

NARRATIVE REPORT

April – June 1997

Fiscal Policy

(a) Corporate Tax

During the policy-drafting process on a new law on corporate income tax, which is scheduled to replace the functioning law later this year, the Finance Ministry regularly approached LFMI with a request to revise the bill and propose amendments. In policy papers submitted to the ministry, LFMI supported the provisions eliminating double taxation and providing for the transfer of losses and exemption of reinvested profits. In view of the expanded tax base, LFMI urged to minimize the tax rate and make it uniform for all businesses. LFMI's comments and recommendations, which were published in the June 19 issue of the financial and business newspaper *Litas*, covered almost all provisions of the bill, including those on taxable and nontaxable income, allowable deductions, assets devaluation, nonperforming loans, taxation of investment, loan provisioning, taxation of income of foreign entities, income tax advance, accounting requirements, etc. **The recommendations were also presented to the prime minister and other high-ranking government officials, a prospect likely to bring about positive changes to the conceptual provisions of the law.**

Alongside the work on the new law on corporate income tax, the parliament has adopted several amendments to the functioning Law on Corporate Income Tax. In its policy advocacy and media campaigns LFMI warned decision makers against frequent law changes, stressing that they destabilize the business climate and have adverse effects on planning business activity. The recent proposal for the functioning law is to impose a 29 percent withholding tax on income of non-residents transferred to tax havens identified by the government. This provision is to replace an amendment adopted only a few months ago, an amendment imposing a withholding tax on non-resident income derived from consultancy-type of services (see LFMI's Narrative Report for January–March 1997). In a policy paper submitted to the prime minister and other cabinet members, LFMI called the proposed amendment an inappropriate and fruitless method to fight tax evasion, which would only impair the country's image, complicate tax administration, and deepen the business community's dissatisfaction with frequent and hasty rule changes. In addition, the amendment would restrain capital movement, forcing it out of Lithuania to "capital friendly" countries as well as stimulate shadow activity and cash settlements, thus reducing revenues not only from withholding tax, but also VAT, corporate and personal income taxes, social security contributions, etc. **LFMI's extensive public relations campaign brought the main weaknesses of the bill to the attention of the business and policy communities.**

LFMI urged policy makers to reject the amendment and compete with tax havens by improving the country's economic climate, liberalizing business conditions, and easing the general tax burden. LFMI stressed that, to avoid frequent law changes, any new policy provision be included in the new corporate tax law scheduled for adoption later this year.

Leontjeva spoke before the Economic Committee of the Industrialist Confederation on property tax on June 17. As a result, the recommendations proposed by the LFMI's president were utilized in the resolution of the committee.

(b) Tax Reform Proposal

LFMI continued to work on conceptual provisions for tax policy reform. Following extensive research and policy analysis, LFMI's tax reform team supplemented the policy proposal with provisions on real estate tax and revised it in line with LFMI's budget reform proposal. LFMI worked out a strategy for public campaign designed to present the tax reform proposal to a broad audience, including the policy and business communities, mass media, and the general public. The campaign is scheduled for September and October 1997.

(c) Tax Administration: Rebuilding the Information System

LFMI's efforts to push forward tax reform have been confronted, among other things, with the government's inability to efficiently administer taxes. Research and evidence suggest that this is due mainly to an ambiguous and complex tax regime and a lack of a uniform information system. On the other hand, LFMI's work on deregulation indicates that there is a bunch of government agencies that constantly require private enterprises to report ever-new information. Such an unsystematic and inconsistent approach imposes a binding constraint on businesses, scatters the information here and there, and fails to ensure its privacy. It should be noted that attempts have been made lately to bolster tax revenues by tightening up on the responsibility for tax evasion as well as utilizing new administrative methods and forced control institutions. Yet, most of these measures are short-term and ineffective from a macroeconomic point of view.

The introduction of a uniform information system would allow to curtail government interference in private business activity and implement a major and long overdue tax reform. It is worth mentioning that **two years ago LFMI brought forward a proposal to unify the tax collection mechanisms of the tax inspectorate and the state social insurance fund. This measure, which will allow to trim government, provoked intense public debates and is now close to being implemented.** During the reporting period, **LFMI worked out a project proposal for rebuilding the information system, another major step towards a limited and efficient government, as well as an essential prerequisite for the introduction of an effective, reliable and economically viable tax system.** In the proposal LFMI set out two main alternatives of rebuilding the information system, indicating the implications and advantages of each of them. The proposal also specified the main functions of the information system and the prospects of its implementation.

