

The Free Market

“If you don’t create a free market, a black market will emerge”



NEWSLETTER OF THE LITHUANIAN FREE MARKET INSTITUTE

2008 NO. 4 (OCTOBER – DECEMBER 2008)

Ms. Rūta Vainienė elected the new President of the Lithuanian Free Market Institute

CONTENTS:

OPINION.....2 p.

Seeing the Old Year Off, Seeing the New Year In.
By Rūta Vainienė

ECONOMIC CRISIS.....3 p.

STATE BURDEN.....4 p.

BUSINESS DEREGULATION.....6p.

ADVANCEMENT OF IDEAS.....7 p.

WHAT LITHUANIANS REALLY THINK.....8 p.

Lithuanians think that the government doesn’t save taxpayer money

Every fourth citizen has paid unofficially for healthcare services in Lithuania, a country of “free” healthcare

ANALYSIS.....9 p.

LFMI's position on the European Commission's proposal to increase excise duty on manufactured tobacco

FROM LFMI'S BLOG.....12 p.

Rūta Vainienė: Ecology and Christmas

Rūta Vainienė: Clever thoughts on a Sunday eve



Starting from 11 December 2008, Rūta Vainienė replaced the previous LFMI President Remigijus Šimašius who was appointed the Minister of Justice on the 15th Government of the Republic of Lithuania.

Rūta Vainienė started to work at LFMI since its inception in 1990. Her scope of activities included economic and monetary policy, tax system, banking, and reforms in state finances. In 1999 – 2004 Ms. Vainienė led the team of LFMI policy analysts and since 2004 actively contributed to many of LFMI activities as Associated Policy Analyst. In 2007 Rūta Vainienė started to lead Budget and Tax Group of the “Coalition for a Free Europe” which includes numerous European libertarian think-tanks. Ms. Vainienė has published a “Dictionary of Economic Terms”, and is also an author of numerous articles and publications.

“We will have to work hard and we at the Institute are used to that. The mission of LFMI does not change; we worked and will continue working on actual issues of economic policy. Lithuanian people and companies look forward to good solutions and we have many things to offer to the government”, the new LFMI's President said.

Ms. Vainienė has resigned from the Council of Vilnius City.

As former LFMI's leader Remigijus Šimašius explained his decision to accept the proposal to become a minister of justice, he had given much thought to this offer and realised that this Government was going to be a solid, pro-reform Cabinet, having a real chance to pilot Lithuania out of a long-lasting period of dragged reforms.

“I leave behind a strong team of professionals at the Lithuanian Free Market Institute which will continue pursuing its mission. The minister's post will grant opportunities to implement those ideas that have been generated at LFMI – to ensure transparency and responsibility in law-making in the first place. Other important tasks will be deregulation in both Ministry-supervised fields and other areas where people anticipate positive changes”, Mr. Šimašius said.

Seeing the Old Year Off, Seeing the New Year In

By Rūta Vainienė, President, LFMI

By a hairbreadth, the year 2008 could have been quite a good one for Lithuanians. The first half of it looked highly optimistic – not only when authorities planned the state and municipal budgets where optimism is never a scarcity, but also when market forecasts were made. The fever of the crisis that hit global markets in August knocked at Lithuania's door later – somewhat in October. Banks became the omens of the crisis, much the same as they herald growing prosperity. In good times they lend money, in bad times they don't. But once you are used to easy access to money, it is never easy to shift to a starvation diet. But even October didn't seem to be so menacing because, to our joy, the right-wing parties won the parliamentary election, promising the Lithuanian voters market reforms. The President offered them to form a new government, which they did. We tied plenty of our hopes to this fact as the right parties are usually less populist, they conduct reforms that build the foundations for long-term economic growth and are in favour of a small but effective government.

Changes in political circles have taken a toll on us at the Lithuanian Free Market Institute when the fourth President of LFMI Remigijus Šimašius was offered and accepted a proposal to become a Minister of Justice. A nicely named Ministry and Minister. And very big challenges. We saw Remigijus off with a minister's portfolio where we inscribed his words written back in 2004 in this newsletter: "Wishing and striving for a better life, the government can assist people in just one way – to become smaller, irrespective of today's or tomorrow's topicalities."

What happened after the approval of the new Government resembled a bad dream, a horror movie or some other kind of art when the story begins to develop in a way you didn't plan or expect, especially as it develops very rapidly and dramatically. The new Government's anti-recessionary plan, drawn at speed on co-operation with several Keynesian analysts and passed by the Parliament, came as a total surprise even to the leftists.

Now we are witnessing the decisions made by our Government* – we all see them in gas stations and

stores, we feel them at home and at work. We are searching for ways to adjust to them and to come through the economic hardship. Full of hope, we've seen the New Year in. What will it bring to us?

The first month will pass quickly: the Government will need to form and approve its programme's action plan where it could table the good news for the market. These are badly needed! There are several solutions that might help overcome this nightmare, injecting some hope of recovery. First and foremost, to my mind, is to eliminate corporate tax on reinvestments. This is an old and amply debated measure that has already been partially implemented and incorporated into the election programmes of two ruling parties. It wouldn't even have repercussions for the national budget in the year 2009 which will be plagued by the crisis. But the benefit would be gigantic! Now that Lithuania applies a 20-percent profit tax and the same rate on dividends, the country has become overly unattractive for business. Even before that we couldn't boast of foreign investments, but the current tax rates will scare away any. Investments are what Lithuania needs the most. It's not consumption but namely investments that determine prosperity.

The other two pivots on which we could build our hopes of a better life are the healthcare and education (not just in higher education) reforms. Although it's not feasible in one year, but in four years these reforms could give juicy fruits. The Lithuanian Government's programme contains welcome provisions in this respect – most importantly, these provisions must be included in the action plan and be implemented. I won't go deep into details, but overall, reforming these systems would not only ensure high-quality services, but would also allow economising budget revenues that have been lavishly shelled out for these areas to date.

