The Free Market

"If you don't create a free market, a black market will emerge"

NEWSLETTER OF THE LITHUANIAN FREE MARKET INSTITUTE - www.freema.org/Newsletter/index.phtml

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NEWS

The 2nd European Resource Bank Meeting will be staged by LFMI

On its 15th anniversary year LFMI will host the second European Resource Bank Meeting (ERBM) in Vilnius, Lithuania, on October 14 -15th, with a mission to improve the strategies and to enlarge the debate to reach all the people in advancing ideas of freedom in Europe. The event will draw about 200 think-tank executives, policy analysts, local leaders and others in a two-day event that will be a combination of exchange of ideas and skill building exercises. During the first day the participants will engage in a constructive dialog in high level presentations on ideological, political and practical issues of free market ideas and principles. The second day will feature the exchange of practical information on think-tank strategies and methods during six skill-building workshops. The ERBM will be convened with the official gala dinner.

LFMI evaluated the 13th Government's one hundred days in office

On March 23 LFMI held a **press conference "A Hundred Days of Government Astray"** to discuss the work of the 13th government during the first 100 days in office. LFMI's President Ugnius Trumpa and Vice-presidents Guoda Steponaviciene and Remigijus Simasius focused on necessary changes in the tax system, especially taxation of residents, and the energy sector, as well as transparent allocation of EU structural funds. Comments were made on the policy actions laid down in the government's work plan.

The Institute's leaders criticised the Brazauskas government for not showing clear guidelines of its future economic and social policy and how it plans to react to the most pressing economic issues such as maintaining economic growth, increasing the country's competitiveness in the EU, preventing the brain-drain, and reducing the growing budget expenditure. LFMI also blamed the government for its irresponsible planning of the tax reform which has already prompted a concern in the business community and the society at large.

As this government was the first real coalition in Lithuania, LFMI admitted that certain conflicts among its leaders may have been provoked by inexperience to work under such a form. LFMI's leaders urged government and parliament members to show more involvement in participating in the EU-wide legislation and active participation in debating such issues. Also, they urged the government to draw a clear-cut and final plan of the tax reform, which would lower taxes, and to start implementing it without further delay.

LFMI has analysed and supported the pro-market services directive

As the first step towards examining EU's legislative initiates and continuing the work in the field of business deregulation, the Lithuanian Free Market Institute (LFMI) has analysed a proposal for a Directive (COM(2004) 2 final/3), the so called services directive, which has been presented by the European Commission and is designed to open up the EU market for services. LFMI also evaluated the directive's impact assessment and studied the position of Lithuania and those of other member states on the proposal and submitted it to the Ministry of Economy, Lithuania's representatives in the European Parliament, the Lithuanian Government and the Parliament in January 2005.

The proposal for a Directive provides a legal framework that would eliminate the obstacles to the free movement of services between EU member states. According to the proposal, companies would be free to provide a number of services in other EU countries without establishing themselves there and operate according to the rules of their home country (the "country of origin" principle). Also, market entry procedures would be simplified significantly to make it easier to establish companies in the EU. What is more important, that subsidies for services will follow citizens to other EU countries, once they are granted in their home countries.

LFMI is of the opinion that the implementation of the proposed directive, within the scope envisaged in the proposal, would advance the economic development and people's welfare across the European Union in all respects. A free movement of services would provide conditions for the establishment and operation of new businesses and allow consumers to choose

among a wider variety of services available and a bigger number of competing service providers. Currently, services account for the biggest share of GDP, although the movement of services within the European Union is incomparably scantier than the movement of goods.

Seeking to back up this law when it came under a fierce attack from France and Germany, the Lithuanian Free Market Institute and 15 EU-based non-government organizations have signed a petition in support of the services directive and submitted it to the European Parliament and the Council of Ministers. In the petition these authorities and each MEP personally have been urged to take necessary steps for the benefit to the future economic freedom and prosperity in the EU and to adopt the services directive as proposed, without limiting the scope of its provisions.

Despite the firm position of the EC, the EU summit in March came to decision to revise the law. It is most likely that the central and most important part - "country of origin" principle – will be discarded from the law. If so, the benefit of this legislation will be minima, if at all. The EC now has time until July to submit a re-write of directive to the European Parliament.