The reform proposal was presented to the prime minister and Finance Ministry officials, as well as published in the Lithuanian issue of the LFMI's newsletter, *The Free Market*, No 3, 1997. It is planned to be included in No 3 of the English issue too. To highlight the reform need, LFMI's expert Guoda Steponavičienė authored an article "Alternatives of Tax Administration: Stick or Computer?" in the largest Lithuanian daily *Lietuvos rytas*, April 21. **As a result of LFMI's policy advocacy and media campaigns, the government has taken concrete steps to initiate a project on rebuilding the information system.**

(d) Budget Reform

Over the last years LFMI has extensively promoted budgetary reform in its policy advocacy campaigns and a number of press and other media appearances. At the request of the prime minister, during the reporting period LFMI evaluated and proposed amendments to the Law on Budget Structure. At a meeting with the prime minister, Leontjeva called for a massive reform of budgetary policy but also discussed a “milder” reform alternative consisting of the introduction of new principles by way of a government resolution. To that end, LFMI submitted to the government a policy paper proposing principles of and procedures for projecting the 1998 state budget expenditures. The recommendations drew on the conceptual provisions of the LFMI’s budget policy reform proposal of late 1996.

(e) Fiscal Decentralization

During the previous reporting period, LFMI prepared a policy reform proposal on local government reform, including exhaustive recommendations concerning the responsibility assignment between tiers of government, transfer of state-owned property to municipalities, privatization of municipal functions and assets, and application of tenders in municipal service delivery. LFMI also set forth two alternatives of financing municipal functions, measures to implement them, and relevant policy implications. The policy proposal was submitted to Prime Minister Vagnorius, the Ministry of Administrative Reform and Municipal Affairs, the Finance Ministry, the corresponding parliamentary committee, the budget and finance committee, parliamentary factions, and the Lithuanian Local Government Association. **This initiative drew the policy community’s attention to fiscal decentralization issues and contributed to better informed debates. To support these efforts, the Local Government Association published LFMI’s recommendations in its newsletter *Savivaldybiu Zinios*, May 22, 1997.**

LFMI’s Legal Expert Šimašius and Policy Analyst Brogienė participated in a policy-drafting group of the Ministry of Administrative Reform and Local Government on a draft law on local government financing. The LFMI’s experts took part in formulating conceptual provisions of the law and submitted proposals concerning the principles of and procedures for financing local budgets.

Financial Infrastructure

(a) Finance and Credit

The parliamentary Budget and Finance Committee instructed the government to submit proposals concerning the creation of a conceptual framework for Lithuania’s financial and credit system. To that end, the committee provided an inventory of issues to be addressed in developing the conception. The government set up a policy-drafting group to draw conceptual provisions, enrolling in it, among a number of government officials, LFMI’s Policy Analyst Audronė Morkūnienė.

During the first meeting of the working group on April 23, each member was delegated with a task of preparing relevant materials from his or her field and general proposals for the creation of the conception. In response to that, Morkūnienė submitted to the group an

overview of operational principles of pension funds as well as fundamental provisions of the bill on private pension funds. Subsequent meetings of the working group showed that it lacked a clear-cut vision of the object and purpose of the conception. **Recognizing the importance of the financial and credit system for the country's economy and seeking informed and constructive work of the policy-drafting group, LFMI drew recommendations for the structure, object, content, principles, and implementation methods of the conception in question. The policy paper was disseminated among the group members, high-ranking government executives, and the working group on the pension fund bill.**

In commenting on the topic areas listed by the Budget and Finance Committee, LFMI recommended that the conception address the issues of public finance, an area in which the state plays an extraordinary role and which has a major effect on the country's economy. According to LFMI, the conception should encompass the following areas:

1. Operational principles of a central bank as currency issuer.
2. Operational principles of financial institutions and intermediaries, including
 - a) operational and security principles of the banking system and credit institutions (including supervisory principles and forms);
 - b) capital market infrastructure (including the National Stock Exchange, the Securities Commission, investment funds, financial brokerage firms, pension funds, etc.); and
 - c) operational principles of other intermediaries (insurance companies).
3. Principles of public finance, including
 - a) principles of state budget formation (on the expenditure side);
 - b) principles of budget formation (on the revenue side) and taxation;
 - c) principles of local budget formation; and
 - d) principles of public borrowing and responsibility assumption.