In the course of the first three months, the Government will be able to ascertain the efficiency of its anti-recession plan. In the first quarter, the bulk of the new tax rates and changes of the tax base will have "demonstrated their teeth," and those which won't will not produce any results later in the year either. So we will see whether the national budget collected additional revenues from higher VAT, whether the raised excise duty rates met their expectations, what signals are being reported by Lithuanian border guard services and healthcare institutions regarding the consumption of shadow "goods" and how the State Social Insurance Fund is dealing with its budget deficit.

* Measures set forth in the anti-recession plan that took effect as of 1 January 2009:

- a 19-percent rate VAT (formerly a 18-percent rate);
- a 5-percent rate VAT break removed from a number of goods and services, including press publications; all kinds of events of art, culture and sport; museums and exhibitions; hotel and passenger transport services; ecological food products; fresh iced meat; live, fresh and iced fish. All these items are applied a uniform 19-percent rate VAT;
- until June 30, a 9-percent rate VAT will be applied to non-periodicals and state-compensated pharmaceuticals;
- a 15-percent rate of the personal income tax (formerly a 24-percent rate), plus an additional 6-percent healthcare insurance tax – overall, 21 percent;

-
- the non-taxable minimum eliminated for medium- and high-income earners, applying it to low-income earners and working people with children (different sizes);
 - a 20-percent rate profit tax (formerly 15 percent rate);
 - a widened circle of payers of social insurance contributions, including persons who receive royalties, farmers and sportspeople.

Other changes that took effect from 1 January 2009:

- increased excise duties on petrol, diesel and liquid gas;
- increased excise duties on alcoholic beverages and tobacco products;
- increased prices of natural gas and electricity.

> LFMI's position on the Coalition's anti-recessionary plan

24-11-2008 | In response to an anti-recessionary plan drafted by the new Government, LFMI has prepared a policy proposal on how to act under the existing economic crisis. It is stated in the material that the future Government will confront serious challenges as a result of a long-lasting – and still pursued – reckless policy of public finances, which is especially menacing as economic downturn gains momentum. In addition, the Institute issued a press release, warning that the future Coalition's anti-recessionary plan envisages, among a number of welcome measures to trim budget expenditure, increases in Lithuania's major taxes. The following presents a summary of LFMI's arguments and proposals regarding the anti-recessionary plan.

The second quarter of 2009 will come as a critical try-out to the Government. Money will be a lack - that's as sure as fate. The Government may move either to correct its mistakes or to deepen them even further, which will determine our life not just in 2009, but also during the entire term of this Parliament. It's certain that no new revolutions or reforms will take place until presidential elections on May 17 and until their second round and elections to the European Parliament on June 7. That's the way life goes: the best tool that disciplines politicians is not a voter-given mandate, but fear that during the next elections this mandate will be granted to their political opponents. This tool is both disciplining and, on the other hand, discouraging from unpopular reforms. So the new Government will have a chance to scrap fruitless decisions and do everything to prevent socialism and populism from triumphing in the 2009 elections. Mind it, such a danger really exists since the right parties have strongly disappointed the country's electorate.

It's possible that the Government will attempt to borrow money, perhaps even from the International Monetary Fund. On April 1 the currency board system will celebrate its 15th anniversary in Lithuania: it has made Litas a solid and credible currency that has withstood internal and external crises. In times of crises, politicians always tempted to entrench upon the Litas' stability. It's because governments find it much easier to print money out of air than trim expenditures. The second half of this year will be crucial – those willing to unplug the tap of the Lithuanian currency will not lack. There is not a single circumstance under which the currency board scheme, safeguarding Litas from politicians' whims, loses its power of automatic functioning. It is only politicians' reluctance to cut boosted public spending that may come as a threat to our national currency. And since the biggest price bubble has surfaced in this particular sector, it is in the politicians' power to explode it. This is the biggest challenge, so let's wish our government to stand up to it.

* * *

We mustn't obey instigations that our central bank must resort to active policy and we mustn't take loans if their terms are the devaluation of litas, what the IMF has proposed doing in Latvia. If the tap of the Lithuanian national currency was unplugged, we would humourlessly repeat the words of the famous Soviet film-hero Ostap Bender: "The financial abyss is the deepest one – you can fall into it your life long."

*Rūta Vainienė,
Lithuanian National
Radio*

The future Coalition's anti-recessionary plan puts forward not only an expected cut in public spending, but also an increase in most tax rates. Such a move would only exacerbate the current recession and its effects on people, businesses and the state. The three main taxes – VAT, personal income tax and corporate tax – shall all be increased and set at the level of 20 percent. The equalization of tax rates may sound politically attractive, yet it is worthless in the economic sense and will increase the tax burden. The increase in VAT will lead to higher prices of most products and services, decrease the purchasing power of consumers and consumption. Moreover, budget revenue will increase by less than the Coalition expects, because higher taxes imply less economic activity.

Currently, 130 thousand people possess business certificates (a lump-sum annual tax which allows simple economic activity without registering a company and avoiding bureaucratic routine),

and the Coalition has proposed to abolish them. Coercing these individuals to register individual businesses, pay a 20 percent income tax and do bookkeeping will be an incentive for these individuals to move into the shadow economy. Even if business licences are in some cases too cheap and they may serve as a cover up for an actual employment (thus avoiding paying an income tax), it is this simplest form of business with an easy market entry and little administrative burden that may serve as a buffer to unemployed people during the recession.