A full text of LFMI's position is posted online: http://www.freema.org/Research/Sdir.phtml.

LFMI's new Project on energy security

In March 2005 the Lithuanian Free Market Institute (LFMI) launched a new project "Energy security: economic analysis of political arguments" which is implemented through the cooperation with an international security project carried out by the Atlas Economic Research Foundation**.** The goal of this project is to determine the level of energy dependency of Central European countries, which have poorly integrated their energy infrastructure to western neighbours while being integrated to eastern neighbours, on the energy resources from Russia and possible problems related to it. The analysis will also show what measures can be effective in ensuring energy security and continuous stability in those countries.

The analysis will be based on the empirical data collected, historical knowledge on the subject and theoretical understanding of motivation of both private and public bodies in the energy sector. The analysis will focus on the Central Europe and its energy relations and dependency on Russia. A particular focus will be placed to the Baltic States and Lithuania, where the issue of energy dependence, especially after the gradual closing of the Ignalina's nuclear power plant, is critically important.

The project is scheduled to be completed in May 2005.

Lithuania doesn't need a separate policy on clusterization, says LFMI

Continuing its involvement in the field of the knowledge economy, LFMI has analysed an address to the Lithuanian government, submitted by a group of associations and scientists in December 2004, urging the Government to set a separate policy on clusters until 2006 in which the state played the "catalyst's role" and stimulated entrepreneurship and innovation. In its comments to the Government, LFMI stated that there is no reason and need to formulate a cluster policy in Lithuania as problems plaguing cluster companies are typical of the entire business sector and should be solved by general means of economic policy. For example, in the first place the government should overhaul the systems of tax and tax administration, land acquisition procedures, public administration, legislature and courts, education, social policy and others.

LFMI's position on Lisbon Agenda and labour market regulations

On January 19, 2005 LFMI and the UK Embassy in Lithuania staged a round table discussion on the Lisbon Strategy and employment regulation. The event was aimed at discussing the impact the regulation of the labour market has on the competitiveness among EU member-states as well as on the implementation of the Lisbon Strategy, illustrating with examples in Lithuania and the United Kingdom.

LFMI has prepared a position paper on the Lisbon Agenda and labour market regulation, which was presented during the round table discussion. According to LFMI, the European Union fails to achieve the primary Lisbon goal "to become the most competitive knowledge-based economy" because social cohesion has been presented as the goal supplementing the EU's economic goals such as higher employment, productiveness, competitiveness and economic growth, rather than contradicting them. For instance, at the same time the strategy lays down liberal measures (better business conditions, less extensive employment regulation, etc.) and interventionist measures (ensuring the quality of workplace environment, maintaining the current number of workplaces, promotion and protection of individual groups, collective agreements' priority against individual contracts, etc.).

The Institute is of the opinion that Lithuania should take an active part in the EU legislature process and to present a clear-cut, openly and transparently coordinated position, which has not been the case with the Lisbon Strategy and other important issue. LFMI's policy analysts call government representatives to admit the inconsistency between the Lisbon goals and the European social model and to support initiatives of milder regulation in the EU and to back up minimal requirements in deregulating rather than regulating.

LFMI's position on the Lisbon strategy and employment regulation is posted online: http://www.freema.org/Research/Lisb.pdf.

Investment Climate Survey in Lithuania

In 2004 the Lithuanian Free Market Institute participated in conducting an Investment Climate Survey which was contracted by the World Bank. The goal of the survey was to generate establishment-level quantitative information that would help evaluate the performance of business enterprises and identify constraints to doing business. The report on the survey was presented in February 2005 at a discussion held by the Ministry of Economy.

The topics discussed in the report encompass Lithuania's competitiveness, innovation and productivity, opening and closure procedures of companies, the tax environment, employment regulation, the quality of education, availability of financial resources, infrastructure, business regulation, and corruption.

The study provides multiple benchmarks of Lithuania's business climate against other countries, especially the new EU member states, and recommendations for further improvement of business conditions. The main proposal among them is to strengthen the quality and abilities of the labour force and the education system in assimilating new knowledge and technologies.

