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## **What Can We Learn From Slovakia's Transition?**

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Many in the Ukrainian business community believe that the successful resolution of Ukraine's challenges lies in free and democratic competition, private enterprise development, and property rights. Yet, the business community has rarely united its diverse voices to advocate for policies needed to foster growth and economic freedom. On November 14-15, 2005, CIPE and its partners the Institute for Competitive Society (ICS) and the Ukrainian Center for Independent Political Research (UCIPR) did just this. The groups organized a conference to bring together over 180 representatives of Ukraine's private sector to discuss common priorities and the importance of advocating for the business community's needs during this important time of economic and democratic reform.

In his presentation at the conference, Dr. Oravec outlined Slovakia's transition experience and offered his suggestions for how to improve the business environment in Ukraine. Using Slovakia's success as evidence, he argued that reforms should be implemented as a complex package as quickly as possible. A sustainable system of business-friendly reforms is possible to achieve, but it requires solid legislation, determination, and active involvement on the part of the business community.



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## Overview

Many in the Ukrainian business community believe that the successful resolution of Ukraine's challenges lies in free and democratic competition, private enterprise development, and property rights. Yet, the business community has rarely united its diverse voices to advocate for policies needed to foster growth and economic freedom. On November 14-15, 2005 CIPE and its partners the Institute for Competitive Society (ICS) and the Ukrainian Center for Independent Political Research (UCIPR) did just this. The groups organized a conference to bring together over 180 representatives of Ukraine's private sector to discuss common priorities and the importance of advocating for the business community's needs during this important time of economic and democratic reform.

Jan Oravec, President of the Entrepreneurs Association of Slovakia, gave a presentation on the first day of the conference, during which he discussed lessons learned from Slovakia's transition.

## Remarks by Jan Oravec

I was asked by the conference organizers to share with you Slovakia's experience during the economic and political transition of last fifteen years. You may be unsure as to whether there are commonalities between Slovakia and Ukraine, which are very different countries. Slovakia is a small country of 5.3 million people, while Ukraine has almost 50 million people. Slovakia has almost no natural resources, while Ukraine is rich in natural resources. There are many differences between our two countries, but there are many things that we have in common.

What do we have in common? First of all, both Slovakia and Ukraine are transition countries. I don't like the term "transition country" because... show me a country on the globe that is not in transition? Every country is in permanent and constant transition. The commonality between these particular countries is that they need to make transitions [to democracy and a market economy] in a relatively short period of time. What other countries achieved over decades or even

centuries, newly democratic states are expected to do in years or even months.

There are three crucial processes that we are all facing. First, we are undergoing a transition from a totalitarian, communist regime to multiparty democracy. Second, we are undergoing an economic transition from a centrally planned economy to a market economy. These two transitions cannot be successful if we are not able to make a successful transition from state paternalism to individual responsibility. This last transition must take place in the minds of the people, politicians, and businesspeople.

When we look at this group of the transition countries, we can identify a sub-category: countries that came into existence ten to fifteen years ago when the former Soviet Union, former Yugoslavia, and former Czechoslovakia disintegrated. What Slovakia and Ukraine both have in common is that they are newly established countries, and they need to make the transition from being a part of the federation to being truly independent states.

Slovakia came into existence on January 1, 1993, when Czechoslovakia split into two independent countries: the Czech Republic and Slovakia. The split had very serious consequences.

First of all, there are two major risks for newly established states. The first is that the international community, including the international business community, perceives such countries as having an uncertain future. That is why, especially during the first years of Slovakia's and Ukraine's independence, there were very low expectations concerning the performance of the economy and the internal development of the country. These concerns were reasonable because as newly established countries, they were more vulnerable to extreme fluctuations. It is important to remember that we all learn by doing and we are now independent. We have our own responsibilities, we are responsible for our successes, and we are also responsible for our mistakes.

