since June, like when he told a Czech newspaper in August 2006 that he may just reform the existing tax scheme rather than implement the flat tax, and modeling the Czech Republic on the suggested reforms of Slovakia's Prime Minister Robert Fico. (Lomas 2007). But on 8 June 2007 the Czech coalition government passed a reform package through Parliament that called for the introduction of a 15-percent flat tax ("Czech ODS-led Coalition Government Approves Tax Reform Package" 2007). By August of that year the Czech Republic was officially a flat tax country.

The Czech Republic's road to the flat tax is one of the more unusual of the flat tax countries studied in this project. Despite the "island of conservatism" described by Hanley, it took the Czech Republic thirteen years to adopt and pass a flat tax. The ideas were present since at least 1998 but yet there was no adoption until 2009. What does this mean and what does that say for our explanations? First, it took a shake-up in the leadership of the dominant conservative party to finally get the flat tax on the public agenda. Though Klaus was known internationally as a Thatcher devotee, Topolanek's reign as party boss of ODS and later as Prime Minister was the first step in actualizing the flat tax as an acceptable public policy. Second, along with Estonia and Slovakia, the Czech Republic had policy champions and carriers of the flat tax idea. Not only Topolanek, but Riman, Kalousek and Tlusty all at one point or another publically defended or articulated the flat tax idea. This is at least a first step in validating the idea of the flat tax. Thirdly, political parties played a predominant role in shaping the ideational discourse. Without the power of ODS, like Slovakia's SDK before them, there is no flat tax.

The idea of the flat tax held sway over Czech elites supportive of the policy. But if this section shows anything it is how important *politics* is to the adoption of the flat tax. In Estonia, the flat tax was approved with little fanfare and almost no controversy. In Latvia and Lithuania, the flat tax was a consequence of bureaucrats, economists and technicians thinking quickly about how to solve a fundamental problem. In Slovakia, the flat tax comes about due to the rejection of Meciar's authoritarian government and the movement toward a more open system under Dzurinda. However, in the Czech Republic, politics mattered in a way that yet to be witnessed the previous Baltic cases. Revealed was serious party division surrounding the actual adoption of the flat tax, not after the fact as seen in the Baltic cases. The political battle over the flat tax was more hotly contested in the Czech Republic than in other flat tax countries. There was the obvious conflict between the ODS and the Social Democrats: social democrats described flat taxers as media "tourists" and those with a propensity for flat tax "fetish". But perhaps most surprising was the public infighting between Prime Minister Topolanek and former finance minister Tlusty. The idea of the flat tax was discussed by all parties, validating explanation two for the very first time in the entire dissertation.

Rival Explanation 1 and 2: Rationality and External Pressure in the Czech Republic

Not surprisingly, perhaps, the more "political" the talk is about the flat tax, the less there is discussion about the simple functionality of the tax. Thus the Czech case seems to invalidate rival explanation two. It is no coincidence, I think, that when the flat tax was articulated primarily by economists and tax administrators like in Latvia and Lithuania the flat tax debate lacked an ideological quality. Economists and administrators saw the nuts and bolts of the flat tax and all the problems it could solve. But politicians and party leaders speak in ideological overtones and shortcuts. The flat tax became the centerpiece of two different party's platforms: the platform of the flat tax protagonists (ODS) and the flat tax antagonists (Social Democrats). Lastly, the policy change was totally carried out by domestic actors, invalidating rival explanation one regarding external pressures.

Diffusion in Slovakia and the Czech Republic

Thus far, the chapter has highlighted the adoption processes in Slovakia and the Czech Republic. In Slovakia, the transition from the Meciar regime to the Dzurinda regime set into motion a series of processes that enabled the flat tax to be adopted. Among these include the role of policy champions, political parties, Western-trained economists and think tanks in relaying ideas through the chambers of government. In the Czech Republic, lengthy dialogue about the flat tax finally gave way to its adoption, spurred in part by policy elites, political parties, and a shake-up of the conservative leadership. The first two sections of the chapter explain the process of adoption, but still cannot explain *how* or *where* the flat came into being in Slovakia or the Czech Republic. In a previous chapter, Kurt Weyland's varieties of policy diffusion were discussed. Those varieties included diffusion via external pressures, via normative and symbolic appeal, via rational learning, and via cognitive heuristics. Though diffusion itself is not the *cause* of adoption, it adds a great deal of context to the adoption process.

First, what about external pressures in Slovakia? It is true that Dzurinda's government was clearly motivated by the prospect of acceptance into institutions like the EU, NATO, and OECD. The integration issue went a long way towards keeping the first cabinet together, a "broad coalition of parties…with little in common except their dislike for Meciar and commitment to moving toward the West" (Fisher 2006, 186). But Dzurinda made it clear that his country had little desire to harmonize its taxes with other EU-member states, arguing that he would never let European bureaucrats "tie our hands", and that flat tax reforms were successful in increasing the state budget. Instead, he argued, it was the responsibility of each country to decide which tax plan best suits them ("Dzurinda Rejects EU Tax Initiative" 2007). As far back as 2003, Slovakia's Miklos had little use for outsiders telling him how to run his shop. When the IMF predicted budget shortfalls after Slovakia's decision to go with a flat tax, Miklos largely ignored them and claimed that the tax would do what they wanted it to: reduce the tax burden, make the system more transparent, and reduce tax evasion ("Lower Than Expected Tax Collection Raises Concerns" 2003).

To the extent that there was "central coordination" from afar, if anything the coordination was incredibly decentralized. Milada Anna Vachudova described the interplay between Slovakia and international institutions as one of "passive leverage". She argued that membership in these institutions created focal points of cooperation for domestic parties, incentives to improve domestic policies, and accountability to implement those policies once elected. In short, domestic actors used international institutions for their own ends. "Active leverage" — the actual carrots and sticks of membership — "had little success in changing the policies of Slovakia" (Vachudova 2008, 28-29)

In the Czech Republic, external pressure and central coordination were markedly absent. As Hanley explains, the Czech right, in comparison to other center-right parties in Central and Eastern Europe, was much more "Euroskeptic." The aforementioned Blue Chance paper argued that EU membership was not a panacea to cure all of the Czech Republic's economic problems. The party concluded that it would not sacrifice its independent reforms on the flat tax and welfare to satisfy the edicts of outsiders. Moreover, the ODS believed that some states used integration as a way to put off their own domestic reforms and accepting the "harmonization" policies of the EU (Hanley 2008, 17, 208).

Second, does normative and symbolic appeal makes sense of the Slovak or Czech case? In symbolic and normative appeal cases, policies are adopted to meet the prevailing norms of society and politics. This might help to explain Slovakia had the flat tax actually been a "prevailing norm". When Slovakia adopted the flat tax in 2004, it was the first democratic country outside of the Baltics to do so. Among its neighbors it was a renegade and certainly not normal. Poland, Hungary and the Czech Republic – Slovakia's peers – had no success implementing flat taxes. Moreover, the flat tax was a policy of tremendous controversy. After the defeat of the Slovak Democratic Party, newly elected Social Democrat Robert Fico immediately called for the abolition of the flat tax.[61] The National Association of Employers battled Fico on the issue, asking the new PM to preserve the right-of-center policies established by the previous regime ("Employers Call for Stable Business Environment After Election" 2006). Fico was defiant: "It is necessary to discontinue the philosophy built on cheap labor. The government's objective will be to change the present situation in income distribution…" (Fico's Path Returns to Socialist Ways" 2006).

By the time the Czech Republic's flat tax became official, the flat tax was no longer a passing fad. Ten other countries in the meantime had adopted a flat tax. Yet it still took Topalanek a year and a half of fighting in Parliament before the flat tax could be approved. Even then it required two Social Democrats to abstain from the vote to get it passed. In short, "symbols" lose their "appeal" when not very many like them, including international organizations, other politicians and even your own people. According to a scientific poll conducted by Czech polling agency SC & C in March 2009, more than 61-percent of Czechs agreed that the rich should pay the burden of the taxes ("Let Rich Pay Higher Taxes, Czechs Say in Poll" 2009).

Third, the cognitive heuristics model argues that policy adopters make decisions with limited information. This model helped to explain Latvia and Lithuania, two countries that followed Estonia's example but did so without knowledge of the full scope

[61] Fico did not get his wish. His Finance Minister Jan Pociatek announced that the flat tax would be kept intact, although the Social Democrats introduced tax deductions for low-income groups and created a "millionaire tax" for the highest earners ("Pociatek to Keep Flat Tax" 2006).

of the flat tax debate. By the time Slovakia adopted the flat tax in 2004 and the Czech Republic in 2008, everyone had the knowledge and information on the plusses and minuses of the plan. One could argue that Slovakia and the Czech Republic knew too much! Before the Czech Republic even introduced their flat tax in 2007, an investment group called Patria Finance released a study suggesting that 74-percent of Czechs would be worse off if a flat tax was adopted ("Patria Finance: Proposed Flat Tax Would Leave 74% of Employees Worse Off" 2007). Indeed, both left and right in their respective countries knew how the flat tax would affect their constituencies.