As part of the project, a survey of Lithuanian companies was carried out in 2004. According to the poll, tax-related issues and regulatory uncertainty continue to preoccupy Lithuanian businesses as the most important business constraints. The tax burden tops all other constraints by a large margin. Sixty-seven percent of respondents see the tax burden as a major or very severe obstacle, while over 30% of them mention taxes as the highest or second-biggest obstacle for the development of their business. Other factors impeding business activities are uncertainty of regulatory policy (40.6%), tax administration (37%), anti-competitive or informal practices (when business representatives induce state institutions to resort actions that restrict competition, especially in large privatisation deals, 36%), and low skills education of workers (30%).

The Investment Climate Survey in Lithuania is posted online: **http://www.ifc.org/ifcext/economics.nsf/AttachmentsByTitle/IC-lithuania.pdf/$FILE/IC-lithuania.pdf** (2,98 MB, PDF).

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COMMENTS

In the following article LFMI's Vice-president Guoda Steponaviciene comments on the revamped Lisbon Strategy and the services directive.

Wishful Thinking is Not a Strategy

By Guoda Steponaviciene, Vice-president, LFMI

Lately two documents of the European Union have been discussed quite widely and passionately – a new version of the Lisbon Strategy and a proposal for the so-called services directive. No doubt, they are very much interrelated, though rather different in scope and complexity.

Being an essential and concrete element in the implementation of the Lisbon Strategy, the services directive turned out to be a test to verify if the strategy is just a mere pile of politically worked out compromises or a real commitment to change the living and working conditions in Europe.

After reading the Commission's proposal for the services directive, at first I felt puzzled indeed. I haven't seen anything more reasonable from the economic point of view in the EU legislation lately! Well, no question, there are excellently targeted provisions on a number of particular issues in the EU legislation, however, a broader view on economic policy is blurred enough.

One of the best examples of this blurred approach, next to the European Constitution, is the famous Lisbon Strategy. It was recognized in its mid-term review by a number of authors that the lack of focus in the strategy, caused by multitude of the tasks, makes the strategy unsuitable for implementation. More to that: these tasks themselves fall into different, directly non-comparable plans. They could be structured, however, only if a certain hierarchy was set up.

Yet, the document's political nature didn't allow putting things in a line based on common sense. Instead, sophisticated EU jargon positioned all of the major targets – economic growth, social cohesion and sustainable development – on one level.

True, this is very human: people want all kinds of public goods at one time, otherwise they don't feel happy. But alas, the laws of nature and human behaviour do not allow this to happen. First of all, the law of scarce resources is there, and prevents us from having everything simultaneously. It makes us chose one or another wanted good, not all together. It makes us evaluate things and pay for one by another. In the realm of material life, the law of scarce resources is the major ruler which can never be forgotten if one wants to realise their wishes.

While observing political debates over economic strategies, it seems that most of the speakers have never heard of this law. Or they find it so terrifying that forget it instantly. This makes the decision makers' life easier psychologically, but it doesn't help the strategy to be implemented.

Another law that hinders the implementation of the European three-headed goals is the law of human behaviour. All humans have a natural motivation to act in the way which is beneficial for them (what is beneficial is an exceptionally individual decision). It means that provisions of economic policy shape actions of society. Substantial social guarantees undermine incentives to struggle to find a job, and considerable obligations imposed on enterprises - to become an entrepreneur. If taxes are kept high to finance social allowances and environmental projects, there is less incentive to start a business, to expand it or to report all income officially. Also, high education for free increases incentives to study seeking to postpone work, and free health care services result in unavoidable queues for treatment and inefficient use of resources.

These two laws are sufficient to see that it is the merest wishful thinking striving to have economic growth together with increased social cohesion and sustainable development. Five years had to pass to start talking about it, however, in hints and symbols only.

The revised Lisbon Strategy was presented by the President of the Commission nearly in the same way as the services directive – with a clear priority of goals and defined trends to achieve them. However, the Communication on a new Lisbon Strategy contains the same politically correct and economically void statements about the multiple goals and the "invaluable" European model. The attempt for a change has been done, but, alas, it's just an attempt so far.

The fate of the services directive is taking a similar course: the proposal has been rejected by the two biggest EU member states as a threat to the European model. This threat most likely originates from the fact that provisions of the directive do respect the above mentioned laws. They address the issue of efficient distribution of resources in the common market (the law on scarce resources) as well as motivation to expand services into new markets (the law on motivation of economic activity).