LFMI's policy paper set out the aims of creating the conceptual framework for the financial and credit system as follows:

- to define the government stand on the development of the Lithuanian financial and credit system;
- to define the role of the government in the development of the system (through ownership relationships and regulations); and
- to define ways and methods of implementing the conception.

LFMI urged to renounce government involvement in areas not related to the administration of public functions.

(b) Private Pension Insurance

At the suggestion of the World Bank, the Social Security and Labor Ministry launched work on a new draft law on pension funds, delegating the task to a newly formed working group. LFMI's Policy Analyst Audronė Morkūnienė was invited to be a member of group. After a series of meetings, the working group worked out a new conceptual framework for private pension insurance, which, according to LFMI, comprised a number of inadequacies and fallacies. During the policy-drafting process, which consisted of close to 20 meetings, LFMI took concerted effort to advocate sound and viable principles of private pension

insurance, a maximum reliance on the market, extensive investment in wide-ranging financial instruments, and internal risk control mechanisms as the cornerstones of a credible and sustainable operation of pension funds. LFMI promoted fully-funded pension insurance based on a defined-contributions scheme as well as two types of pension funds, cooperatives and joint stock companies.

The conceptual provisions of the law were submitted to the June 4 cabinet meeting. It should be noted that it was the first time that, rather than analyzing the technical text of law, the cabinet had debated conceptual principles and fundamental provisions of a policy issue, a practice proposed to the government by LFMI earlier this year. LFMI had argued that consideration of concepts rather than technical legal statements was much more efficient since it did not allow to conceal the inability to understand the essence behind empty words, as is often the case with laws.

After a close consideration, **the administration endorsed two types of pension funds, cooperatives and profit-seeking joint stock companies, an idea proposed by LFMI over a year ago, and supported a system of pension fund organization based on clear-cut principles of ownership and interests.** The Vagnorius administration instructed the lawmakers to set out clear property relationships in private pension provision, eligibility criteria for pension benefits, and explicit insurance principles that would govern the disbursement of pension benefits. According to the prime minister, the law must ensure that pension fund assets be used only for accumulating pension contributions and providing retirement benefits. **It should be noted that the opinions voiced by cabinet members were largely based on LFMI's proposals, which shows that the institute's public relations campaign has had a profound impact on the policy-making process.**

The same cabinet meeting adopted a major decision to set the upper earnings limit on the employer's 30 percent share of social security contributions at 3 or 3.5 times the average salary from the autumn of 1997, a measure that LFMI had been advocating over the last years, stressing that it would lower the tax burden for the work force and reduce incentives to hide real wages.

At the request of the parliamentary Social Security Committee, LFMI drew a record of major events in the policy drafting process on private pension insurance and an overview of worldwide experience in pension fund investment.

Following the international seminar "Private Pension Funds: Laying the Foundations", held by LFMI in March 1997, LFMI produced a policy paper delineating resolutions of the seminar and recommendations for further action steps in building viable foundations for private pension funds. The recommendations had been formulated by the seminar's round table. **The policy proposal was submitted to parliamentary committees, ministries, the Securities Commission, the Board for Insurance Affairs, and other relevant institutions, helping to create a consistent action plan for pension reform in Lithuania.**

LFMI received some feedback from the participants of the seminar on the seminar resolutions and policy recommendations. Prof. Antal Deutsch of McGill University said the following about the pension system proposed by LFMI: "A clear and easily administered system—a system under which the interests of all participants would coincide

with the central objective to provide for retirement—is the best way to guarantee pension obligations”.

LFMI gave a broad coverage of the event in its newsletter *The Free Market*. An overview of the seminar and brief summaries of the seminar papers were published in No 2 of the Lithuanian and English issues of the newsletter. No 3 of the Lithuanian issue published the resolutions and policy recommendations formulated at the seminar’s round table.

LFMI’s Policy Analyst Morkūnienė participated in, and delivered papers to, a range of domestic and international events relating to social security issues, including

- an Eurofaculty conference “Comparative Economic Transformation Experiences”, Riga, April 17-20;
- an ASRC seminar “Pension System Models”, Warsaw, April 26;
- a Social Security and Labor Ministry seminar “EU and Social Security Requirements”, Vilnius, April 10;
- a UNDP and World Bank seminar “Monitoring and Evaluating Social Policy”, Vilnius, April 22-25.