Lastly, policy diffusion could be a consequence of rational learning. In other words, to what extent does a new adoptee learn from old adopters? At a meeting in Bratislava in April 2000, Slovak Prime Minister Mikulas Dzurinda met with Estonia's Mart Laar. Laar made clear that Estonia was ready to share with Slovakia — and anyone willing to listen for that matter — their experiences transitioning from former Soviet republic to free market democracy. During the meeting, then Slovak President Rudolf Schuster "showed active interest toward the Estonian tax system" ("Estonian PM Mart Laar Said..." 2000). At this point Laar briefed the President on the flat tax system point by point. In 2008, Lithuanian President Valdas Adamkus met with Slovak businessmen to discuss the myriad of economic opportunities between Vilinius and Bratislava. During the meeting Adamkus noted the shared features between Lithuania and Slovakia's tax systems. He concluded by telling the businessmen how Lithuania's tax burden went from 33-percent of income to 27-percent, falling more in line with other flat tax countries (Vaida 2008). He made light of the fact that now it was Lithuania learning from Slovakia, not the other way around!

In the Czech Republic, Topolanek hosted a conference entitled "Flat Tax – the Basis of Tax Reform" in June 2005. The conference included politicians from nine European countries and became something of a "Who's Who" in the flat tax vanguard. Among others were Slovakia's Miklos, former Estonian Prime Minister Juhan Parts, the Czech Republic's own finance minister Vlastimil Tlusty and the then Heritage Foundation's (now the Cato Institute's) Daniel J. Mitchell. A spokesperson for the ODS party summarized the event like so: "...It is obvious why ODS Chairman Topolanek invited to Prague primarily the representatives of the countries that already introduced [the] flat tax and therefore can serve as an example for us" ("Mirek Topolanek Joined By ODS Foreign Partners…" 2005). These examples show policy diffusion in practice: two groups, one teaching a policy innovation, and a second, learning about it.

But the rational learning model only helps to explain *learning* about the policy, not its adoption. The Czech Republic already knew about the flat tax in 1998. In fact, the ODS proposed the policy as part of their political program that year. As it turns out, they lost the election, and the flat tax was shelved for eight more years. Even after a narrow victory in 2006, flat tax proponents had to fight diligently for their cause. In Slovakia, the reign of Meciar made it impossible for forward-looking economic reforms to make it on the agenda. It even took Dzurinda and Miklos – two people who already knew about the flat tax well before 2004 – to get the bill shepherded through Parliament.

Slovakia and Czech Republic show that in adopting a flat tax, timing also matters. In the early adopter states of Estonia, Latvia and Lithuania, it only took a few years for the flat tax to go from idea, to legislative bill, to law. Each successive adoption, starting with Slovakia, got more difficult. This is partly due to the "knowledge" elites now had of the flat tax (both good and bad) but also a consequence of coalitions of flat tax antagonists who are found in places like Slovakia, the Czech Republic, Poland and Hungary. Therefore, the right political setting must exist for policies to be adopted, regardless of when one learned about them or not. Second, political leaders wedded to the flat tax must deal with other leaders who sharply oppose it. In Estonia, the flat tax was adopted amid little fanfare and very little controversy save a last minute change of heart from then PM Edgar Saavisar. All the fights about the flat tax have occurred *after* its adoption. In Latvia and Lithuania, the flat tax was basically an unheralded pragmatic policy decision that was done so, as one observer noted, with little consciousness about its political message. Not so in Slovakia and the Czech Republic. The "knowns" of the flat tax have created sharp divisions among society, its interest groups, and its politicians.

Conclusion

Slovakia and the Czech Republic were latecomers to the flat tax club. Unlike in Latvia and Lithuania, where changes in tax policy were relatively easy, changing the tax scheme (and keeping it that way) has been much more difficult in Slovakia and the Czech Republic. These countries owe their adoption in large part to the commitment of right-wing politicians, political parties and think tanks. But their commitment and knowledge of the flat tax alone did not guarantee adoption. The political environment as well had to be favorable for success.

In the latter part of the chapter, the "rational learning" model of policy diffusion is stressed. Unlike the "early" adoption cases of Latvia and Lithuania, the "late" adopters of Slovakia and Czech Republic learned a great deal of the strengths and weaknesses of the flat tax by studying prior adoptions. Latvia and Lithuania simply did not have enough information to go on and thus acted based on limited information. For Slovakia and the Czech Republic there seemed to be unlimited information, which, on the one hand, enabled more connections between flat tax supporters. On the other hand, however, it also brought forth a number of individuals critical of the flat tax, slowing down the adoption process.

The next chapter introduces the non-adopters of Poland and Hungary. Offering variation on the dependent variable, I examine two states that seem primed to adopt a flat tax based on the theory of policy diffusion but for a number of reasons, have not. What is argued is that *diffusion* does actually occur in Poland and Hungary; however, *adoption* does not. That is to say, the idea of the flat tax spread throughout Poland and Hungary without ever being adopted. In Hungary this is because of strong ideological and political antagonisms to the flat tax. In Poland, some of those antagonisms exist, but the main impediment has been the structure of government, which offers serious checks on the power of parliament alone to pass legislation. The specifics of these cases will be developed in the following chapter.

CHAPTER 6

DIFFUSION WITHOUT ADOPTION: THE CASES OF HUNGARY AND POLAND

Introduction

The “big three” of Poland, Hungary and the Czech Republic have long been considered the leaders in political and economic reforms in Eastern Europe. These three countries – for example – were the first Eastern European countries chosen for membership in NATO. Poland and Hungary, in particular, were also the first countries to begin negotiations for acceptance into the European Union in 1994.[62] Hungary, Poland and the Czech Republic also share a common history of dissent against the communist system. Three major protest movements — the Hungarian Revolution of 1956, Czechoslovakia’s Prague Spring, and Poland’s Solidarity — are indicative of the contrarianism of all three countries (Lach 2006, 206). These legacies of dissent enabled reformers in each country a jumping off point when communism officially collapsed in 1989, and the Soviet Union fell two years later.

Despite the leadership of the big three on crucial political and economic reforms, only the Czech Republic has reformed its tax system to include a flat tax. It was the leadership of the Baltics, and the perpetually backward Slovakia, that spurred the flat tax movement along in Eastern Europe. This chapter addresses a crucial question: Why have two major players – and leaders -- in Eastern European politics not adopted a flat tax?[63]

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[62] However, the Baltics, Slovakia, Czech Republic, Hungary and Poland all were accepted into the EU on the same day, 1 May 2004.

[63] Theories of policy diffusion specifically state that geography and proximity are central reasons for how policies diffuse. From this perspective, it is perplexing that two states in such close proximity to other flat tax adopters would not adopt the tax themselves.

Tested will be two explanations. The first explanation (identified as explanation three in Chapter Two) claims that in states that do not adopt the flat tax, we would observe that the flat tax idea conflicted with progressive ideas about economics, economic theory and good government. Ideas contrary to the flat tax prevented flat tax adoption in those countries.

In the case of Hungary, the flat tax has been a prominent idea and part of political discourse since at least 2005. However, two barriers have been prominent in the Hungarian case. First, the major party pushing for the flat tax – the Alliance of Free Democrats – is small and not very popular. What this has meant is that they must align with other parties (in this case socialists) to even be a part of the ruling coalition. Couple this with political infighting within the Alliance of Free Democrats and the most prominent supporters for the flat tax have all but disappeared. For Poland, separation of powers has precluded, thus far, a flat tax. Though the current parliament (or *Sejm*) is composed mainly of the Civic Platform party, the major supporter for the flat tax in Poland, Polish President Lech Kaczynski has consistently been antagonistic to the tax. In fact, any passage of the flat tax through the *Sejm* stood to be vetoed by Kaczynski.[64] Moreover, like in Hungary, divisions within the party have been prevalent in Poland with some wanting to move full steam ahead with tax reform while others have been more reticent.

The rival explanation (identified as rival explanation three in Chapter Two) claims that in states that did not adopt the flat tax we would observe that external pressures or regard to self-interest prevented adoption, rather than actors being wedded to

[64] This chapter was composed before the tragic death of President Kaczynksi. Certainly the possibility for a flat tax is greater now than before .

particular alternative ideas. For this claim to be validated we would need to observe the presence of dominant institutions wielding their force on Hungary and Poland to prevent the adoption of the flat tax. Though the IMF has historically been critical of the flat tax, Hungary's and Poland's decision to not adopt had more to do with local politics than international ones. As to rational self-interest, there appeared tremendous incentive to reform the tax system in Hungary and Poland, especially with the pressures of tax competition throughout Eastern Europe and glaring budget deficits. This did not happen, however. The idea of the flat tax greatly mattered in Hungary and Poland, particularly among policy champions and parties wedded to the idea. Yet, those ideas were also confronted by contrary ideas that undermined the legitimacy of the flat tax, and defended their respective progressive legacies.

This chapter is organized in three sections. The first section details Hungary's economic and political dynamics and their reticence to adopt a flat tax. The second section looks at Poland's non-adoption, relating the political arrangements that have prohibited the flat tax. The last section looks into policy diffusion in Hungary and Poland. But what was being diffused? My argument is centered on the notion that policy ideas can diffuse without ever being adopted. The *idea* of the flat tax diffused to both Hungary and Poland; however, the political environment prohibited the adoption. For example, Poland has known about the flat tax as long as the leadership in Slovakia, yet has had tremendous difficulty adopting the flat tax. Adoption requires a certain political process that is distinct from the "learning" involved about new policies. I am also cognizant that as of this writing there are various predictions that both Poland and

Hungary will adopt the flat tax by 2011 or 2012.[65] The purpose of this chapter, however, is to show in further detail how flat taxes are understood and diffused in Eastern Europe, though in this case, not adopted.