The idea to adopt some version of the services directive has not been abandoned (the same political correctness). However, consideration of opponents' arguments poses a very big question mark, whether the revised directive will have any meaningful effect at all. Opponents call lower salaries, caused by general differences in wealth in the EU countries, 'social dumping' (although goods produced by the same low-paid workers didn't deserve to be called like that!). As a result of pressure from opponents, exceptions on the principle of free services that can be made by the national state are being expanded to fit the goals of public policy. This actually means that exceptions can be applied in any case and removes the very purpose of the directive.

As one American has noticed: Europeans want to have everything changed without changing anything. This also has a reference to one more law - the law of cause and effect.

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INTERVIEW

This interview with LFMI's President Ugnius Trumpa was published in Lithuania's leading daily Lietuvos rytas*, on March 8, 2005, in the midst of heated economic debates over the tax reform in Lithuania.*

Government would Like to Scoop Out from an Empty Bucket

It's a mistake to link the tax reform only to the introduction of euro

Ugnius Trumpa, LFMI's President, Interviewed

The ruling coalition's and economists' positions on the tax reform in Lithuania are different as black and white.

When debating the tax reform, politicians from the left-wing majority claim that Lithuania needs to generate additional revenues to reduce the budget deficit, if it wants to introduce the euro from the beginning of 2007.

Economists, in their turn, call for not focusing only on the launch of the euro as the country is being plagued by significantly graver problems.

Emigration of the workforce, a lack of qualified labour, a shortage of investments – these are but a few problems which, if unsolved, would leave Lithuania at the tail end of the poorest EU member states.

Back in the autumn of 2004, the Lithuanian Free Market Institute (LFMI) made an analysis of tax reforms implemented in other EU countries. However, the left-wing Government of Algirdas Brazauskas showed little attention to it.

The daily *Lietuvos Rytas* interviews LFMI's President Ugnius Trumpa about the planned tax reform.

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- The ruling majority at first declared that they have agreed upon the tax reform, but afterwards each of the four parties in coalition started criticizing this agreement. Is the tax reform so important indeed? What flaws has the current tax system then?

- People in Lithuania pay an income tax which is unquestionably too high. Countries that pursue reforms apply personal income taxes at the rate between 13 and 19 percent.

Lithuania with it's a hefty 33-percent rate and a fairly big social security contribution paid by employers,[1] is not competitive any more among both EU's newcomers and old-timers. Politicians in Lithuania have already managed to realize that and understand they must do something about that.

The other reason why the country's tax system must be changed is the need to finance the delayed reforms in education, social security and health care. These areas have been so neglected that they may collapse at any time.

- It means that the goal of the Brazauskas Government is to collect more money into the budget?

- A relentless itch to collect more budget revenues is the primary reason why the government is seeking to impose new taxes.

But how can they get this money? Well, this question leads to the most complicated puzzle which has been causing real havoc in politicians' heads.

As labour in Lithuania is taxed extremely heavily, it would be fairly insensible to raise the personal income tax; consequently, new taxes are seen as the first way out. So the government puts forth a draft law on the real estate tax for residents, initiated when the Conservative party was in power.

But this is absolutely clear that this tax won't put an end to all financial problems.

If only expensive real estate is taxed, the government is likely to fail to raise the planned revenues, and this might serve as a temptation to tax all owners of real estate in the end.

However, if cheaper residential property is taxed just as well, the burden will strike hardest the middle class which is the most dynamic part of society. This layer will sustain a serious blow. More than that, the administration of this tax may be unbelievably costly, and the receipts from the tax will be relatively negligible.

It seems that the Prime Minister has already evaluated the ratio of political risk to economic benefit: that's why he started changing his opinion about the real estate tax.[2]

The majority of people in Lithuania feel their load of taxes is too heavy, so any talks about levying news taxes are politically condemned to fall.

- Politicians' views regarding the planned tax amendments change almost overnight. How would you explain this fact – different interests of parties' supporters?

[1] Employers pay a 29-percent social security contribution, employees – four percent.
[2] After a strong reaction from the business community, economists and academics, the Prime Minister announced he didn't want the real estate tax anymore, although after some time later he said that the tax would probably be introduced but only to the real estate used for commerce *(editorial note).*

- Some problems lie in the ideology. The left parties find it especially difficult to cut taxes. Although at present taxes are being reduced not only by the right but also by the left politicians a number of countries worldwide. The economy is forcing to act in this way.