(c) Capital Market

Leontjeva and Morkūnienė delivered papers to a major international conference “Lithuanian Capital Market and Investment Opportunities”, staged by the National Stock Exchange and Lithuanian Investment Agency on May 15-16. Leontjeva read a paper “Privatization and Prospects for Private Sector Development”. Morkūnienė’s presentation was entitled “The Rise of Pension Funds as Institutional Investors”. During the conference Leontjeva was interviewed for a news program of the Lithuanian Television, and Morkūnienė commented on pension fund issues for *The Baltic Times* (“Pensioners Just Wanna Have Funds”, May 30).

Private Enterprise

(a) Setting up and running business

Unfavorable conditions for starting and operating a business, which lately have caused a considerable decline in the number of private enterprises, prompted the government to draw a law on small and medium-size businesses that would provide for “additional measures to improve the business climate”. Having evaluated the bill, LFMI concluded that it brought forth preferential tax treatment and other benefits for SME, failing to remove major obstacles to starting and operating private business activity.

LFMI’s Vice-President Trumpa and Legal Expert Šimašius submitted a policy paper to and testified before the parliamentary Economic Committee against the bill. It was stressed that all business are shackled by the existing barriers to market entry and operational difficulties, such as complex registration procedures, unnecessary and unwise licensing requirements, high tax rates, and petty business regulations. In view of the whole range of business constraints and unnecessary regulations, legalization of preferential conditions for selected businesses—a measure immoral from the taxpayer perspective—

would fail to further business development. It would only force businesses to split into suboptimal sizes to become eligible for tax breaks as well as bolster bureaucracy and corruption. LFMI's experts pointed out that tax breaks granted to selected interest groups without reducing public spending would place an additional burden on all taxpayers. In addition to outlining major fallacies and potential consequences of the bill, the policy paper proposed a new approach to addressing business problems—by improving conditions for all enterprises.

The LFMI's members emphasized that the provisions of the bill were not consistent with Lithuania's transition to a free market economy and commitment to building favorable and equal conditions for private businesses, fostering fair competition and taxation, reducing government intervention in economic affairs, and fighting corruption. LFMI's compelling and accurate arguments gained support of the committee, leading to the declining of the bill and returning it to the Economic Ministry for reconsideration. LFMI's position on the bill and Simasius' interview were featured in the *May 5 Lietuvos rytas* ("Assisting Businesses by Providing Equal Conditions").

(b) Bankruptcy

At the request of Government Chancellor Čilinskas, LFMI evaluated a draft law on bankruptcy and submitted comments and proposed amendments concerning the application of the law on legal entities, the right to file bankruptcy suits, the circumstances of instituting bankruptcy proceedings, the appointment of temporary administrators, and the order of satisfying creditors' claims. LFMI expressed approval of the bill's new criteria for determining insolvency and legalization of restructuring as a rehabilitation measure.

LFMI's President Leontjeva delivered a paper to a World Bank seminar "Restructuring of the Public Sector", Vilnius, June 25. LFMI's Senior Policy Analyst Vainienė participated in the seminar as a discussant.

Monetary Policy

In late 1996 the government adopted a program designed to phase out the currency board and restore the functions of a classical central bank. It is a common belief that a central bank as an independent institution can best represent public interests by means of monetary interventions. LFMI believes that a consistent monetary policy of a central bank is an essential prerequisite and guarantee of commercial banks' safety, strong currency, and sustained economic growth. A central bank exerts a profound influence on interest rates, regulates money supply, and acts as a lender of last resort. Often times, however, central bank actions fail to achieve desired results and entail grave consequences for economy. Yet, no one, save the bank itself, keeps track of, and analyses, its interventions, therefore the link between central bank actions and economic tribulations remains obscure.

LFMI has launched a new Central Bank Policies Monitoring Program, which is designed to keep track of all central bank interventions and analyze them in terms of their expediency, efficiency and consequences. LFMI will work openly and comment on how central bank measures meet the objectives of stable currency, banks' safety, and

economic growth. LFMI will continue to advocate automatic currency issue and nondiscretionary monetary policy as crucial factors of the country's transition to a market economy. LFMI will press for legal amendments to relevant laws that would ensure sound and transparent monetary policy. Regular public campaigns will be launched to demonstrate the aims of central bank interventions and their implications for the country's economy. Drawing on collected data, LFMI will develop analytical material setting out exhaustive conclusions on the central bank's monetary policy.