Hungary: A (Short) History

Like other Eastern European countries studied in this project, market-related economic reforms produced early results that had many questioning its promises in Hungary. High inflation, high unemployment, declining incomes, and increased inflation were part and parcel to the new capitalist experiment (Chan 2007, 157). Included in these early reforms was a change in the Hungarian tax scheme. Beginning in 1988, Hungary adopted progressive taxation based on the Swedish model, with rates reaching 60-percent on the high end. As Anders Aslund's *Building Capitalism* pointed out: "The social democratic model became one standard for tax reforms in this region. Central Europe followed the Hungarian example rather closely, as neither Poland nor the Czech Republic displayed any liberalism in taxation" (2002, 228). Currently, Hungary has the second-highest tax burned among members of the OECD, after income taxes increased following a government increase in 2006 ("MDF to Push For Flat Tax After Coalition Collapse" 2008).

The burdensome tax structure has led many to call for a change in Hungary. Several problems have been present, not the least of which is the increased tax

[65] In writing my 2008 article "The Adoption of the Flat Tax: Economic Ideas in Eastern Europe" I used Poland as a case study for adoption. All within a period of six months of writing the article, Poland adopted the flat tax and then rejected it. While this adoption/rejection was frustrating – given that Poland was an adoption case in my project – it also helped me think more about the actual mechanisms involved in policy adoption, and how that process is more intricate (and difficult) than one might think.

competition going on in neighboring countries like Slovakia and the Czech Republic. The idea that Hungary is falling behind countries that were once considered late developers is disconcerting. For example, the news that Slovakia was accepted into the Euro zone was an embarrassing blow, described in the *Budapest Times* as akin to when the Soviets beat the Americans into outer space with the launch of Sputnik ("Slovaks Are Smarter than Hungarians Seem to Think" 2008). Second, critics of the Hungarian model have noted the insurmountable deficits created by social programs like pension reform. This created a double-bind. On the one hand, Hungary is losing out to its low-tax (or efficient tax) neighbors so as to maintain a robust safety net provided for by higher taxation. However, Hungary cannot raise enough taxes as it is to protect these social programs. Increased deficits and the need to balance budgets make it more difficult to overhaul a tax system that according to some observers is in crisis (Forelle 2009).[66] Thirdly, the flat tax is seen once again as a solution to tax evasion and the rise and power of black markets, or "clandestine employment" ("Economy Minister Wants a Flat Tax as of 2009" 2006). Left-of-center Prime Minister Ferenc Gyurcsany noted that since 1989 little had been done to address the problem of grey and black market economies. Some type of tax reform was needed to address this problem, which could be solved by more simplistic and efficient method of taxation, something akin to the flat tax ("PM Calls for Heightened Measures Against Tax Evaders" 2007). [67]

[66] In the case of the Baltics, however, the converse was true. Why? First, the Baltics were willing to cut social programs as they reformed their tax code, something Hungary was not willing to chance if the new tax did not return the expected revenue. Second, Hungary had more entrenched interests within the tax bureaucracy that nascent bureaucracies like Estonia, Latvia and Lithuania did not have.

[67] Though Gyurcsany recognized the problem, it did not mean he found the tax change to be an appropriate solution to this problem.

The development of political parties in Hungary is crucial to understanding both the exposure given to the flat tax as well as the problems Hungary faces while trying to adopt the reform. The Hungarian party system, as Juri Lach has argued, created a rallying point for reform-minded individuals in the early 1990s (Lach 2006, 200). These post-Communist parties have been characterized as existing in a “two-dimensional political space” (Chan 2001, 156). The first parties were divided between supporters of the old Communist regime and the various anti-Communist groups that rose to power with the promise of reform (Chan 2001, 157). These parties have had remarkable staying power. The communist Munkaspart, for example, has had a constant place in the Hungarian party system since the beginning, though they are relatively weak by comparison. Four other parties have been mainstays in Hungary: the Hungarian Socialist Party (MSZP), Federation of Young Democrats (FIDESZ), Alliance of Free Democrats (SZDSZ) and the Hungarian Democratic Forum (MDF) (Spirova 2007, 61, 71). Two parties in particular — FIDESZ and SZDSZ — are particularly important to the flat tax story.

FIDESZ is a long-standing conservative party in Hungary that started out as little more than an “anticommunist political club” (Spirova 2007, 92). But FIDESZ expanded their little “club”, first, by savvy organizational skills. FIDESZ capitalized on the fragmentation of other, smaller conservative parties by creating a “catch-all” party of all comers. Second, FIDESZ discarded narrow neoliberal views in favor of more traditionally conservative, or nationalist ones (Spirova 2007, 92-95). In 1994, for example, FIDESZ, ran their campaign on reducing the role of the state, increasing privatization, and privileging entrepreneurship (Batory 2007, 55). But by 1998, FIDESZ shifted away from a party of radical neoliberals. In response to market turmoil, FIDESZ embraced a pro-welfare line in 1998, changed their name to FIDESZ-MPP (now the Hungarian Civic Party), changed the way they dressed, cut their hair, and abolished the age restriction on who could join in the party. They also left the Liberal International, a cross-national coalition of neoliberal political parties in Europe. FIDESZ became the status quo party, far from the radicalism that preceded them (Batory 2007, 55; Chan 2001, 170).

The SZDSZ, on the other hand, has consistently held the banner for neoliberalism in post-Communist Hungary. This banner includes a broad "agenda of progressive reform towards libertarian social values and placing trust in the market place" and membership in Europe's Liberal International and the Alliance of Liberals and Democrats for Europe (Batory 2007, 53-54). SZDSZ is known as the party of young, secular, urban and educated members who are virulently anti-communist and devoted to adapting a Western model onto Hungary (Bozoki 1999, 110). The SZDSZ are also heirs to the Hungarian 'Samizdat' movement. Though the movement had its origins in the Soviet Union, the human rights campaign slowly spread through Eastern Europe, hiding anti-communist texts within secretive literature. The human rights activists joined radical free marketers, and thus, SZDSZ was created in 1988. Originally, noted researcher Zsolt Enyedi, the SZDSZ party was a cross-coalition of social democrats, liberals and radical anti-communists, but over time, "socialists and anti-communists dropped out, and the liberals prevailed" (Enyedi 2006, 180). Whereas FIDESZ created a catch-all party, SZDSZ went in the direction of ideological purity. Despite SZDSZ's insistence on free-market principles the only party for which they have been able to build coalitions has been MSZP, the major socialist party in the country.

Explanation 3 and Rival Explanation 3: Progressive Ideas, Rationality, and Institutions

The relationship between SZDSZ and the socialist MSZP is a surprising one but one of compromise. Batory noted that despite divergent approaches to the issues market reforms or social protection, the two parties have largely eschewed identity politics unlike their main challengers FIDESZ (Batory 2007, 49). When the Hungarian parliamentary elections of 2002 and 2006 went to the victor MSZP it appeared to give the SZDSZ the opportunity it needed to enact a flat tax in the country. Serving as a junior partner in a coalition with the ruling party, talks were underway to develop and implement a new tax regime by 2009 ("SZDSZ Requires Flat Tax as of 2009…" 2006). But a flat tax would only be agreed on if SZDSZ accepted an economic reform program that initially included tax hikes and austerity measures to balance the budget. This would mean that property taxes and VAT taxes would be raised in the short term to make up long-standing deficits. The principal mover and shaker on this issue was Economic Minister Janos Koka, who became the most articulate spokesperson for the tax reform ("Hungary Liberals Want Flat Tax After Belt-tightening" 2006). By 2006, Koka had set-up a Convergence Council" to oversee measures like euro convergence, economic competitiveness, and the flat tax. The flat tax was a central feature of the liberal SZDSZ's economic policy ("Liberals Offer Plans to Help Competitiveness" 2006). Koka was also trumpeting the tax policy to foreign audiences, detailing his plan to the

Hungarian-German Chamber of Commerce in fall of the same year ("Economy Minister Wants Flat tax as of 2009).

But three years have come and gone without any movement toward a flat tax. Most frustrating for flat tax proponents has been the fact that at — one time or another — every party has recognized the need for a flat tax. This includes the opposition conservative parties Hungarian Democratic Forum (MDF) and FIDESZ ("MDF to Push for Flat Tax After Coalition Collapse" 2008). But the main ideological support for the flat tax, the SZDSZ, has recently dealt with increased unpopularity and divisions within their ruling coalition. Feeling as though MSZP was not moving quickly enough toward significant economic reforms, they quit the coalition in April 2008. Now the SZDSZ has moved towards working with MDF to try and advance the tax system, while FIDESZ has "shied away" from its "arch enemies" (the SZDSZ) on this issue ("Liberals Renew Call for Flat Tax" 2008).

Problems have also existed with SZDSZ. By the middle of the summer 2008, the party had a public opinion approval reading of less than 1-percent. In June, SZDSZ replaced Economic Minister Koka and placed Gabor Fodor in his place. In his six years at the helm, SZDSZ members felt as though little had been accomplished by Koka. As the *Budapest Times* wrote:

> The SZDSZ must concede total failure as a supporter of tax cuts or at least the simplification of the tax system. It sounded like a mockery when Koka — barely after standing down as minister — suddenly started blustering about a 'radical tax-cut package' and the urgent need to 'unburden the economy' ("What Does Hungary Still Need the SZDSZ For?" 2008).