A lack of experience in carrying out tax reforms is one more roadblock for the coalition.

Having no experience and economic background, our politicians take no interest in the tax reforms that have been conducted in other countries.

For instance, our institute has made an analysis of tax reforms in other countries and submitted it to the government, however, nobody from there took a deeper look at it.

On the other hand, parties fail to find consensus promptly because Lithuania has never had such a mixed coalition.

- Let's say, parties will agree, and changes in tax rates will be instituted already from the next year, perhaps some new taxes will appear.

But if budget revenues shrink after that, one party of the coalition will start blaming the others for proposing an improper version of the tax reform. This can break up the coalition, can't it?

- Such a scenario is quite possible. That's why tax issues are being debated so vehemently at present.

But the central issue today is not the coalition's crisis but the fact that Lithuania has come to the crossroads: will our economy grow as fast as it did or will the growth slump?

If taxation of labour is not reduced radically, the country's resources of economic growth will be exhausted in five or ten years. It's enough that Lithuania is lagging behind its neighbours in attracting investments, not mentioning the fact that it is leading in taxing its labour force.

If such situation remains, investments will continue bypassing Lithuania. And then not only the labour force will emigrate. Then the capital of local investors, sustaining economic growth today, will flee to more attractive markets as well.

- But politicians don't talk about attracting investments; they don't seem to be concerned about the emigration of the labour force. The Prime Minister is only repeating the fact that new taxes are necessary for the introduction of the euro. Is the government wrong here?

- Linking the tax reform to the launch of the euro is a politically risky decision. It's a mistake that has to be amended instantly.

If after the introduction of the euro people see that the economy is not growing, while prices are rising, they will pin the blame for all of their tribulation on this government and the euro. You can't think of a better scenario to disqualify membership of the EU and the EMU!

Of course, the problem with the budget deficit must be tackled but the government shouldn't present everything so as if Lithuania will perish if it doesn't launch euro in 2007. It is equally absurd to say that if the country doesn't impose a real estate tax for residents, it won't be able to bring in the euro.

- But we need money to make reforms anyway. Where to get it?

- The basic source for that is better administration of budgetary expenditure. It's no secret that this is Lithuania's weakest ability as far as administration is concerned. The European Commission stated that as well before the country entered into the EU.

However, even today we don't see any attempts from the government at least at trying to grapple with this problem. Not a single ministry is analysing the effectiveness of their work. The Ministry of Finance feels no responsibility for that. The National Audit Office of Lithuania is supposed to do so according to its bylaws, however, it doesn't.

For this reason plentiful resources are either wasted or don't hit the targets they were meant for.

The second source is tax privileges and exemptions. All tax favours have emerged as a result of protecting some interest groups at the expense of others.

But if the government sets to eradicate tax privileges without cutting the personal income tax today, this would be a political mistake. How can government officials tell the people who have enjoyed good tax conditions that now these conditions will be eliminated without giving anything in compensation?

So it's indispensable to lower the income tax significantly and to remove tax exemptions at the same time.

- But income tax decuctions from education fees show the government's position to encourage people to seek higher education.

Decuctions from contributions to fully-funded pension insurance motivate people to save for the old age.

By repealing these tax favours the government will cease encouraging people to learn and save.

How to dovetail these aims?

- The best form of expenditure administration is when people themselves decide where they will spend their money.

If we talk about a clumsy administrative system, which by way of tax relieves aims at directing peoples' activity and influencing their choice, then we talk about a totalitarian, not a free society.

Once Lithuania has made the decision to renounce government as the means of regulation when we chose the course of a free state and a free society.

So we should expel from our mind those magically attractive forms of administration when decision makers imagine that they have the lever to sway the members of society by trying to pin-point how they should live.

Besides, tax exemptions create preconditions for conflicts among various interests. If government loves some groups more than others, those others feel harmed and unappreciated. Such a system encourages others to seek for government favours as well, and this paves the way for corruption.

Interviewed by Mantas Dubauskas, coorespondent of 'Lietuvos rytas'

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ESSAY

The following essay was published in 'The State of the Union: Market-Oriented Reform in the EU in 2004', a new report by the Stockholm Network.