The proposal to bring in more people into the state social security system is hasty and short-sighted. Increasing the

number of people covered by social security implies more revenue yet more spending, thus this proposal as a solution to the social security fund's problems is inappropriate. Another proposal is to „temporarily“ decrease the transfers from the social security fund to private pension funds. Currently, 900 thousand employees participate in the private pension scheme that has allowed participants to transfer up to 5,5 percent of their social security payments to private pension funds, yet the Coalition has proposed to halve the amount transferred and invested. This is a blow to everyone who has made a conscious choice in favour of private pension savings, to 8 private pension fund management companies, and to Lithuania's image as a reliable investment partner.

LFMI proposes not to increase tax rates and instead focus on abolishing tax privileges (primarily reduced VAT) and cutting state expenditure. A number of positive changes has been outlined in the anti-recessionary plan, including proposals to liberalize employment rules, reduce corporate tax rate on reinvested profits (50 percent of reinvested profits would be tax-free), simplify procedures of opening and closing a business, decrease the number of state institutions that control businesses and simplify territory planning procedures. LFMI's analysts recommend that the Coalition act vigorously in those areas, because the most important thing the new Government can do to alleviate the recession is to streamline bureaucracy and business regulation, to make business flexibility possible.

> Conference “Economic Crisis: Lessons and Opportunities”

On 3 December 2008, LFMI staged its annual event “Economic Crisis: Lessons and Opportunities.”



Rūta Vainienė and guest speaker from CATO Institute (USA) Dr. Richard Rahn

LFMI was honoured to host economist from CATO Institute Dr. Richard Rahn as a guest speaker of the conference. He delivered a [presentation on the causes and effects of the global financial crisis](#). Ms. Vainienė spoke about business cycles and the impact of monetary policy. The event was concluded by a discussion about what the government, businesses and people should learn from the current crisis.

> LFMI urged the new Government not to build a chaos in the tax system

17-12-2008 | Lithuania's new Government has submitted to the Parliament about 50 draft laws in line with the bill on the state budget. In response to that, LFMI held a press conference where representatives from investors, business and accountants associations took place as well. Members of associations opposed the planned revolution in the country's tax regime and called on the new Government not to make mistakes that might be deleterious.

This tax assault has become a miserable example of horrific law-making. Draft laws were secretly debated by the government on Saturday, on Monday they were approved at a demonstrational government sitting, on Tuesday they were officially registered in the Parliament, on Thursday to Monday they were adopted in a sprint, and they will come into effect in 15 days from their submission, that is, from January 1. A regular procedure specifies that any laws that introduce or change taxes must allow a six-month period before such legal acts take effect, except when such changes are related with a law on the national budget and are contemplated together.

*Giedrius Kadziauskas,
Verslo Žinios*

According to LFMI, the Parliament has been flooded with about 50 draft laws, containing amendments to more than 220 articles. On top of that, as much as 106 of them were related with tax computation and payment. Overall, the new Government moved to hastily change not just the tax rates but also the tax base.

As LFMI's President Rūta Vainienė stated, not a single circumstance - not even a crisis - could justify an additional chaos in the economy, which would ensue after such sudden changes in the regulation of most taxes were adopted. She also warned that all this legislation, drafted in a rush, might contain errors because neither government officials nor lawyers nor individuals to whom these regulations will be applied have time enough to closely examine the proposed draft laws. Ms. Vainienė also pointed out that market agents would be forced to learn how to apply the new tax rules in three or four days – such haste doesn't do honour to the country which is striving for Western values.

LFMI proposed, first, to implement only minimal changes to the tax system that were related with the tax rates and tax breaks; second, not to institute any changes in the country's social security system; third, not to halt or cancel the pension reform; and fourth, to adopt changes in the tax base only after publicly debating them and following regular procedures

of law-making, allowing the established period of six months before any amendments come into force.

> Lithuania's President consulted with independent experts

The future government says: „The social insurance fund lacks money – let's insure more people and we'll have more revenues.” But they don't give much thought to the fact that an individual insured today will be receiving contributions tomorrow. In other words, you pay in one cent and you take out one litas.

Rūta Vainienė, Ekstra

23-12-2008 | LFMI's President Rūta Vainienė took part in the Lithuanian President's meeting with independent economic and legal experts to debate the bill on the 2009 state budget and an accompanying package of other bills. The aim of the meeting was to find out what consequences the bill on the national budget would exert on the state and people, if it was signed or vetoed.

LFMI's President Rūta Vainienė was rather critical about the bill on the 2009 state budget and other draft laws. She expressed an opinion that it might be even healthier to the Lithuanian economy, if the President vetoed the budget bill and other amendments altogether. As a result, according to her, the tax system would remain intact, while the state would live in January 2009, spending budget resources, equalling one-twelfth of last year's budget.

LFMI's President proposed another solution as well – signing the law on the 2009 state budget but vetoing certain legal acts submitted to the President in line with the budget bill. In Ms. Vainienė's opinion, Lithuania's President should not sign amendments to the Law on the Profit Tax and those legal acts that regulate social security and health insurance contributions.

> Profit tax is the most defective tax in Lithuania, says LFMI

05-11-2008 | Continuing activities in the area of the profit tax, LFMI staged a press conference to propose ways how to reform one of the most harmful taxes in Lithuania, profit tax, by shifting to a single taxation of dividends. LFMI argued that this tax was one of the old taxes, the application of which had become inert and did not correspond to the current challenges. For these reasons, the application of this tax must be revised.

The flaws of the profit tax are systemic and cannot be solved by merely streamlining the tax base or changing the tax rate – the initiatives constantly contemplated by decision makers. A non-objective profit tax rate and complex and regressive procedures for computing the tax base are among the major defects.

At present, shareholders' income is being tax twice: first, when income is earned at company level, and, second, when dividends are paid out. LFMI proposes to reform the profit tax by shifting to a single taxation of the profit tax, that is, taxing dividends paid out.

The profit tax is not the main source of budget revenues, accounting for negligible 9 percent of Lithuania's national budget. Most importantly, LFMI believes, the money which

would not be channelled to the budget would be reinvested by private companies into their own activity.