In the beginning of 1993, when Slovakia became independent, there were many low expectations. Slovakia

was considered the region's outsider. There were even predictions of an early collapse of the Slovak economy and the probability of Slovakia reuniting with the Czech Republic. After these very negative expectations in the beginning, after 12 years of transformation, today the situation is completely different. Slovakia today is not perceived as an underdog or outsider in the region. It is perceived as either the Detroit of Europe, with many car producers establishing their factories in the country (Volkswagen, Peugeot, Citroën, and KIA), or as the Hong Kong of Europe, with important economic and political reforms introduced during last couple of years.

So I would like to go very quickly through the period when Slovakia was seen as the ugly duckling of Europe. In the past 15 years - like in a fairy-tale - this ugly duckling has transformed into a shining star of the reform process in Europe. How did this happen? I think the old adage is that 'before it will get better, it must get worse.' In the beginning of this process, there was a very serious crisis, which was the result of very bad and irresponsible macroeconomic policies enacted during the first five years of Slovakia's independence.

We needed to find solutions. And we had two major sources of inspiration. One of them was the current economic policies of Western Europe. Actually, they were not really inspirations; rather they were an example of how not to construct economic policies. The true inspiration was the long-forgotten wisdom of Western thinkers like Adam Smith, who said that you need to reduce the role of government in the economy, which will maximize the economic and social freedom of citizens and businesspeople. And then, if you have a crisis, you need to have responsible and responsive politicians who are ready and able to implement necessary reforms.

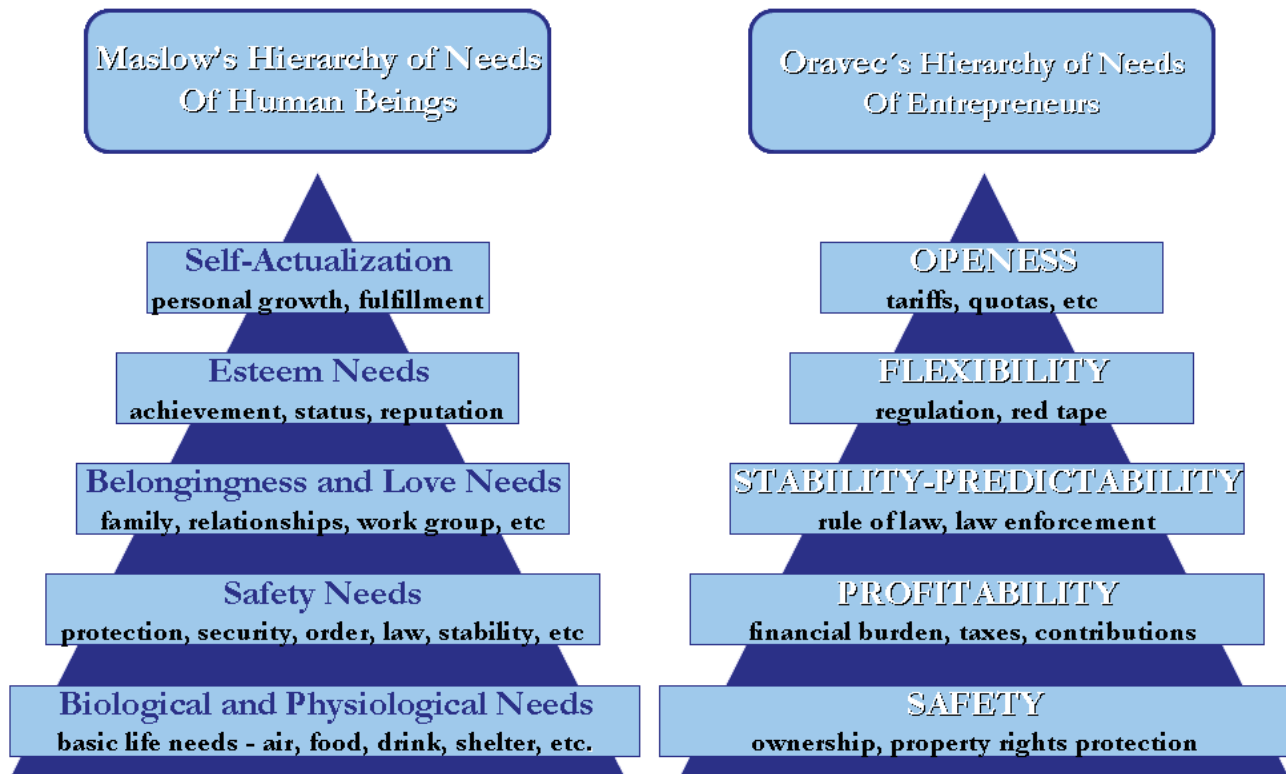
Let me briefly describe this crisis because you will see that the current situation in Ukraine is very similar to what happened in Slovakia. In the beginning, between 1993 and 1998, state property was privatized primarily by friends, families, and others loyal to the government, with a total lack of transparency. Certain sectors and companies were excluded from the privatization, namely the banking sector, the energy sector, and other very