Furthermore, July 2008 saw the MDF accuse SZDSZ of reneging on their commitment to implementing a flat tax. MDF chairwoman Ibolya David accused SZDSZ of creating a

‘Potemkin opposition’ out of the flat tax.[68] If the MDF were to expose the SZDSZ as a fraud, one journalist suggested, the flat tax’s historical supporters would fall by the wayside and perhaps with it a basic discourse on free market principles (“Third Force” 2008). This is further disconcerting to SZDSZ, who have had trouble recently positioning themselves as free market conservatives after years of cooperation with the predominant socialist party (“Two Parties, Two Dilemmas” 2008).

Political stalemate has seen flat tax support come from other channels in Hungary. Former finance minister Laszio Bekesi formed the group Reform Alliance, composed of academics and businessman, to try and influence politics in Hungary. The flat tax has been a particularly prescient concern. Bekesi’s group lobbied for an 18-percent flat tax on income and businesses. Bekesi argues that fundamental tax reforms have been hard to achieve because politicians care more for remaining in office than implementing controversial policies. “FIDESZ decisively rejects our proposals… [and] the party doesn’t want to do anything that could damage its current popularity,” said Bekesi (“We Won’t Back Down” 2009). And Bekesi claims the MZSP is scared of pro-flat tax groups like Reform Alliance because they appear to be too “big” business. His remark about the business claim: “Why shouldn’t that be the case? Their voices carry weight and have the chance of being listened to by those responsible” (We Won’t Back Down 2009). In short, the current consensus is that Hungary has “no chance” to adopt a flat tax anytime soon (“Economy Minister Sees No Chance for Flat Tax Rate” 2008).

Hungary – like its predecessors in Estonia, Slovakia and the Czech Republic – had two policy champions in Koka and Bekesi. But Koka’s influence was greatly

[68] This refers to Grigory Potemkin’s efforts to build “fake” villages in the Crimean part of Russia to fool Empress Catherine II into believing progress was occurring in the region. It also was used to mask more serious problems occurring in the area.

mitigated when he was removed from the party and Bekesi was retired and out of politics by this time. His influence in creating the Reform Alliance is important to note, however. As previously discussed, groups like the Lithuanian Free Market Institute and Slovakia's MESA-10 were important purveyors of ideas. In Hungary, though, flat tax ideas were challenged by contrary ideas. Linda Cook stated that Hungary (and Poland) were the only Eastern European countries committed to welfare state ideas at periods of economic recession (Cook 2007, 5). Unlike McNamara's model which states that economic crises necessitates economic innovation, Hungary held true to a basic social democratic framework. Hungary was the preeminent Eastern European state devoted to the Swedish model of taxation (Aslund 2007, 116).

The inability to adopt the flat tax also shows the domestic political battles revolving around the party system. Hungary's SZDSZ was the primary party responsible for articulating the flat tax. But the nature of coalition politics in Hungary has made it difficult for SZDSZ to simply impose their will onto the political environment. Couple this with the infighting of the leadership of the party and the flat tax did not have a chance. In Hungary it was also not simple rational self-interest that prevented the flat tax. There were critics of the progressive system like Gyurcsany who believed that the tax system was failing and unable to efficiently collect revenue. But for left-of-center leaders like Gyurcsany the flat tax was not an option. It conflicted with progressive ideas and the established Swedish model. Once again it was the *domestic* nature of flat tax politicking precluded external pressures.

Poland: A (Short) History

Poland's democratic transition could not be understood without reference to the famous Solidarity movement. Beginning as early as the 1950s and gaining in strength in the 1970s, working-class, anti-communist movements began appearing throughout Poland. In 1980, this movement – given the name Solidarity – had spread nationwide. When membership reached 10 million in 1981, the ranks of Solidarity was a cross-class coalition of workers (both white and blue collar), intellectuals, and entrepreneurs. They were led by a former electrician named Lech Walesa (Castle and Taras 2002: 55-56). When Poland had its first democratic elections June 1989, Solidarity won all but one of the seats they contested in the *Sejm* (or parliament), and 99 out of 100 in the Senate. Some saw this as a referendum on the old regime, though turnout was unexpectedly low at just 62-percent (Jasiewicz 2007, 90). In the presidential election in November 1990 Walesa defeated three other candidates to become the first post-communist president of Poland. The election also revealed the major political cleavages between the candidates and their ideology: Walesa's Christian-Democratic/conservatives, Tadeusz Mazowiecki's liberal-democrats, Wlodzimierz Cimoszewicz's socialists, and Stanislaw Tyminski's nationalists/populists (Jasiewicz 2007, 90).

In the following presidential election in 1995, Walesa lost his bid at reelection to socialist candidate Aleksander Kwasniewski. In the first round of elections, thirteen candidates vied for the presidency with Walesa trailing Kwasniewski by 2-percent of the votes at 33-percent to 35-percent. But in the second round of elections did not favor the center-right Walesa. In a now-famous television debate, the youthful and well-spoken socialist trumped an “irascible and arrogant Walesa” (Castle and Taras 2002, 99). Walesa lost 48-percent to 51-percent, with the Solidarity bloc divided on the Walesa candidacy. Walesa even lost his own hometown by a 13-percent margin. Further, Kwasniewski won his reelection bid in 2000 thus “contributing to the… consolidation of the socialist political field” (Jasiewwicz 2007, 91). The Democratic Left Alliance (SLD) and Labor Union (UP) parties took 41-percent of the seats in the *Sejm* election the following year further demonstrating the power of left-of-center parties.

Polish analyst Krysztof Jasiewicz noted that politics in Poland exists on a swinging “pendulum” between left and right (Jasiewicz 2007, 95). In the early 1990s Christian-Democratic and conservative groups made up the bulk of parliamentary seats, the mid-to-late 1990s it was composed of social democratic groups, and through the 2000s has swung back to right-of-center and neoliberal parties. As the pendulum has come back right, adopting a flat tax seemed to be a greater reality. The year 2001, for example, was a critical year for the slow turn towards a right-of-center *Sejm*, in particular with the creation of the new Civic Platform (CO) party.

Formed in January 2001 as more of a civic club than a political party, CO is crucial to understanding the right turn in Poland and also the creation of a flat tax discourse in the country. Three individuals known together as the “three tenors” — former finance and foreign Minister Andrzej Olechowski, Parliament Marshall Macej Plazynski and Senate Deputy Marshall Donald Tusk – created the grouping that would emerge as a serious opposition movement from 2001 onward (Szczerbiak 2006, 95). In September 2001 parliamentary elections PO tallied 12.7-percent of the votes to finish second in the voting to the Alliance of the Democratic Left and the Union of Labor

(Castle and Taras 2002: 103). It composed itself of upwardly mobile, middle class members (Szczerbiak 2006, 103). More importantly, it was Tusk who in 2005 became a vocal advocate for Poland's nascent tax reforms (Ellis 2008, 98). Like in Hungary, however, Poland has had a tumultuous road to flat tax adoption.

Explanation 3 and Rival Explanation 3: Progressive Ideas, Rationality, and Institutions

"The promises to introduce a flat tax rate in Poland have been made for so long," wrote the editors of the Polish News Bulletin, "that many people all over the world, including flat tax system co-inventor Alvin Rabushka, have actually started to believe that the process had already been completed" ("The Vanishing Flat Tax" 2008). So goes the complicated process that tax policy reform has taken in Poland. As early as 1998, then finance minister Leszek Balcerowicz promoted the idea of a flat tax (Burba 1999). Balcerowicz was the chief architect of Poland's shock therapy program in 1990, which minimized the role played by state institutions and liberalized trade policy (Paczynska 2009, 132). In a 2005 article in the UK's *Telegraph* newspaper, the opening lead stated that Poland's decision to join the "flat-tax revolution" would be a "wake-up call" for the rest of Europe (Evans- Pritchard 2005). But eleven years later Poland has yet to adopt a single rate of taxation on income.

Like the Baltics, Slovakia and the Czech Republic before them, Poland looked toward the flat tax to solve some basic problems. First, it reduces the incentive to hide income or find tax havens elsewhere on behalf of people with money. Second, simplistic tax procedures make it both easier to collect taxes from the perspective of the bureaucracy and easier to file from the perspective of those taxed. Lastly, it is presumed that the flat tax does not "punish" those who make money, thus encouraging people to work harder and thus, the economy grows as a whole ("The Vanishing Flat Tax" 2008) .

It seemed as if Poland was on the verge of adopting the tax in 2005. In March, finance minister Miroslaw Gronicki introduced a flat rate of 18-percent to be adopted by 2008. But the election of president Lech Kaczysnski in September undermined Gronicki's reform, as Kaczysnski favored a two-tiered income tax when he came into office. He also ignored the pro-flat tax Civic Platform (PO) party in favor of his own Law and Justice Party (PiS), and Self-Defense (S-O) and League of Polish Families (LPR), two nationalist parties (Ellis 2008, 98).

The party has continued to carry the banner for the flat tax and has also increased in popularity. In September 2007 elections, Civic Platform won 41.51-percent of the seats in parliament. The party's leader, Tusk, became Prime Minister. It was at this time that a flat tax would be a reality. "Poland must implement a flat tax-rate, which is an extremely urgent project," said deputy chairman of the economy and finance Zbigniew Chlebowski ("Poland's Would Be Winner" 2007). But a change in the tax scheme came with its own set of problems. First, skeptics were concerned that switching to a flat tax system would create a budget deficit. (This has been the concern of the IMF since the first adoption of flat taxes in 1994). Chlebowski answered that government services would need to be cut or reassign administrative capacity to local governments. Second, Civic Platform and their coalition partners the Polish Peasant's Party were still concerned that whatever bill was passed would face veto by President Kaczynski and could not be overridden by the parliament. "The Law and Justice [party] and the Left and Democrats will support the president. A lost cause is not worth fighting for," noted Sejm speaker Jaroslaw Kalinowski ("Bad Time for Flat Tax Rate" 2007).