> LFMI's analysis: Lowering taxes and balancing the budget - both crucial and feasible

10-10-2008 | On the eve of endorsing the bill on the 2009 state budget, LFMI disseminated a press release, calling on the Government to markedly reduce the tax burden and balance the national budget. Prior to that, LFMI made and submitted to decision makers a policy proposal on how to balance the public finances even with the ongoing financial crisis.

The need for cutting taxes is especially strong in the course of economic stagnation. Consumers and businesses are compelled to save more today than a year ago. The Government should alleviate this burden by reducing the tax burden for market agents and people, plus start saving itself.

Back in May 2008, LFMI submitted a proposal on the tax reform and recommended lowering the personal income tax (PIT) rate to 11 percent; repealing the profit tax and taxing only dividends; scraping all tax breaks of PIT, VAT and other taxes; setting the upper ceiling on contributions to the State Social Insurance Fund, equalling the amount of five average wages; increasing the portion of social security contribution to be transferred to private pension funds to 10 percent; not raising VAT and applying minimal excise tax rates, allowed by the EU; and not introducing a real estate tax.

“Decision makers often consider LFMI's proposals on cutting taxes as unrealistic and contend that a resulting budget shortfall would inhibit proper fulfilment of state obligations. But this is not true. We have formulated just one really feasible proposal out of a multitude on how to balance the budget. We seek to demonstrate that the government's reluctance to reduce the tax burden has been predetermined by its own reluctance to do so,” stated LFMI in the press release.

The Institute's proposal is based on very conservative assumptions that GDP and budget revenues do not grow. If LFMI's proposal was implemented, the national budget would not receive 3,252 million litas in revenue. But the Institute submitted yet another proposal on how to trim public spending by 4,272.6 million litas. LFMI argued that this trimming is indispensable seeking to balance the budget, whereas the deficit of the 2008 budget was financed from borrowed resources.

* * *

> Greater opportunities to agree individually or collectively would lessen growing tensions in the labour market

20-11-2008 | LFMI staged a press conference to present measures which would help prepare for and curb a pending rise of unemployment. According to LFMI, in the course of an economic crisis, simplification and flexibility of employment regulation would lessen pressure for employers and, most importantly, employees.

As data from the Lithuanian Labour Exchange shows, the number of people seeking employment went up by 30 percent in October 2008, compared to October 2007, while jobs created decreased by 26 percent. Such figures signal that lay-offs will become more frequent already from the start of 2009.

The Institute highlighted that under such circumstances flexibility in the labour market was vital as never before, reminding that other countries predominantly launch reforms to increase flexibility when the situation in the labour market becomes especially acute.

The Lithuanian Labour Code has been acknowledged as rigid and inflexible both by Lithuanian businesses and foreign specialists. Therefore, LFMI proposes not to apply specific provisions of the Labour Code when employers and employees agree individually or collectively. For instance, the Institute recommends that employers and employees were allowed to agree individually on various aspects of working time – the duration of working day and working week, overtime work, vacations or the terms of firing. In addition, labour market participants should be allowed to agree collectively and not to comply with the Labour Code's rules regarding the introduction of summary recording of working time, payment for overtime work, night work or work on national holidays.

LFMI also proposes to simplify the procedures of concluding labour contracts. More to that, it would be expedient to discard privileges applied to trade unions, which undermines employers' incentives to establish trade unions.

> LFMI's discussion on the credibility of the Lithuanian electricity market



Participants of the debate (from the left): Remigijus Šimašius, LFMI; Carlo Stagnaro, Istituto Bruno Leoni; Giedrius Kadziauskas, LFMI; Virginijus Poderys, National Control Commission for Prices and Energy; Rymantas Juozaitis, company Leo LT

On 21 October 2008, LFMI staged a discussion “The Lithuanian Electricity Market: Credibility and Price Today and Tomorrow.” The event focused on the existing and future problems of the Lithuanian energy market, the myths about the supply and the price of electricity and the needed economic policy solutions in the country's electricity sector.

Mr. Carlo Stagnaro, Director of Research & Studies at Istituto Bruno Leoni, gave a key [presentation “The Energy Challenge for Europe and Lithuania.”](#)

> LFMI opposed restrictions of alcohol consumption

Government regulation is very multitudinous. Decalogue consists of ten rules, and the Code of Hammurabi was carved on one stone tablet in 1700 BC. It is the EU law that occupies 80,000 pages and the Lithuanian Parliament that adopts 3,000 laws and amendments per year. The more rules are adopted, the less freedom we have to choose our own itineraries.

*Giedrius Kadziauskas,
Veidas*

03-10-2008 | As the Lithuanian Parliament was setting to adopt amendments to the Law on Alcohol Control, LFMI disseminated a press release, stating that the Parliament will fail to solve the problems of immoderate consumption of alcoholic beverages. As the Institute argued, “hardened” consumers would find ways to dodge the new restrictions, while occasional consumers would be coerced to adjust to limited opportunities.

Although the Parliament's intention to reduce the number of drunken drivers on the Lithuanian roads was welcome, the tools envisaged were dubious, having negligible effectiveness.

The draft law on alcohol control set forth a prohibition of trade in alcohol in gas stations. Trade in alcoholic beverages is a profitable share of business in gas stations, therefore, LFMI contended, after instituting this prohibition, gas stations will be forced into shortening their working time or even firing some workers.

Other restrictions laid down in the draft law encompassed a prohibition to keep open bottles of alcoholic beverages inside cars (vehicles), restrictions of time allowed to trade in alcohol in stores and a prohibition to consume alcoholic beverages in higher education establishments and for persons under the age of 18. According to LFMI, such restrictions were illogical and would hardly affect the most problematic groups of society, meanwhile posing difficulties in obtaining, selling and consuming alcohol products.