Pension Reform in Lithuania

By Monika Kacinskiene, Policy Analyst, LFMI

No other word has come to define an entire decade of Central and Eastern European history like 'reform'. Common sense suggests that poorly conceived or executed reform is worse than no reform at all, yet those enacted across the region since the fall of Communism have often been less than ideal.

Lithuania is no exception. Since regaining its independence in 1991, the country's legislative process has often retracted, sidetracked, and for long periods entirely abstained from, reformist legislation. The rapid economic growth of the last two years (in 2003, GDP grew by nearly 10%), and the political leverage this offered for expensive structural reforms, only highlight the failure of the government to pursue such a course. It is sufficient to simply take a look at the situation of healthcare or education systems today.

Over the past year, the state-run healthcare system has begun to show signs of deterioration, and requires far-reaching reform. For example, while it is ostensibly state-financed, it currently constitutes up to 50% of some household's monthly expenses. So far, the government has only proposed temporary, and ineffective, measures to curb these rising costs. However, its willingness to acquiesce to the demands of striking doctors, who are badly underpaid, usually only buys them a brief respite. Equally, when a hospital does not have the equipment necessary for a given surgical procedure, the patient simply has to raise the money independently, and usually obtains the procedure in Scandinavia. That Lithuania's healthcare system is failing both doctors and patients is one of the country's worst-kept secrets. Yet reform is consistently deferred despite the current economic conditions that would significantly ease its burden.

Unfortunately, the much tinkered-with education system has not brought much improvement to the old one. Despite having a very high proportion of university graduates, Lithuania lags behind much of Europe in productivity because the system has an inherent bias towards the quantity rather than the quality of its higher education. This has saturated the domestic labour market, and created a potential new threat to the economy by encouraging economic migration. The government however, has once again chosen a non-solution by simply increasing the amount of money it spends per pupil.

Similarly, changes in agriculture are limited to compliance with the EU's Common Agricultural Policy (CAP). The important reforms of strategic budget planning and business deregulation are similarly in a legislative limbo. Admittedly, over the last three years, steps have been taken to recover individuals' savings from the pre-independence period; however, the process is still far from a satisfactory conclusion.

One piece of major, though still relatively modest and cautious, reform nevertheless progressed significantly in 2004. Until the end of 2003, Lithuania relied on a simple redistributive mechanism to provide for its elderly. The traditional pay-as-you-go (PAYG) system, employed in many European countries, is based on a money transfer from workers to retirees. This system, otherwise known as the first pillar of the three pillar pension model, accounts for 90% of total pension income in the European Union countries. Despite its widespread use, however, the system is flawed in a number of ways. Firstly, it places sole responsibility for future pensions in the hands of the politicians. Second, it encourages early retirement while discouraging job mobility. Third, it places a high burden on labour, though it excludes the self-employed.

But most importantly, a PAYG pension system places an unsustainable strain on government social spending. Some EU countries are currently piling up liabilities on the scale of war debts. On current trends, nine EU countries will have accumulated gross debts of 150-300% of GDP by 2050, causing the eventual collapse of a system to which pensioners have diligently contributed throughout their working lives. However, many countries are beginning to experience the breakdown of their PAYG systems. While the current state pension constitutes 30-40% of the average salary, it is very difficult to maintain a normal standard of living below 70%. Fundamentally, the flaws in the system are encoded in simple demographics. The population of Europe is ageing at an ever increasing rate, and within 30 years, the ratio of over-65s to those aged 20-64 will double. This will create an irresolvable fiscal imbalance wherein a small number of providers will be unable to support a growing number of pensioners.

Acknowledging the inevitable, the Lithuanian Government began modelling what was to become a three-pillar pension reform in 2000. A second pillar was eventually added to the first pillar tax-roll contributions in January 2004, and a third pillar – voluntary savings – is being implemented in the New Year. While Lithuania was the last of the three Baltic States to undertake this reform, the pre-existence of the model elsewhere meant that its implementation occurred relatively smoothly. This is doubly impressive given the extremely short period of time – the package of laws were adopted in July 2003, and the first round of subscriptions completed by December – during which state institutions had to prepare by-laws, and the fund-managing companies had to both acquire licenses and carry out promotional campaigns. In fact, Lithuania's transition has been much less troublesome than similar shifts in most European countries, despite the truncated timeframe.