This has not stopped the current Tusk government from laying out its own "strategic" plans for the future. In February 2008, Secretary of State Slawomir Nowak guaranteed a flat tax by 2012 ("Government: Flat Tax Rate in 2012" 2008). How would they accomplish this? In the first place they have reduced the number of tax brackets from three (19, 30 and 40-percent) to two (18 and 32-percent respectively). Observers indicate this would soften the blow of budget deficits. And Kalinowski has argued that the two brackets is fairly close to a flat tax, because the highest tax bracket effects only 1-percent of taxpayers anyway. ("Bad Time for Flat Tax Rate" 2007). Moreover, this "flattening" of the tax code would initially help to keep people from seeking early retirement. As it stood, employees would retire from their occupations around age 50 and work odd jobs under the table to avoid taxes ("New Tax Regime, Salaries Up" 2008). "Early retirement is a kind of trap," said current Finance Minister Jacek Rostkowski. "People choose it but then spend the next decade working under the table, and then it turns out their pensions are much lower than what they need. And they are in a situation of poverty, because they stopped working too soon" (Solska and Tarnowski 2008).

But three months later the flat tax was causing concern for the government and members of Civic Platform. Tusk backed Finance Minister Rostkowski and others in the government – like Nowak and Kalinowski – who argued that Poland needed to straighten out their budget mess prior to changing the tax code. Rostkowski, who spent much of his life as an academic and economist, has been increasingly cautious about reforming towards a flat tax. He told the Polish newspaper *Polityka* that any introduction of the flat tax would have to be done “responsibly” and in line with coalition partner PSL’s wishes to maintain pro-family benefits (Solska and Tarnowski 2008).[69] Party leadership within Civic Platform, mainly Chlebowski, wanted a flat tax as early as 2009. The ongoing dilemma was over the veto power of President Kaczynski. Tusk’s government believed that waiting it out until 2010 meant they could run their own candidate for president when Kaczynski’s term expired. This would enable them to implement a flat tax with little resistance. Chlebowski believed the longer Poland waited to reform their tax regime, the longer problems would persist (“PM See Flat Tax Not Before 2011” 2008).

The inability to pass the flat tax in Poland says something about ideas but more about the nuts and bolts of what the tax reform would mean practically for Poles. Though Poland had an early policy champion in Balcerowicz and later in Gronicki – as was the case with flat tax adopters in Estonia, Slovakia, and the Czech Republic – and while it is true language like “pro family benefits” is a pejorative as to what “pro family” really means, the Polish example revolved around the pragmatic aspects of the policy change more than the ideational components. As to explanation three, there is an ideational content to Poland’s non-adoption but ultimately non-adoption was the result of uncertainty on the part of some Polish politicians as to the flat tax’s effects. The uncertainty was whether the flat tax would ensure the pro-growth, pro-efficiency reform seen in the Baltics and Slovakia, or whether it would result in growing inequality and budget shortfalls. While the flat tax supporters highlighted the former, skeptics highlighted the latter.

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[69] This combination of free-market attitudes with social sensitivity has been a hallmark of Polish politics, political scientist Kenneth Chan has argued. Even after Balcerowicz introduced successful shock therapy measures, he was still concerned about “worker’s concerns” within such a program.

Additionally, there were structural constraints on the *Sejm* to pass legislation. This constraint was the veto power of the office of the president, who claimed he would block any flat tax legislation. There was in part, a rational self-interest among elites which mitigated against adoption. Flattening the progressive rate to only two brackets is a good example of the piecemeal, pragmatic approach that Poland adopted in contrast to a country like Estonia. Lastly, like in Hungary, the decision not to adopt was primarily domestic in origin and owed little to outsider institutions.

A final note needs to me made about why Poland has had trouble adopting a flat tax: public opinion. The Polish case is the only case studied where the public have played a vital role in shaping the debate. The most recent May 2008 poll indicated that 68-percent of Poles were against the introduction of the flat tax. The most against the tax were older people who believed that the tax unfairly benefited the rich. This despite the fact that 80-percent still feel as though the current system is too complex and needs to be reformed ("Flat Tax Increasingly Unpopular With Poles" 2008). The primary support for the flat tax is among well-educated, well-off young people who are in the minority ("The Vanishing Flat Tax" 2008). What has been even more puzzling to some observers is though over half the Polish population described themselves as conservatives, the policies of the Polish right, including the flat tax, have been less popular (Castle and Taras 2002, 132). With the electoral connection that exists between politicians and their constituents a movement towards introducing a flat tax becomes problematic. Gronicki admitted that flat tax reforms are easy to support from the position of the finance ministry but more difficult for parliamentarians ("Interview With Former Finance Minister Miroslaw Gronicki" 2007).[70]

Policy Diffusion and Rational Learning in Hungary and Poland

The literature on diffusion helped to understand flat tax adoption in the early adopter cases of Latvia and Lithuania and late adoption cases of Slovakia and the Czech Republic. As previously mentioned diffusion can only explain how ideas or policies are delivered into the political process but cannot explain what *causes* adoption. Moreover, the diffusion literature unwittingly implies that diffusion and adoption are often the *same* thing. What the Hungarian and Polish cases reveal is how diffusion and adoption are distinct entities. In this section I argue diffusion of the flat tax occurred but not its adoption.

What is meant is that the policy of the flat tax received serious political consideration by political parties and their leaders. The idea itself *diffused*, or spread to others. This was not an isolated incident or geographic anomaly. The flat tax began to surround Hungary and Poland on all sides. However, adoption was not possible. Drawing from the "rational learning" idea, both Hungary and Poland learned about the experiences of others. Some leaders and parties knew what they thought to be the successes of the flat tax, and others saw why the flat tax was problematic. By 2005 (and

[70] Gronicki's point is a prescient observation. In early adoptions of the flat tax (Estonia, Latvia, Lithuania and Slovakia to some extent) many of the champions were either appointed positions like finance ministers, or tax bureaucrats. Both positions are shielded from the public in a way that elected officials are not. If policy comes from the "experts" it perhaps is more palpable than from a politician.

indeed by 2009) the flat tax revolution was no longer the novelty it was in the Baltics, or even by “late adopters” such as Slovakia and the Czech Republic.

In one case of rational learning, former SZDSZ party leader Janos Koka had a highly publicized meeting with Romanian Finance Minister Varujan Vosganian and Senator Peter Ekstein Kovacs. At the 2008 meeting the flat tax and social spending cuts were discussed, as Romania itself adopted the tax reform in 2005. As Koka discussed: “We wish to learn from Romania’s experience and to benefit from your expertise” (“Romanian Ministers, Hungarian Politicians Discuss Fiscal Policy” 2008). Slovakia was also a prominent example used by Hungarian politicians and observers. Slovakia’s PM Dzurinda was held up as an example of how to put a “backward, isolated” country back on track by enabling “sensible tax rates” (Mainka 2005). Learning was also apparent through the auspices of the Liberal International, a transnational organization that brings together liberal and free market parties throughout the world. Membership includes Hungary’s SZDSZ, Estonia’s Reform Party, and Latvia’s Latvia Way Party. Because the Liberal International brought together member parties throughout the European Union, the SZDSZ became further entrenched “in placing libertarian social values…and trust in the market place” (Batory 2007, 54).

Learning is also present in the Polish case. The flat tax was discussed as early as 1998 by Leszek Balcerowicz, a committed neoliberal who was seen as one of the premier economic reformers in the region. But the introduction of the tax in Poland is generally credited to Miroslaw Gronicki, the Minister of Finance under the left of center government of Marek Belka. Belka himself was at one time a devoted free-market ideologue, with a degree from the University of Chicago. He was also one time a student of Milton Friedman. Gronicki — who made his career as an economist — received a degree from the University of Pennsylvania and worked as an adviser for the World Bank. Gronicki was jet-setter who advised governments in Ukraine, Georgia and his own Poland before being appointed to work in the government. It was Gronicki who became the focal point for flat tax reforms when every newspaper and observer around the world thought Poland's new flat tax would revolutionize Western Europe. The *London Times* in 2005 reported his promise to do away with the "complex grid" of tax rates by 2008 (Browne 2005).

One way to explain Hungary's and Poland's divergence from the rest of Eastern Europe's flat tax path is to argue that there is an ideational gulf between them. Aslund suggests as much when he notes the "social democratic" model adopted by Hungary and Poland compared to the "neoliberal" model adopted by Estonia was part of an ideational divide (Aslund 2002, 228). Analyst Adam Michnik argued that in Poland "there is a need for the presence of a socialist care for the poorest, a conservative defense of tradition, and a liberal reflection on efficiency and growth" (Michnik as cited in Chan 2001, 171). But if this were the case, how did a "social democratic" country like the Czech Republic achieve the neoliberal flat tax? The Czech Republic had a parliament that was able to pass the tax, a political party committed to the flat tax after a change in its leadership, and political elites devoted to its passage. This is not to say that ideas did not matter. There was clearly a strong neoliberal presence in the Czech Republic from Vaclav Klaus onward. The same can be said for Hungary. In survey data collected by J. Simon, free-market views were present not only among liberals like SZDSZ but also among socialists and nationalist conservatives (Batory 2007, 50).