The Parliament adopted amendments to the Law on Alcohol Control that came into force from the beginning of 2009.

ADVANCEMENT OF IDEAS

> Lithuania featured in “The Washington Times“

14-12-2008 | “The Washington Times” publishes a column by Dr. Richard W. Rahn, a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth, who has recently visited Lithuania as a guest speaker at an annual event of the Lithuanian Free Market Institute.

His article “Consequences of the Bailout” briefly outlines the current economic situation in Lithuania that “has been a shining star,” the current dangers to the Lithuanian economy and the measures that the country’s new government has proposed.

The text of the article can be downloaded [HERE](#)

> LFMI held economic studies for best applicants

On November 10-16 LFMI organised a week of economic studies for the best applicants, which was staged for the first time in Lithuania. Comprehensive lectures on 14 topics of economic policy were delivered to senior students of economics or other social and humanitarian sciences, as well to graduate professionals.



These courses focused predominantly on the Austrian school of economics. Thirty-five best applicants, selected by the courses’ commission, were accepted to the courses. All students received official certificates.



All lectures were delivered by well-known Lithuanian analysts and internationally acknowledged lecturers who specialise in the Austrian economics.



Partners of this project were *Swedbank* and the ISM University of Management and Economics

I would like to thank the organisers for this week of studies where they presented the ideas and thoughts which, to my belief, have the power to change the world and its order towards a positive direction. We’ll be waiting for new educational initiatives of the Institute.

Paulius Sluškonis, participant of LFMI’s studies, LFMI’s blog

* * *

WHAT LITHUANIANS REALLY THINK

The Lithuanian Free Market Institute and a Lithuanian market research company RAIT continue implementing a joint project that aims at ascertaining public attitudes towards various economic policy issues. According to a new poll conducted in October 2008, Lithuanians strongly believe that in the face of an economic crisis, the country's government does not save taxpayer money. One more poll was carried out in November to find out whether people had paid, officially or unofficially, for healthcare services. The following presents the results of the two polls.

Lithuanians think that the government doesn't save taxpayer money

As the results of a representative opinion poll conducted in October 2008 demonstrate, in the face of the current economic recession, ordinary Lithuanians save the most, private businesses keep nearly in step with them, while state institutions save the least.

	Save the most (percent)	Do not save at all (percent)
People	69	4
Private business	34	12
State institutions	3	67

According to LFMI's Junior Policy Analyst Kaetana Leontjeva, respondents reported about their own behaviour or the behaviour of their friends and acquaintances while evaluating the trends in people's saving. Naturally, in the course of a crisis, people are more concerned about their finances, which leads them to cut expenses on non-primary commodities or services (e.g. entertainment). When expressing their views about business saving, people also tend to think private companies save to a large extent. There has been a growing number of news reports in Lithuania that businesses allocate fewer funds for advertising and decrease the volume of production or even temporarily halt activity. Thus, it can be assumed that this information has contributed to shaping people's views about extensive saving by business.

Meanwhile, more than two-thirds of those polled believe that state institutions in Lithuania do not save at all. It can be presupposed that Lithuanians would want their government to follow the people's and business' lead and to save more than at present. "Interestingly, the answers of respondents who hold jobs reveal that civil servants and employees working in the public sector are convinced the most that the government isn't saving budget money," commented LFMI's analyst.

This representative sociological survey was conducted on October 3-14, 2008 using face-to-face interviews. It is an Omnibus poll. 1,040 permanent Lithuanian inhabitants aged 15 to 74 were interviewed. Statistical error does not exceed 3 percent.

Every fourth citizen has paid unofficially for healthcare services in Lithuania, a country of "free" healthcare

A representative opinion poll conducted in November 2008 was carried out to elicit whether Lithuanians have paid, officially or unofficially, for healthcare services in public or private healthcare institutions over the past five years. The following question was whether they would pay for an operation or other treatment in the future.

The survey revealed that only 25 percent of Lithuanians have not paid officially or unofficially for healthcare services. As much as 87 percent of respondents (of these who reported to have paid unofficially) would pay unofficially for an operation, if needed, in the future.

According to the survey, 25 percent of the Lithuanian population did not pay any money for healthcare services. Forty-nine percent of those polled covered the full or partial price of healthcare services in public or private institutions. Twenty-five percent reported to have paid unofficially or gave presents to doctors or nurses. Overall, a total of 59 percent of respondents paid officially or unofficially for healthcare services, 10 percent did not refer to any healthcare institution and 6 percent did not answer at all.

The results of the survey show that there is a considerable difference between views of those who referred to medical institutions and not, and those who paid unofficially and those who did not for the services rendered. Respondents who reported they hadn't visited any healthcare institutions over the past five years claim they wouldn't pay unofficially for operations (57 percent) and for other services (75-78 percent). Whereas even 87 percent of respondents (of those who paid unofficially for medical services) would pay again unofficially for operations and 43-57 percent would pay for other services.

As LFMI's President Rūta Vainienė commented, the Lithuanian Law on Health Insurance specifies that primary-, secondary- and tertiary-level healthcare services are covered from the Mandatory Healthcare Insurance Fund, but the survey shows that people are willing to pay in full or in part for their medical services.

According to Ms. Vainienė, the results of the opinion poll lead to an assumption that the current mechanism of funding of healthcare services fails to ensure desirable healthcare services or a desirable quality of these services. Although legal acts declare that nearly everything is covered from the Mandatory Healthcare Insurance Fund, in reality, however, all what people receive is queues in medical institutions, concealed methods of treatment and perceiving that people will not get desirable services without paying additionally.