The second pillar of the three pillar model (TPM) allows every socially insured employee to direct 2.5% of his earnings into a private pension fund (of his choosing) from January 1, 2004. This contribution rate will be increased annually (at the expense of the first pillar share) until it reaches 5.5% in 2007. All age groups of the employees are free to choose whether to participate in the second pillar and to start private saving in a pension fund or to stay completely dependent on the State Social Security Fund (Sodra).

The introduction of the second pillar does not incur any changes on those willing to remain within the PAYG system. Those taking part in the funded second-pillar system, however, now can accumulate funds that will remain the sole property of the individual, and can also choose the fund and manager who best suits them on a risk/return ratio.

Open to all

These reforms in Lithuania also allow all employees to participate in the second pillar, a provision unique within Europe. In most countries, workers have been discriminated against on the basis of age. The Lithuanian decision not to do so is both fair and economically well-reasoned. Participation benefits should depend on individual contributions, not imprecise age brackets. Equally, if the state disqualifies people from the second pillar, it would need to guarantee sufficient returns from the first pillar to provide for one's old age. Such a guarantee would significantly increase the cost of the present pensions system, and distort the very rationale of the private solution.

Guaranteed returns and investment security can only be ensured through competition. The Lithuanian Law on the Pension System Reform is rather obliging in this respect – it allows participation of both financial intermediaries as well as life insurance companies, so fostering conditions for competition. Indeed, competition could be strengthened further if similar reforms were enacted at European Union level. For example, competition among pension funds would increase if an individual could save for their basic pension - second pillar - in any EU member state.

The funded pillar model has three obvious economic advantages. It boosts economic growth (extra savings lead to higher investment and thus faster growth); it provides an incentive to remain in the labour market longer; and it is a more efficient use of capital. Although these economic outcomes are secondary to the social purpose of pensions, they function as a supporting and advancing mechanism. The funded pillar model also motivates people to become actively involved in decisions about their pensions.

The main and essential shortcoming of the present reform, on the other hand, is the size of instalments that could be directed into the second pillar – they are too small to allow big returns on investments. As such, they may be limiting participation levels since the incentive to save remains insufficient. Further reform of the pension system must increase the size of these contributions to allow low- and middle-income workers to accumulate real wealth. However, one rarely noted advantage - or beneficial consequence - of the pension reform is the significant effect it has had on the amount of wage transactions in the informal sector. Official statistics suggest that 30% of Lithuanian wage earners receive additional wage payments under the table, and a recent survey of market participants suggests that as many as one in four minimum wage earners receive additional informal wages.[3] The introduction of the funded pillar model will encourage people to declare their true earnings.

This pension reform is a significant, albeit small, step towards a sustainable and financially sound national pension system. Certainly, the system has been adopted enthusiastically by fund management firms and ten companies are now offering their services. Public interest has been similarly impressive. As many as 48% of Lithuanians have chosen to participate in the new system, while in Latvia and Estonia, participation rates hovered around 6-7% during the first two years of the funded pillar model's adoption. Fears about a dearth of competition among service providers and a lack of public participation have thus proved to be unfounded. Considering that participation is not obligatory, the number of participants is more than impressive: the results of the first two stages were not only better than those in neighbouring countries; they also far exceeded the Social Ministry's most optimistic projections.

The danger is that the Government now will rest on its laurels. A reform of the reform will soon be needed to ensure the system's long-term sustainability and the public's willingness to participate in it, to facilitate the success of the third – voluntary savings – pillar, and most importantly, to encourage reform in other sectors of the public services.

[3] LFMI, *A Survey of Lithuanian Economy,* 2004-2005 (1)

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FEATURE

In this article LFMI's Vice-president Guoda Steponaviciene discusses the defects of, and solutions to, the European health care. This article has received honourable mention in the TCS essay contest on reforming European health care. TechCentralStation (TCS), a free-market oriented, on-line think tank.

Client or (In)patient? Curing Is Painful

By Guoda Steponaviciene, Vice-president, LFMI

In the times when EU's best practices are widely copied, health care policy seems to be much at a disadvantage. Complaints about health care are being voiced in every European country. Though different in words, in general they revolve either around long waiting lists, a poor quality of services or inappropriately big spending or a mixture of these defects. No wonder, why.