However, Hungary faced political challenges unseen in the Czech Republic, and certainly unseen in the Baltics and Slovakia. First, the major supporter for the flat tax, SZDSZ, was never able to gain the popularity or stamina of parties like Slovakia's SDK or the Czech Republic's ODS. Instead, they were junior partners of the major socialist party in Hungary, MZSP. They quit the coalition in 2008 believing no progress was made on the flat tax front. Second, infighting within the SZDSZ and its major proponent Janos Koka led to his ouster in June 2008. Unlike Estonia's Laar, Slovakia's Dzurinda, or the Czech Republic's Topolanek, there was no major elite to take the stand for tax reform. Thirdly, worries about reelection have mitigated sweeping changes that would cut budgets or seemingly privilege the rich at the expense of the working class.

In Poland, similar institutional and political roadblocks exist. The most prominent is the division between the executive and legislative branch. Though in the early 2000s right-wing parties like Civic Platform (PO) increased in popularity and won the *Sejm*. Donald Tusk, a major spokesperson for the flat tax, became Prime Minister. But the election of Lech Kacyzynski from the Law and Defense Party (PiS) guaranteed a veto of any pro-flat tax legislation. Second, divisions within the party have hurt progress toward tax reform. Part of the problem has been a division among the right. Castle and Taras argue that the right has been significantly divided on issues like economics, tradition, and religion (Castle and Taras 2002, 133). Even within PO there was controversy about the pace of policy change. Tusk backed an approach that sought to balance the budget prior to changing to a flat tax. Chlebowski wanted to push forward despite budget problems.

Coming back to the question of whether ideas mattered in Poland and Hungary, it is important to note how much resistance there has been to the flat tax in both countries. A central thesis of Chris Edwards and Daniel J. Mitchell's book *Global Tax Revolution* is that cutting marginal tax rates or adopting flat taxes create a sort of cascading effect where other countries are forced to change their ways or suffer economically. They specifically commented that Hungary and Poland are beginning to "feel the pressures" that surround them (Edwards and Mitchell 2008, 63). One would think the only rational thing to do from the Hungarian and Polish perspective was to give in and adopt the tax. Surprisingly, this has not happened. For right or wrong, the flat tax has been a controversial idea whose supporters evoke it as the final piece of the reform puzzle, and its detractors deride it as unfair and favorable to the rich. The idea of the flat tax diffused, but trying to adopt it proceeded with much greater difficulty.

Conclusion

Hungary and Poland are flat tax laggards in an Eastern Europe full of flat taxation. In Hungary, committed ideologues like Janos Koka could not overcome party infighting and ideological strife to get a flat tax on the docket. In Poland, political constraints coupled with concerns of the flat tax "effects" and public opinion were insurmountable. This does not mean that the flat tax had no presence in Hungary and Poland. On the contrary, the flat tax has been a part of the political discourse for at least five years in Hungary and for more than ten years in Poland. The flat tax had, indeed, diffused. Both countries learned from the predecessors, but perhaps learned too much, knowing both the good and bad of flat tax policies. This made adoption especially difficult.

The next chapter is the last chapter of the dissertation. It will summarize the previous case studies and which explanations were validated. From evaluation of the explanations we can make some general claims about the adoption process. The chapter will also identify six specific components that go into understanding the flat tax in Eastern Europe. Lastly, I look to the future to see where the flat tax agenda is headed. It has been exactly sixteen years since Estonia made the fateful decision to adopt a flat tax. Since then almost the eastern bloc of an entire continent has moved to the flat tax. Will that trend cease, or will there be a continuation of the flat tax "revolution"?

CHAPTER 7

CONCLUSION: REFLECTING ON FLAT TAX ADOPTION

Introduction

This dissertation aimed to understand why countries in Eastern Europe adopted flat taxes. The flat tax presented itself as something of a political puzzle. Though many American politicians (Dick Armey, Steve Forbes) had discussed the flat tax, to this American it seemed foolhardy to believe the United States would ever have a flat tax.[71] To find out that Estonia could do something that Americans thought impossible – if not unwise – was fascinating to learn. Despite the assertion by journalists who first covered the flat tax story that the flat tax was nothing more than a pragmatic policy decision, I suspected there was something more. In doing research, writing a short essay on the topic and reflecting more about it I was struck by the commitment of elite carriers, or policy champions, like Mart Laar, Ivan Miklos and Miroslaw Gronicki. This spurred me to think more critically about the flat tax and its place in Eastern Europe.

My initial explanations suggested that the flat tax was an ‘idea’ that was chosen despite the “knowns,” or consequences of the policy change. The ideational thesis also accounted for the flat tax in ways that the rationalist or external pressure argument cannot totally account for. This does not mean that ideas acted alone; on the contrary, elite carriers, tax bureaucrats, and political parties were central variables in the flat tax story. Moreover, countries that adopted the flat tax after Estonia did so, I argued, because they

[71] Prior to Woodrow Wilson’s signing of a progressive tax in 1913 the United States did have something of a flat tax. It was not called a “flat tax,” however. In 1894, the United States government passed the Wilson-Gorman Act, which taxed all incomes above $4,000 at a flat, 2-percent rate (Dunbar 1894).

learned from the experiences of those countries that came before them. Thus, there was a domestic process of adoption, but also an international process of diffusion. Are these explanations valid? The question was simple enough but the research was labor-intensive and along the way, revealed a number of interesting findings I was not expecting.

This conclusion will accomplish three goals. First, in the following section I will summarize the eight explanations (four explanations and four rival explanations) in light of the data collected in chapters three through six. This summary will also detail which perspectives best explained adoption, while also analyzing the validity of the diffusion explanation (See Tables 11 and 12). The second section adds context to the flat tax story by looking at the various component parts which make adoption possible. Though this context adds depth to the causal explanation of flat tax adoption, each part is only a piece of the flat tax puzzle. When taken together we get a clearer picture of the adoption (and diffusion) processes. The third section asks a crucial, but thus far, unasked and unanswered question: How revolutionary is the flat tax revolution?

Explanations 1-4

Explanation 1: In states that have flat tax policies we would observe a shift in ideas that caused a shift in policy.

Explanation one was validated in three cases: Estonia, Slovakia and the Czech Republic. In these cases the idea of the flat tax held considerable power for politicians, economists and tax bureaucrats. The flat tax could not be understood by rational considerations alone. Though a perceived economic failure instigated policy change, the turn to the flat tax was not simply a consequence of that failure. Estonia, Slovakia and the Czech Republic could have reformed the current system, as modeled in Poland, for example. Instead they scrapped the progressive system altogether, owing their mission to flat tax pioneers like Milton Friedman, and Robert Hall and Alvin Rabushka. In these cases both elite carriers and political parties helped to shape the debate and shepherd the flat tax idea. In Slovakia, the think tank MESA-10 played a role in supporting the flat tax. Latvia and Lithuania did not have an observable shift in ideas. Instead, they believed the flat tax was the most efficient and simple way to fix their problems, regardless of its ideological hype.

> Explanation 2: In states that have flat tax policies we would observe discourse about the appropriateness of said idea which caused a shift in policy. Some actors would stump in favor of the idea and others would be opposed.

Explanation two is only validated in one case: the Czech Republic. Latvia and Lithuania had no public debate. Slovakia and Estonia had some degree of public contestation but very little. Estonia's debate came after the adoption of the flat tax. Slovakia's transition from Meciar to Dzurinda was hotly contested, but these were about general ideas of good government rather than specific policies. So why did the Czech Republic have serious debate about the flat tax? First, there were distinct ideational conflicts between left and right about the best way to collect revenue. The Civic Democratic Party and Social Democrats had serious ideological divisions that provided and insight into the ideas that either promote or undermine the flat tax. Second, the Czech Republic – who did not adopt a flat tax until 2009 – had a wealth of information to debate about. Whereas Estonia, Latvia and Lithuania had "early" adoptions at a time when little was known about the flat tax, the Czech Republic perhaps "knew too much."

> Explanation 3: In states that do not adopt the flat tax, we would observe that the flat tax idea conflicted with progressive ideas about economics, economic theory and good government. Ideas contrary to the flat tax prevented flat tax adoption in those countries.

This explanation is validated in Hungary but invalidated in Poland. Both Hungary and Poland had committed flat tax devotees who hoped for the passage of the flat tax in their respective countries. Koka was the preeminent leader in Hungary, and Gronicki was the spokesperson in Poland. Koka's ideas were in an uphill battle from the beginning. The Hungarian social democratic framework, modeled on the Swedish example, was hard to overcome. Laszio Bekesi's pro-flat tax Reform Alliance remarked that changing politics and minds in Hungary is so hard because of preconceived notions of "big business" and fairness. Hungary also took a stand (or risk?) by keeping the progressive tax in the face of mounting budget deficits. In Poland, politicians were less concerned with ideas and more concerned the "effects" of the flat tax. Additionally, in both Hungary and Poland, the political dynamics were not conducive to flat tax adoption. That is, the divisiveness of the party system in Hungary and the federalist structure in Poland specifically negated flat tax adoption.

Explanation 4: In states that adopted the flat tax after Estonia (the first adopter), we would observe that other states emulated the policy, or what is called policy diffusion. Previous adopters were instrumental in the adoption of the flat tax by other adoptees.