According to LFMI, the current system of healthcare funding needs serious overhauling. First, the state must define explicitly what medical services and to what extent will be covered from the Mandatory Healthcare Insurance Fund. Second, healthcare institutions would then be able to decide whether this funding is sufficient, if not, they would be able to clearly set the size of co-payments charged at an individual institution. Third, funding from the Mandatory Healthcare Insurance Fund must be provided to private and public healthcare establishments on an

equal basis, so that a person who pays mandatory healthcare insurance contributions was granted freedom to choose a medical institution himself/herself.

This representative sociological survey was conducted on November 7-16, 2008 using face-to-face interviews. It is an Omnibus poll. 1,046 permanent Lithuanian inhabitants aged 15 to 74 were interviewed. Statistical error does not exceed 3 percent.

* * *

ANALYSIS

Continuing activities in the area of tax policy, LFMI has responded to the European Commission's plans to increase excise duty on manufactured tobacco. The Institute has formulated its position on the issue and submitted it in October 2008 to relevant authorities. The following presents the full the text of LFMI's position.

LFMI's position on the European Commission's proposal to increase excise duty on manufactured tobacco

1. Current excise duties on manufactured tobacco in the European Union and Lithuania

Under European Union directive on the structure and rates applied to manufactured tobacco, Member States must apply a minimum excise duty which has to fulfil two requirements. The minimum fixed amount of excise duty is EUR 64 per 1000 cigarettes and the excise duty must be at least 57% of the retail price of the most popular price category cigarettes (proportional minimum). Member States that apply an excise duty above EUR 101 per 1000 cigarettes do not have to fulfil the 57% requirement.

Excise duty on manufactured tobacco that is currently applied in Lithuania consists of EUR 22.9 per 1000 cigarettes specific excise duty and 20% ad valorem excise duty calculated based on the maximum retail price. Lithuania has assumed an obligation to reach the minimum excise duty requirements by 2010, set out in the European Union directive – EUR 64 and 57% of MPPC retail price.

Thus, the European Union directive requirements and excise duties on cigarettes regulated by Lithuania's Law on Excise Duties can be summarized as follows:

- EU directive requirements:

- o Minimum excise duty: EUR 64 per 1000 cigarettes
- o Proportional minimum: 57% of MPPC retail price

- Taxation according to Lithuania's Law on Excise Duties:

- o Specific excise duty: EUR 22.9 per 1000 cigarettes.
- o Ad valorem excise duty: 20% of maximum retail price.

2. European Commission's proposal to change the method for calculating excise duty and to increase excise duty

European Commission is proposing to reform the tobacco excise duty system. The reform comprises several proposals:

- To replace MPPC with weighted price average (WAP) as the benchmark for proportional minimum requirement. Also as a result of this change, minimum excise duty rate requirement set out in the European Union directive will apply not only to MPPC cigarettes (as is currently provisioned), but to all the cigarettes sold in the country. Weighted average price is calculated by dividing the product of the number and price of cigarettes sold by the total number of cigarettes sold. Effect on the size of the excise duty may be twofold. If relatively expensive cigarettes are more popular in a certain country, then the minimum excise duty calculated using weighted average price as a benchmark would be smaller than excise duty calculated using MPPC. And vice versa: if relatively cheaper cigarettes are more popular, excise duty calculated based on weighted price average would be larger compared to the one calculated based on MPPC. If the most popular cigarettes are in the middle range price category, excise duty would be the same with either method.

- To increase minimum excise duty on cigarettes in line with internal market price harmonization and health considerations. It is proposed to increase minimum excise duty on Jan. 1, 2014 from EUR 64 to EUR 90 per 1000 cigarettes and the proportional minimum from 57% to 63% of weighted price average. According to this proposal, Lithuania would have to implement these requirements starting from Jan. 1, 2016.

- To widen the band of specific excise duty share of total tax burden from 5% – 55% to 10% - 75% in order to make excise duty structure more flexible.

- To bring gradually the minimum rates for fine-cut tobacco intended for the rolling of cigarettes into line with the rate for cigarettes. The chosen taxation relationship between fine-cut tobacco and cigarettes is 2/3. Thus, the minimum excise duty for fine-cut tobacco should be EUR 43 per kilogram, and the proportional minimum requirement should be 38% of weighted average price. Applying the aforementioned relationship on the proposed excise duty increases for cigarettes from Jan. 1 2014, excise duty on fine-cut tobacco would be increased to EUR 60 and 42%.

- To adjust for inflation the minimum requirements for cigars, cigarillos and smoking tobacco. This is needed to take into account inflation for the period 2003 to 2007, which has been 8% according to Eurostat data on the annual rate of change of the harmonised index of consumer prices. It is proposed to increase minimum requirement to EUR12 for cigars and cigarillos and EUR22 for other smoking tobacco.

- To amend and toughen the definition for cigarettes, cigars and pipe-tobacco in order to avoid tobacco product name manipulations aiming for the lowest excise duty.

- European Commission regularly examines the structure and rates of excise duty in Member States and uses information on the quantities and prices of the tobacco products released for consumption. In order to ensure an efficient and effective collection of this information from all Member States, new rules are proposed regarding the provision of information as well as the definition of the necessary statistical data.

3. Effects of raising excise duty on cigarette prices in Lithuania

As regards Lithuania, the most important change proposed in the directive is the increase of the minimum excise duty which will lead to increased prices of tobacco products. The most popular price category (MPPC) cigarettes in Lithuania cost EUR 1.45. Considering that since March 2008 the specific excise duty per 1000 cigarettes is EUR 22.9, excise duty amounts to EUR 0.46 per cigarette pack. According to the combined excise duty calculation method and the Law on Excise Duties, ad valorem for cigarettes is calculated as a percentage of maximum retail price indicated on the pack. Currently ad valorem is 20%, consequently ad valorem of the most popular price category cigarettes amounts to EUR 0.29. Thus, combined excise duty amounts to EUR 0.75 or 51.6% of the cigarette price.