important sectors of the economy. The prices of gas, electricity, and rent were not regulated, and so they were kept artificially low. The government conducted very irresponsible fiscal policies that increased expenditures without finding alternative revenue sources. Growing budget deficits and corruption – those were the inevitable consequences. While government borrowing increased, private investments decreased because the interest rates on the financial market by 1998 exceeded 30% with single-digit inflation! That was a crazy situation for businesses: you were not able to get credit because the government took all credit from the financial market. Foreign investors were very discouraged with this situation - they chose to invest in other countries - and our companies were seriously undercapitalized as a result. In addition, the legislative framework was more and more distorted by vested interests.

All in all, Slovakia's transition was going in the wrong direction, Slovakia was excluded from all integration processes, including the integration into the European Union, NATO, and the OECD. All neighboring countries became members of international organizations, but Slovakia was ignored. We were told to wait until our system matured; we needed to start enacting better economic and social policies.

So, what was the reaction? The first step is to agree that the country is headed down the wrong path. The Orange Revolution occurred here because Ukrainian citizens agreed that their country was moving in the wrong direction. Something similar occurred in Slovakia in 1998 - but without an Orange Revolution. Instead, in the parliamentary elections, people voted in support of political parties promising to change the direction of the country considerably.

The newly elected, reform-oriented government introduced significant reforms after 1998. I would say that we adopted the reforms in two major waves. In the government's first term, 1998–2002, the reforms were very fundamental and worked to lead Slovakia to the same level of development as the other transition countries, because we were lagging behind. After these were successfully adopted in 2002, the government introduced an even more ambitious package of reforms



that aimed to accelerate previous reforms. This program helped make Slovakia's political and economic system among the best in the region.

So, what was the first wave of the fundamental reforms about? First of all, the irresponsible macroeconomic policies of the government were replaced by more responsible policies. Fiscal increase was replaced by fiscal restrictions. Government started to be more cautious about expenditures and started to introduce many important reforms, including the acceleration of privatization. The banking sector was privatized completely. We began to privatize all companies in the energy sector. Prices were deregulated completely or partially, and the deregulation was taken out of the hands of the government. We established a system of independent regulators, who regulated prices in the energy, telecom, and other network industries.

As a result of these changes, Slovakia was accepted as the member of the OECD and NATO, and finally Slovakia successfully joined the group of European Union accession countries in 2004. These were the

only fundamental changes that were necessary to build further reforms. And the second wave of reforms was implemented after 2002.

What is the lesson here for Ukraine? You should try to implement reforms as a complex and consistent package. Slovakia became very famous because of its flat tax. Although Ukraine has a flat tax as well, the flat tax in the case of Slovakia is only one piece of the broader reform package. And this reform package consists of at least seven very fundamental reforms that were consistently implemented.