Explanation four was validated in all four diffusion (or emulation) cases. Latvia, Lithuania, Slovakia and the Czech Republic were all influenced by previous adoptions. However, the manner in which the policy diffused was different in the "early" adopters than it was in the "late" adopters. The early adopters had limited information to work from and therefore practiced what Weyland called a "cognitive heuristic" model of diffusion. Late adopters like Slovakia and the Czech Republic practiced "rational learning" because of the information available to them prior to their adoption.

Table 11. Validation of explanations

COUNTRY	Explanation 1	Explanation 2	Explanation 3	Explanation 4
Estonia	Yes	No	N.A.	N.A.
Latvia	No	No	N.A.	Yes
Lithuania	No	No	N.A.	Yes
Slovakia	Yes	No	N.A.	Yes
Czech Republic	Yes	Yes	N.A.	Yes
Hungary	N.A.	N.A.	Yes	N.A.
Poland	N.A	N.A.	No	N.A.

Note: N.A denotes that particular explanation is not applicable to those cases.

Rival Explanations 1-4

Rival Explanation 1: In states that adopted the flat tax we would observe the power of external pressures (or institutions) caused adoption and not the power of ideas.

In no case was rival explanation one validated. It is true that external institutions were always around. The IMF, World Bank and the EU were powerful institutions that stood to reshape one's political and economic situation. This is nowhere more apparent than in Slovakia, where the adoption of the flat tax coincided with its acceptance into the EU. Slovakia's Prime Minister Dzurinda was also committed to turning his country toward these institutions rather than away from them. However, domestic governments that adopted the flat tax did so without these institution's permission and guidance. Everyone interviewed in this dissertation and all secondary research confirms that flat taxes were domestic decisions. According to several different sources, groups like the IMF have actually been diametrically opposed to the flat tax (Laar 2004, Mitchell 2008, Aslund 2008).

> Rival Explanation 2: In states that adopted the flat tax we would observe the power of rationally-expressed self-interest caused adoption and not ideas.

This rival explanation is validated in two cases: Latvia and Lithuania. Rational self-interest was apparent in every case; after all, the flat tax was not only an idea but an instrument to fix a pressing economic and political problem. But in Estonia, Slovakia and the Czech Republic, ideas also mattered to the elites and economists who championed them as more than just a means to an end. Latvia and Lithuania's adoption was relatively unheralded and uncontroversial. There was no public discussion and the flat tax had no ideological content behind it. The flat tax solved a problem, or at least, appeared to solve a problem.

Rival Explanation 3: In states that did not adopt the flat tax we would observe that external pressures or regard to self-interest prevented adoption, rather than actors being wedded to particular alternative ideas.

This explanation is validated in the Polish example but not in the Hungarian example. Hungary, as previously argued, could not get past its social democratic roots to champion a flat tax. The idea of the flat tax ran counter to its ideational tradition. In Poland the flat tax was not approved because of what people perceived it would do (favor the rich) or what they were not sure it would do (like create budget deficits). Self-interest was not the only thing preventing adoption as party faction and separation of powers also played their part. Once again, external pressures were markedly absent from the observations.

Rival Explanation 4: In states that adopted the flat tax after Estonia (the first adopter) we would observe that these states did so independently and without regard for the flat tax in other states.

This rival explanation is invalid in all four cases studied, as well as the two cases of Hungary and Poland. A variety of diffusion processes occurred in these six cases.

Table 12. Validation of rival explanations

COUNTRY	Rival Explanation 1	Rival Explanation 2	Rival Explanation 3	Rival Explanation 4
Estonia	No	No	N.A.	N.A.
Latvia	No	Yes	N.A.	No
Lithuania	No	Yes	N.A.	No
Slovakia	No	No	N.A.	No
Czech Republic	No	No	N.A.	No
Hungary	N.A.	N.A.	No	N.A.
Poland	N.A.	N.A.	Yes	N.A.

Note: N.A denotes that particular explanation is not applicable to those cases.

Flat Tax Adoption in Context

This second section deals with six points that add context to flat tax adoption and go beyond the validation or invalidation of the dissertation's explanations. These six points provide depth to the study and shed light on the intricacies involved in the passage of the tax. Though these points themselves are not causal claims about adoption, they do detail some of the *how* and *why* specifics needed to understand adoption. Moreover, the following also touches on some of the unexpected findings from the dissertation.

1. Domestic elites act as 'carriers' that help to formulate and deliver ideas.

A noticeable dimension of flat tax adoption has been the presence of committed elites who serve as "carriers" of new ideas. (See Table 13). In Estonia, Mart Laar became the most vocal and prominent carrier for the flat tax. Other elites like Ardo Hansson and Heiki Kranich helped to articulate the specifics of the tax. Laar saw the flat tax as part of a package of free market ideas that were fundamentally pro-growth and anti-communist. In Slovakia, appointing the right people went a long way towards achieving a flat tax. Mikulas Dzurinda, a right-of-center prime minister, nominated Ivan Miklos as his Finance Secretary. Even in the face of early criticism, Miklos took on the flat tax and shepherded it through to adoption. Martin Bruncko, Miklos' chief economic advisor, became the international spokesperson for the plan. The Czech Republic's spokespersons included Prime Minister Mirek Topolanek and Finance Minister Vlastimil Tlusty. Even countries that could not adopt a flat tax have domestic elites who tried to advance a flat tax agenda. In Hungary, Janos Koka became a vocal advocate despite being shut out from his own party. In Poland, former Finance Minister Miroslaw Gronicki stumped for the flat tax and Zbigniew Chlebowski worked for the flat tax in his current position as finance minister.

Table 13. Elite carriers			
NAME	COUNTRY	POSITION (at time of adoption or diffusion)	YEAR
Mart Laar	Estonia	Prime Minister	1994
Ardo Hansson	Estonia	Economic Advisor	1994
Kalev Kukk	Estonia	Economic Advisor	1994
Heiki Kranich	Estonia	Finance Minister	1994
Mikulas Dzurinda	Slovakia	Prime Minister	2004
Ivan Miklos	Slovakia	Finance Minister	2004
Martin Bruncko	Slovakia	Economic Advisor	2004
Mirek Topolanek	Czech Republic	Prime Minister	2008
Martin Riman	Czech Republic	Trade Minister	2008
Vlastimil Tlusty	Czech Republic	Finance Minister	2008
Janos Koka	Hungary	Economic Minister	2009
Laszio Bekesi	Hungary	Finance Minister (Retired)	2009
Donald Tusk	Poland	Prime Minister	2009
Zbigniew Chlebowski	Poland	Finance Minister	2009
Miroslaw Gronicki	Poland	Finance Minister (Retired)	2009

2. Center-Right Political Parties Serve As a Rallying Point For Flat Tax Supporters

Political parties serve an important purpose by organizing interests and bringing like-minded individuals together. They also work hard to win elections. By gaining power through a ruling coalition the flat tax became a much more viable policy choice. In countries like Estonia, Slovakia, the Czech Republic, Hungary and Poland, political parties were major players on the flat tax scene. (See Table 14). Estonia's Pro Patria and Reform Party, Slovakia's Slovak Democratic Coalition (SDK), the Czech Republic's Civic Democratic Party (ODS), Hungary's Alliance of Free Democrats (SZDSZ) and

Poland's Civic Platform (PO) all were openly supportive of the flat tax and pushed for its adoption. For these parties the flat tax was part of a free market, neoliberal framework adopted throughout Eastern Europe.[72] Transnational groups like the Liberal International became a place where like-minded parties could come together and discuss policy issues. Parties in Hungary, Estonia and Latvia were all Liberal International members.

Table 14. Political parties aligned with the flat tax

COUNTRY	PARTY	YEAR FORMED
Estonia	Reform Party	1994
Estonia	Pro Patria Union	1995
Estonia	Res Publica	2001
Slovakia	Slovak Dem. Coalition	1997
Czech Republic	Civic Dem. Party	1991
Hungary	Alliance of Free Democrats	1988
Poland	Civic Platform	2001

3. Knowledge communities are important by validating ideas and bringing people together

Knowledge (or epistemic) communities serve as a third channel for the dissemination of the flat tax idea. This includes think tanks like Lithuania's Free Market Institute, Slovakia's MESA-10, Stanford's Hoover Institute, and the Heritage Foundation. The composition of the think tanks include major players in the flat tax community. Slovakia's MESA-10 was founded by none other than former finance minister Miklos, for example. The Hoover Institute's Alvin Rabushka and the for Heritage Foundation fellow Daniel J. Mitchell have traveled through Eastern Europe in favor of the flat tax As well, international meetings of flat tax advocates at places like the CATO Institute – where Laar and Leszek Balcerowicz were featured speakers – and academic conferences

[72] This is not to say that all center-right parties were pro flat tax. Parties like Hungary's FIDESZ, for example, were much more nationalist and statist than the other right-wing party in Hungary, SZDSZ.

like Topolanek's "Flat Tax" conference bring together like-minded individuals for the purposes of delivering information.