Other Economic Reform Areas

(a) Government Program

During the reporting period, LFMI analyzed a document of proposed steps and measures for the implementation of the 1997-2000 government program. In a policy paper submitted to the cabinet, LFMI highlighted the measures that would be likely to produce adverse effects on the country's economy and proposed alternative ways to achieve economic liberalization. The LFMI's policy proposal addressed the issues relating to budgetary policy, taxation, banking and monetary policy, business assistance programs, investment and export policy, and corruption. LFMI's President Leontjeva testified before the May 4 cabinet meeting on the program in question. Specifically, Leontjeva urged the government to promote economic growth by means of economic deregulation and clear-cut, permanent and equal rules, to eliminate special assistance and subsidy programs for separate interest groups, to identify and remove barriers to business development, to curtail government involvement in economic affairs and focus on improving relevant legislation. **As a result, the government incorporated in the program its commitment to "applying equal tax treatment to all economic entities and products", a statement that will help LFMI bring pressure to bear on decision makers in promoting free-market oriented reforms.**

On June 16 Leontjeva testified before the prime minister on corporate income tax, tax administration, SME, local government, budget reform, and pension reform. A consensus was reached on a number of issues addressed. **The prime minister requested LFMI to propose new principles for redesigning the tax system and legal amendments necessary in launching budget reform. The prime minister also encouraged LFMI to continue the initiated analysis on the creation of a uniform information system for tax administration.**

(b) Management and Use of State and Municipal Property

In view of the importance of the draft law on management and use of state and municipal property, LFMI evaluated it and submitted policy proposals to remove the weaknesses in the law and include alternative amendments.

(c) Government Borrowing

LFMI's President Leontjeva was appointed a member of a working group under the European Affairs Minister responsible for developing guidelines for government borrowing. **The policy group shared a number of proposals and ideas voiced by Leontjeva and aimed at phasing out government borrowing, As a result, a bulk of them was**

incorporated in the policy paper. Subsequently, a government resolution was drafted for the purpose of implementing the decisions adopted by the working group.

OUTREACH

The project activities undertaken during the reporting period generated an extensive coverage of LFMI in mass media, including 26 appearances in print media and eight on radio and television. The print media coverage consisted of eight articles authored by LFMI's staff members, four interviews and 14 published opinions of LFMI's policy analysts.

During the quarter LFMI published two Lithuanian issues (No. 2 and 3) and two English issues (No. 1 and 2) of the newsletter *The Free Market*.

OTHER EVENTS

- Leontjeva delivered a lecture to MA students of economics at Klaipeda University, June 21.
- Leontjeva delivered a presentation on taxes and budgetary policy for the Liberal Youth of Lithuania.
- Leontjeva attended the 29th International Workshop of the Atlas Economic Research Foundation in Herndon, Virginia, USA On April 29 through May 1.
- Morkūnienė spoke to an Eurofaculty conference in Riga “Comparative Economic Transformation Experiences”, April 17-20.
- Leontjeva delivered a paper to a conference “Problems and Prospects of Innovative Activity in Central and East European Countries”, staged by the Innovation Center of Kaunas Technical University, and moderated a panel “Sustainability and Continuity of SME Support Programs and Policies”, Kaunas, June 7.
- Leontjeva spoke to a seminar of the Ministry of Foreign Affairs “Trade Policy: Worldwide Experience and Lessons for Lithuania”, May 13.
- LFMI's Vice President Ugnius Trumpa attended a PRO BALTICA FORUM conference “Baltic Sea Region and the European Union—the Baltic States and Poland: Progress Towards the European Union”, Riga, May 22-23.
- Trumpa spoke to a conference “The Baltic States' Integration into the European Union” on Lithuania's transformation, Tallinn, June 9-10.



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USAID/CDIE/D
Washington, DC 20523-1802
US
Date: August 1, 1997

Dear Sir/Madam,

Enclosed please find a narrative progress report on the implementation of the LFMI/USAID project, Award No. 181-0023-A-00-6322. The period covered by the report is April through June 1997.

Yours sincerely,

Aneta Lomovska
Project Manager

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