These were: the reform of the labor market, liberalization of labor relations, the introduction of the flat tax of 19%,<sup>1</sup> and pension reform. The business environment was improved by eliminating a lot of administrative barriers. All these reforms were implemented. Healthcare was also reformed, and many important changes in the healthcare system were introduced. The educational system was partially reformed as well. And finally, fiscal decentralization was completed - decentralization of decision-making

powers from the central government to lower levels of the government, including decentralization of financial flows.

As a result of that, Slovakia and its ranking improved considerably in all kinds of indices. In the 2005 edition of the World Bank's *Doing Business*, Slovakia was named as the number one country for business environment improvement. In the newest edition, *Doing Business in 2006*, the World Bank ranked Slovakia third. We are now in the top twenty in the world for business environment improvement. Our ranking also improved in other indices, like the "Index of Economic Freedom" produced by the Heritage Foundation; the "Competitiveness Ranking" of the Swiss IMD Institute; or *Forbes* magazine's "Tax Misery Index."

In the final part of my presentation, I would like to say a couple of words about business' view on the necessary changes that must be adopted. I had a chance to read the business association survey<sup>2</sup> carried out for this conference, and I need to say that I was surprised to see that you, as the representatives of the business, see the adoption of new legislation or appropriate implementation of existing legislation and regulations as the most essential action required to improve the business climate in Ukraine. Two-thirds of respondents said that the most important step towards improving the business environment in Ukraine is new legislation or better implementation of existing legislation.

However, I think it is not new legislation or better implementation of existing legislation that is needed. We actually need less legislation, and we need to look at the content of the legislation that exists. It is not the

implementation per se that is the problem. We need to ask why there is a problem with the implementation. There are so many laws, and their content is so restrictive towards the businesses. The rule of law is based on the notion that legislation should maximize the freedom of the private sector. The problem here is exactly vice versa: legislation is imposing maximum restrictions on private businesses and is giving freedom to the government to impose these restrictions!

I would like to present you with five criteria by which to judge a legislative framework: safety, profitability, stability and predictability, flexibility, and openness of the environment. Safety is about the very fundamental protection of property rights, protection of entrepreneurs' personal property, and the property of the company. It must be not only constitutionally guaranteed but supported by a functioning judicial system. Profitability is about government actions to reduce the tax burden, social security burden, and other forms of obligatory payments that are required by various pieces of legislation.

So what are the lessons Ukraine can learn from Slovakia's experience? If reforms are expected to be successful, they need to be radical and implemented as quickly as possible. You will sometimes hear recommendations that you should introduce changes gradually and slowly to see what works and what doesn't; you need to wait, evaluate, and only then introduce further reforms. I don't like this incremental approach, and I believe this is the first step towards failure. Reforms need to be radical and quick in order to be successful; they need to bring early results. In order to bring early results, they need to be implemented as quickly as possible. Slow implementation of reforms not only postpones the first positive results but also undermines their sustainability.

There is a tough political opposition against reform. There are many populists, and there are people that feel very negative consequences in the first months or years after the reforms are introduced. Again, these are additional arguments for introducing reforms as quickly as possible.

## Creating a Favorable Economic Environment

### Five Fundamentals

1. Safety
2. Profitability
3. Stability - Predictability
4. Flexibility
5. Openness

And our experience in Slovakia is that even the best reforms tend to deteriorate. It means that although you introduce the flat tax system, politicians never sleep and their political parties will constantly put forward proposals to introduce new taxes and reintroduce new tax rates. That is why you need to have a mechanism in place to prevent what was already achieved from being undermined. And the best preventative mechanism I can imagine is a set of courageous reforms that bring early results.

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<sup>1</sup>The universal flat tax - 19% for the corporate income tax, personal income tax, and value-added tax.

<sup>2</sup>The survey is available at [www.cipe.org](http://www.cipe.org)

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