By Jan. 1, 2010 Lithuania is obliged to reach the minimum excise duty requirement of EUR 64 and 57% of MPPC retail price. For that, an amendment to the existing law has been put forth proposing EUR 38.5 specific excise duty per 1000 cigarettes and ad valorem of 25% of maximum retail price.

Once these requirements are enforced, specific excise duty would increase by 67% to EUR 0.77, ad valorem would increase by 80% to EUR 0.52 and the price of most popular price category cigarettes would increase by 43.8% to EUR 2.08. Excise duty per cigarette pack would reach EUR 1.29, or 61.7%.

Once the proposed European Commission requirements are imposed to increase minimum excise duty to EUR 90 on Jan. 1, 2016, specific excise duty per cigarette pack would rise 2.4 times to EUR 1.13 and ad valorem would rise 2.8 times to EUR 0.82. Price of one cigarette pack of the currently most popular price category would rise by 110.8% to EUR 3.06. Excise duty per cigarette pack would rise to EUR 1.95 and would amount to 63.8% of the cigarette price.

	Per cigarette pack				
	Specific excise duty	Ad valorem excise duty	Total excise duty	Price	Excise duty share of MPPC price
Currently	0.46	0.29	0.75	1.45	51.6%
As of Jan. 1, 2010	0.77	0.52	1.29	2.08	61.7%
According to the proposal, as of Jan. 1 2016	1.13	0.82	1.95	3.06	63.8%

	Per 1000 cigarettes				
	Specific excise duty	Ad valorem excise duty	Total excise duty	Price	Excise duty share of MPPC price
Currently	22.9	14.49	37.39	72.46	51.6%
As of Jan. 1, 2010	38.26	26.06	64.32	104.24	61.7%
According to the proposal, as of Jan. 1 2016	56.38	41.01	97.39	152.75	63.8%

4. Possible consequences of raising excise duty

Raising excise duty would further increase cigarette smuggling and the illegal market. Smuggling is an economic activity to which laws of supply and demand apply. Raising excise duty increases the price difference between legal and smuggled cigarettes and as a result, demand for smuggled cigarettes rises. When their demand rises, the prices of smuggled cigarettes increase, making smuggling more profitable and leading to a rise in smuggling. In Lithuania as well as in other new Member States the price and other factors are favourable for the expansion of smuggling: prices in neighbouring countries to the East are becoming relatively smaller, new Member States have few border patrol resources, border patrol is plagued by corruption, so the amount of shadow economic activities is considerable. Lithuania's geographic location and public perceptions of smuggled goods are also favourable for smuggling. According to an opinion poll carried out by the Lithuanian Free Market Institute in 2008, as many as 38.9% of surveyed people justify or tend to justify smuggling. When investigating the conditions for the development of smuggling and an illegal market, it is important to consider the volume of corruption and shadow economy not only in Lithuania but also in the potential sources of smuggling – the neighbouring states. The situation is that corruption in Belorussia and in Russia is even more widespread.¹

Seeking to harmonise the tax system with the EU, excise duty has been sharply increased in 2002 – 2004 in Lithuania (between 2001 and 2004 excise duty burden increased by 121%). This has led to a sharp increase in cigarette prices. Raising excise duties reshaped the tobacco market. Sales of legal cigarettes decreased, while smuggling and the illegal market grew in size. According to

¹ More on the effects of excise duty on smuggling and public perceptions of smuggling of heavily taxed products can be found here:

1. A study on economic causes of smuggling http://www.freema.org/index.php/research/a_study_on_economic_causes_of_smuggling/2518
2. Opinion poll on public perceptions of smuggling http://www.freema.org/index.php/research/opinion_poll_public_perceptions_of_smuggling/4656

LFMI's research, in 2004 the market share of legal and illegal market (counting units sold) almost equalled. Due to the rise in excise duty, there was a sharp increase in price difference between prices in Lithuania and those in the main source of smuggled products – Russia. The amount of smuggled products detained rose almost 13 times between 2001 and 2004.

When evaluating excise duty effectiveness, it is crucial to consider changes in gross consumption of cigarettes (that is, both legal and illegal consumption). International experience shows that price rises tend to decrease legal sales rather than change gross consumption, and this effect is due to the expansion of the illegal market. This is what happened in Lithuania as well: when excise duty was increased in 2002 – 2004, gross consumption decreased but this change was not as vivid as the decrease in legal cigarette sales.

Due to differences in cigarette prices in different countries brought about as a result of different excise duties, growing smuggling can create such conditions whereby raising excise duty would lead to a further rise in excise duty. It is possible that when excise duty is high enough and smuggling has increased considerably, the first group of cigarettes that goes into the shadow market are the cheapest ones. As a result, the weighted average price (according to which minimum excise duty is calculated) of the legally sold cigarettes rises. In such a case, in order to comply with the European Commission's minimum requirement, the government will be forced to further increase excise duty, further stimulating smuggling. Thus, we get trapped in a situation where excise duty stimulates smuggling and more smuggling makes us raise excise duty. This is why the European Commission's proposal to increase minimum proportional requirement is harmful.

Cigarette price rises due to higher excise duty would decrease consumers' purchasing power. Compared to the old EU Member States, the standard of living in Lithuania is still low, people spend a larger share of their income on primary commodities. Although cigarette prices in Lithuania are much lower than in the old EU Member States, when assessed at purchasing power cigarettes in Lithuania are not more affordable. It is more common that in countries with lower standards of living a larger share of income is spent on alcohol and tobacco products. Thus higher prices would have more effect on consumers in Lithuania compared to consumers in EU Member states with higher standards of living.

Cigarette demand is relatively inelastic. This means that an increase in cigarette prices does not cause a large drop in consumption. For this reason, once cigarette prices rise, consumers may respond in two ways. Some may be forced to spend less money on other goods, so their purchasing power would decrease. Others would begin purchasing lower quality, and thus even more harmful cigarettes.