4. The flat tax was an idea that solved an economic and political problem

In every case studied, the idea of the flat tax appeared to be a solution to a pressing budgetary problem facing Eastern European economies. The problems were similar: revenue shortfalls spurred by inadequate collection, rampant tax evasion on the part of private citizens, growing black market economies, and unintelligible tax codes that commoners and elites alike could not make sense of. In latter cases like Hungary and Poland, the problem of "tax competition" forced those countries hand to at least look at the flat tax, though it was not adopted. To return to McNamara, in each case studied the flat tax (policy innovation) solved the problem of progressive or gradual taxes (policy failure). In countries that continued to adopt the flat tax (policy emulators) they did so with an eye towards solving a basic problem.[73]

5. There Are Varieties of Diffusion

This dissertation found that flat tax policies diffused too varying degrees and in varied ways across countries. What is argued in this dissertation, however, is that there are *varieties of diffusion* that take place as an idea is diffusing from one state to another. This is predicated on the *timing* of adopting. The closer proximity to the original policy innovator (Estonia) the easier it is to adopt a new policy. In Latvia and Lithuania, they followed the Estonian model rather closely with no controversy or much fanfare at all. The policy diffused from one state to the next in less than two years. The reason for this is that Estonia possessed a solution to a tax problem that only economists knew much

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[73] Once again, in no way does this dissertation argue that flat taxes were successful or a detriment but certainly those adopting the flat tax believed they succeeded elsewhere.

about. Because Estonia was a leader in economic reform it gave tacit permission for others to follow suit. However, the early adopters were bounded by what was "unknown" about the flat tax. Would it work? Would it help the rich or poor? Is the idea conservative, liberal or neither? This is what Weyland calls the *cognitive heuristic* model of diffusion. As tax diffusion continued it was much harder for parliaments to pass through flat tax legislation. By this point the "knowns" were available for public consumption and elites, parties, and constituents began picking sides. In what Weyland calls *rational learning*, states had time to read, study and learn about the advantages and disadvantages of the system. The greater time lapsed from Estonia's original adoption, the harder it was to adopt the tax. Slovakia and the Czech Republic adopted the tax, but not without difficulty. Supporters in Hungary and Poland were not as fortunate.

6. Ideas Can Diffuse Without Being Adopted

Lastly, this dissertation argues that policy diffusion does not necessarily equal policy adoption. Hungary and Poland demonstrate this point. The idea of the flat tax found its way to both states and onto the policy agenda. At this point, however, flat tax detractors knew too much about fairness, inequity and the relationship of the flat tax to neoliberalism. Concerns over budget deficits, or the belief that the flat tax treated the poor unfairly, were common amongst antagonists. Adopting the flat tax carried with it electoral danger, and parliamentarians worried that supporting the flat tax would lead to defeat. In Hungary, the SZDSZ were increasingly unpopular with the general public and in Poland, 68-percent of Poles were dead-set against introducing the tax reform. This was unlike anything seen among the "early adopters" when flat taxes were adopted amid little fanfare.

Flat Tax Revolution?

The title of this dissertation asks whether or not the “flat tax revolution” is really a revolution? Several flat tax commentators have used the word “revolution” to describe the shift in Eastern Europe from progressive tax schemes to flat taxes. Steve Forbes entitled his book *Flat Tax Revolution* (Forbes 2005). The *Economist* headlined a print story with the title “Flat-tax Revolution” (“Flat-tax Revolution” 2005). And in a Cato Policy Report, Daniel J. Mitchell remarked approvingly about the “global flat tax revolution” (Mitchell 2007). In a technical sense, the adoption of the flat tax in Eastern Europe would not qualify as a textbook, political science definition of a revolution. There was, after all, no violence, mass mobilization, or fundamental alterations of the state structure (Skocpol 1979). However, the word revolution is not totally out of place, either. In Crane Brinton’s classic *The Anatomy of a Revolution*, he notes that chronic budget deficits are central starting points to all revolutions. Citing the work of historian R.B. Merriman, Brinton concludes that six seventeenth-century revolutions (England, France, the Netherlands, Spain, Portugal and Naples) all “began as protests against taxation” (Brinton 1952, 38). The inability to collect revenue was also central in the “big three” revolutions of France, Russia and China (Skocpol 1979). And most Americans are familiar with the rallying cry of *no taxation without representation,* which epitomized a central debate not only about representation, but also the legitimacy of various forms of taxation.

Though these examples are far removed from the current struggle in Eastern Europe – and they were not about income taxes primarily – this relationship between taxation troubles and revolt is strong. Starting with revenue shortfalls more generally, and turning to such specific problems as black markets and tax evasion, countries in the Baltics and the former Czechoslovakia revolted against progressive taxation in favor of flat taxation. But like most revolutions, the decision to turn towards a new policy or program is not monocausal. Not only was the tax reform narrative shaped by pragmatic policy choices, but it was also embedded within a set of ideas that both allowed and limited certain choices. As Brinton argued: "no ideas, no revolution" (1952, 53). Brinton was not shortsighted in believing that revolutions were the result of only ideas, when he later noted that "ideas form part of the mutually dependent variables" we are studying (1952, 53). However, without a "new" idea to confront the "old" policy failure, one would be hard-pressed to make any kind of argument about "a flat tax revolution" in Eastern Europe.

A second persistent feature prior to the outbreak of revolutions is some form of state collapse, which can be brought forth by the inability to collect revenue, but also spurred by international crises, foreign debt, or poor leadership. Eastern Europe in the early 1990s – when the first flat tax was adopted – was far from being populated by mature, fully functioning states. Obviously the need for tax reform is case in point. Estonia, Latvia and Lithuania went from a (slowly thawing) communist, authoritarian system in 1990 to a restored parliamentary system by the mid-1990s. Politics and ideas were fluid, and interests had yet to be fully entrenched. This is in part why the Czech Republic, Hungary and Poland had a much more difficult time adopting a flat tax. It is also part of the reason why places like Western Europe and the United States have considerable difficulty trying to change their tax code.

But it also is not true to say that those states were on the verge of collapse, making a flat tax revolution more viable. In no case did the political actors have to alter the state to achieve their goals. It is true those countries had to find elite carriers of their flat tax ideas, engender political parties to do the flat tax bidding, and allow finance ministers the go ahead to draw up the details of the policy. Those are the basic outgrowths of a democratic system, however, not a precursor to revolution. When one observes the inability of the flat tax to be adopted in places like the United States and Western Europe, it has become a truism to mention entrenched interests, or the budget deficits created by such a switch ("Tax System Blamed for Americans Not Saving Enough" 1994). What is not discussed is the marked absence of politicians, political parties and financial ministers putting their careers on the line for the flat tax. There have been a few, namely Armey and Forbes in the United States, and Kirchhoff in Germany. This support has been sporadic and uneven though. Starting in 1994, countries in Eastern Europe have made the flat tax a priority, both those that support it and fight against it. The flat tax is part of an important narrative in Eastern European politics, like gun control or abortion in the United States, or common defense and immigration in the European Union.

Once again, this flat tax revolution is not a revolution proper; at least not in the way we understand the French or Russian Revolution. The flat tax states were not on the verge of collapse, and no one got beheaded. Moreover, flat taxes have not had the type of revolutionary impact that the ideas of democracy or capitalism have had on the world. So far the revolution has taken place only in Eastern Europe, one country in Africa and two countries in Asia. What is revolutionary is that a few small countries in the former Soviet bloc became a source of policy innovation that was emulated by others. Yes, those "others" are not the world's power elite, and no Western industrialized democracy has copied the basic Estonian model. But it raises the question about what else those countries have to offer.

Conclusion

In an academic age when scholars are questioning the distinction between "Western" Europe and "Eastern" Europe and when globalization is said to change the face of politics and economics this dissertation highlights how domestic actors from small countries in eastern Europe – channeling ideas from far away – can make themselves both relevant and different in the arena of public policy. One of the problematic features of the diffusion literature is both its implicit and express recognition that diffusion is a one way street from West to East. For example, in Simmons, Dobbin and Garrett's edited volume on the global diffusion of free markets and democracy, they are quick to point out the Western European and American sources of such developments (2008, 44). The Westphalian system, participatory democracy, mercantilism, and macroeconomics began in Western Europe – to be more specific England, Germany and France – and worked their way across the European continent. While the factual account is not wrong on these points, it ignores the current public policy developments where the West is learning from others.

The best example available is that of Chilean pension reform. In 1980, the Chilean government of Augusto Pinochet adopted a radical pension reform by privatizing the public pension plan, their version of social security (Weyland 2006, 97). The plan was believed to be a success, as national savings rose, investment was up, and countries such as Great Britain and Sweden followed suit several years later.[74] Obviously the flat tax has yet to attract a Great Britain or Sweden to follow their model. But like pension reform before it – which initially spread to other parts of Latin America -- the first diffusion sequences of the flat tax were bounded by geography, specifically Eastern Europe. There are a host of reasons for why other states and regions might not adopt a flat tax, whether they are for political, economic, ideological reasons, or all of the above. Moreover, it is not the goal of the dissertation to predict the future of flat tax adoption (or non-adoption). But the dissertation points to the fact that Eastern Europe can be a place of innovation and exists not to simply model itself on the West, or replicate the failed experiments to their East.

In three years of research and writing this dissertation alone, nine new countries adopted the flat tax. Included in the adoption were such countries as Kazakhstan, Albania, and the tiny African island Mauritius. Though these countries were outside the scope of this study, the rapidity with which the flat tax is growing is surprising and politically interesting. While it is a challenge for policy practitioners in an age when tax competition is a developing threat, it also is a challenge to academics and political scientists. Will these new adoptions be the result of external pressures, a rational response to a tax collection problem, or the result of committed ideologues wedded to the flat tax

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[74] Interestingly enough, Pinochet (like Laar) drew his inspiration from a prominent Chicago economist named Milton Friedman!

idea? Or are there other competing explanations? Continuing to study the flat tax will bring new insight into policy change, adoption and diffusion in world politics.

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