Health care systems, as they are designed in most of the countries in the world, cannot perform well for one principal reason - the state's too active meddling with the public money and abundant regulations. This factor blocks a natural market mechanism in health care systems so that they cannot function properly. State interference itself stems from political interest to please voters and is more or less characteristic to all dominant parties.

We don't question the laws of physics when we study rotation of the wheel just because the wheel belongs to a Ferrari, not to a tractor. However, economic laws of scarce recourses, demand and supply, and the function of the market price seem to be invalid when public health care systems are debated.

European politicians claim they will create quality health care services for all citizens and will maintain low budget deficits at the same time. But the European traditional medicine is increasingly dependant on material resources. So the quality can be enhanced without impairing health care accessibility only through more efficient treatment.

However, in reality things go the other way round as new technologies are more expensive. This fact doesn't run counter to a general economic rule that technologies make things cheaper. Simply, new health care technologies target new

diseases, untreated cases and side-effects of the existing treatment.

We can't escape a rise in prices of health care, if we say that all people have the right at least to try treating their uneasiness. Even if we admit a certain budget deficit (with a rosy hope that one fine day everyone will quit smoking and take exercise to die healthy and quickly), this deficit will still have a tendency to grow as fast as it will threaten countries' financial stability.

To avoid this, countries employ restrictions on spending. They can be passive, e.g. waiting lists for services, and active, e.g. quotas set on drug prescription, regulation of the number of general practitioners in the market, discrimination of private providers of health care services and alike.

In all cases the patient is faced with the same sad result -- administratively restricted accessibility to needed services. There is no way to evade restrictions of demand because recourses available for health care are always scarce. But it is possible to escape from them being artificial and distorting market relations.

Many wonder why the patient is not a central figure of the system. The answer is simple -because the patient does not cover a full price (if any). Public financing of health care eliminates the significance of the price which is a natural regulator of demand.

Once health care expenses are compensated, why not use them lavishly, especially if doctors and nurses are well-paid and are kind. Why not take a taxi to hospital, if the service is covered from patient accounts? Even in those countries where there is no fun to go to the doctor, abundant use of government-paid services is widely observed. People become daily visitors often because they can't get the right service from the very beginning, receive prescribed medicines for very few days (because of quotas) or simply want some socializing.

Administrative means used to control demand can be very efficient in terms of cutting expenses, but they are too harsh in regulating such a complex and vulnerable activity as medical treatment. Waiting lists, quotas for medicines, restrictions on market entry both limit access to health care services and undermine their quality.

In addition, such measures distort patients', doctors' and health care administrators' motivation and build preconditions for corruption. They force doctors to perform tasks that are at odds with their primary duties - to offer the patient the best possible treatment. It is small wonder the prestige of this profession is suffering even in those countries where salaries in the medical sector are high.

It is strongly believed, especially in less wealthy states, that more generous public financing can work miracles in solving these problems. But the theory and the practice of EU's old member states show quite the contrary. The only recipe for curing health care systems is to trim public subsidies and recognize that health care goods and services have an essential characteristic feature - the price.

It should be noted that the existing compensations from patient accounts do not indicate the real prices of health care. They do not show the value of services to the patient. Compensations only reflect the capacity of a country's budget and a prevailing political will. The absence of market prices also make competition among health care providers only formal and limit the scope of private health care insurance.

If the patient is willing to be treated as a client and get a quality service, firstly, he has to cover himself at least a share of the price. The bigger this share, the more the patient will be regarded as a client.

Secondly, the share of the price to be paid by the patient has to be explicitly defined and known to all participants of health care in order to provide a working field for private health care insurance companies.

And thirdly, private health care providers have to be treated as equal to public ones in terms of receiving funds for compensations, market entry, meeting the required standards and so on. These are essential preconditions for competition in the health care sector which would bring a better quality, balanced finances and the system's orientation towards the patient.

Of course, it would be unrealistic to demand that market forces should be introduced into the health care system at one fell swoop, particularly if they don't exist there at all. This wouldn't work even if such an unimaginable political will would occur. However, if decision makers agreed upon an overall direction, changes could be introduced gradually and according circumstances of individual countries.

It is no puzzle why patients and even health care workers do not like changes. However, change is a curing process of the health care system. Who else, if not patients and doctors, can understand that curing is painful?

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