Raising excise duty does not necessarily increase budget revenues. Due to a rise in smuggling and illegal trade, and also due to the possible popularity of cheaper cigarettes, it is likely that instead of increasing budget revenues, raising excise duty would have an opposite effect. Once excise duty taxation grows, followed by the growth of the illegal market, a decrease in budget

revenues due to the growing illegal market may actually be larger than the increase due to higher excise duty. Consequently, budget revenues may decrease.

When excise duty was raised in 2002 – 2004, budget revenues from tobacco products did not decrease since the effect of falling legal sales was outweighed by the effect of higher tax rates. On the other hand, the budget lost a considerable amount of potential income due to growing illegal sales. According to LFMI's research, in 2004 the budget did not receive about half of potential revenues from excise duty on tobacco due to the shadow market. In 2005 – 2006 legal sales grew sharply and consequently so did budget income from tobacco excise duty.

Raising excise duty would increase inflation. The proposed sharp increase in excise duty on cigarettes would raise cigarette prices, contributing to a rise in consumer price index.

5. Conclusions and proposals:

- The European Commission's proposal to bring gradually the minimum rates for fine-cut tobacco into line with the rate for cigarettes, and toughen the definition for cigarettes, cigars and pipe-tobacco in order to avoid tobacco product name manipulations aiming to apply the lowest excise duty is commendable.

- We propose not to approve of raising minimum excise duty from EUR 64 to EUR 90 per 1000 cigarettes, since the proposed increase in excise duty in Lithuania would be harmful: it would negligibly reduce consumption, decrease potential budget revenues, diminish consumers' purchasing power and increase inflation.

- The main goal of proportional requirement is harmonisation of excise duty in EU, yet it does not achieve this goal. Increasing proportional minimum requirement would lead to raising excise duty in those countries where excise duty is already high in absolute terms, compared to the EU average. For this reason, we propose either to abolish the proportional minimum requirement or not to accept its increase from 57% to 63%.

* * *

Rūta Vainienė: Ecology and Christmas

08-12-2008 | Last week the Institute had a guest from CATO Institute in USA – Dr. Richard Rahn. As we drove past the Town Hall – where the city's Christmas tree was being assembled – I drew our guest's attention to the fact that our Christmas tree was ecologic. I just repeated what we, the dwellers of the Lithuanian capital Vilnius, had been told about our "constructed" Christmas trees for several years in a row now.

It is difficult to convey how the guest was genuinely surprised at the fact that the tree was artificial and it's even more difficult to convey his spontaneous laugh at the fact that the tree was presented as natural. Just think of the amount of the energy that had to be wasted to produce the metal framework, to which artificial branches manufactured in chemical plants were fixed. And think of what can be more ecologic than a renewable resource – a tree, which in addition absorbs carbon dioxide as it growth.

"Ecologic" plastic Christmas trees used for home decoration are "ecologic" and "contribute" to real ecology to the same extent. If people bought natural fir trees for Christmas, sellers would grow them. If we decorate artificial trees, no one will bother at their free will about growing real fir trees.

It is especially often maintained that the market fails in the area of environment protection. But this Christmas example testifies to the contrary.

Rūta Vainienė: Clever thoughts on a Sunday eve

08-12-2008 | Yesterday I spoke with my friend who runs a business in the United States. She put in simple words what we explained in economic terms. Here are her thoughts:

"Attempts to control the current economic crisis may not only safeguard people's deposits, but may also insensibly lead the world to universal socialism and a common world-wide government. At the moment, national governments nationalise banks, and at the next stage all objects of national importance in bankruptcy perhaps will be nationalised. It is projected that as a result of the crisis, rigid global regulation will emerge, bringing in line restrictions on business because business is inseparable from financing. Quite recently we were terrified by large-scale nationalisation in Venezuela, however, we suddenly grasped at it ourselves as at a lifebuoy. The world-wide government will be steering what is called a free market system. Will it succeed? Even Mr. Greenspan - a long-time authority of US finances who is currently blamed for the run-up of the crisis – has confessed in confusion that he had fallaciously perceived the laws of the free market. Interesting processes are developing. Might it be that a silent overturn of the global system is taking place before our own eyes?"

The Free Market is a quarterly newsletter of the Lithuanian Free Market Institute, disseminated in electronic form for free.

Sign-up for our free newsletter!

To receive *The free Market*, please send your name and e-mail address at Laura@freema.org.

The Free Market is posted on-line at http://www.freema.org/index.php/menu/newsletter_the_free_market/813.

© LFMI, 1996 - 2008. All rights reserved. Reproduction of articles is permitted, provided credit is given and copy of the reprinted material is sent to LFMI. To request permission to reprint *The Free Market* articles, please call (370-5) 272 4241 or e-mail Laura@freema.org.

The Free Market is published by the Lithuanian Free Market Institute – an independent non-profit organisation established in 1990 to advance the ideas of individual freedom and responsibility, free market and limited government. Our motto is

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

The founders of LFMI are – Prof. Kęstutis Glaveckas, Nijolė Žambaitė, Dainius Pupkevičius, Petras Auštrevičius, Elena Leontjeva and Darius Mockus.

LFMI pursues its mission by conducting research on key economic policy issues, developing conceptual reform packages, submitting policy recommendations at the legislative and executive levels, drafting and evaluating legislation, and launching public campaigns. LFMI's activities also include sociological surveys, publications, conferences, workshops, and lectures.

LFMI receives financial support from individuals, corporations and foundations. Devoted to the principles of private ownership, LFMI accepts no funds from the Lithuanian government.

Lithuanian Free Market Institute
16A J.Jasinskio Str.
LT-01112 Vilnius, Lithuania
Tel. (370-5) 252 6255, (370-5) 252 6263
Fax (370-5) 252 6258
www.freema.org (English)
www.lrinka.lt (Lithuanian)