Does the West Know Best?

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Martin Bruncko, Gabriel Calzada, Christofer Fjellner, Andrei Grecu, Johan Hjertqvist, Pavel Hrobon, Philippe Manière, Miroslav Mikolasik, Dan Mitchell, Johnny Munkhammar, Stephen O'Connor, Matus Petrik, Ugnius Trumpa

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Stephen O'Connor is a Washington DC-based publishing executive and former eastern European publishing entrepreneur. In 1992 he helped launch the uniquely independent English-language weekly *Budapest Business Journal*, and in 1993 led a management buy-out of the title. In 1994 he moved to Poland, where he was instrumental in the launch of the *Warsaw Business Journal* and several other business and consumer titles. In 1995 his group launched *The Prague Business Journal* in the Czech Republic (now named *Czech Business Weekly*) and in

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Introduction

Terence O'Dwyer

When ten new member states joined the European Union in May 2004 they not only turned the EU into the world's biggest market, but the accession of these central and eastern European countries also provided the necessary impetus for a fundamental re-evaluation of the EU's economic and social model. In the twelve months since accession, the original fifteen have witnessed at closer hand the tremendous social and economic reforms that have taken place in the eastern states. Will they finally have to sit up and take action?

In February 2005 the Stockholm Network and the Centre for New Europe collaborated to bring together some of the leading experts from eastern and western Europe to attempt to reach an answer to the question, does the West know best? Our authors reached a unanimous and unequivocal answer: the West does not know best at all, and would do well to learn from its neighbours in the East.

This set of speeches, based on the aforementioned proceedings, aims to ascertain what, if anything, can be learned from eastern European reforms in the fields of health and social security, tax, competition and regulation, and the labour market. Could the introduction of market mechanisms in the provision of healthcare really have solved the problem of an ageing population in Slovakia, as Martin Bruncko argues? Or is it the case that reform along market-oriented lines has in fact not yet gone far enough, as Matus Petrik claims? Is the European social model doomed, as Johnny Munkhammar suggests? If so, what action must be taken? Is western Europe ready for the introduction of flat taxes? These questions and more are addressed in this volume.

All those with an interest in the future direction of Europe would do well to pay heed to the analysis and conclusions set forth in this volume. For if one thing is made clear here it is that, as Pavel Hrobon argues, the West can learn from the demonstration that radical reform is possible and that it can have extremely positive results for economic growth and prosperity. Let us hope that politicians nationally and at EU level will listen.

1

Does the West Know Best?

Martin Bruncko

Let me start by drawing you a picture of what a European country might look like five or ten years from now. Imagine a country where the tax system is very simple and transparent, and where all citizens and companies pay a 19% flat tax rate. Imagine a country without an overly regulated labour market and where the welfare system helps all those in need without removing the incentives for those who are able to work to find a job quickly. Imagine a country with universal health insurance coverage, but where healthcare costs are not ballooning, in spite of an ageing population, because people are provided with a system that motivates them to make the right choices about their healthcare and health providers are actually compelled to be efficient. Imagine a country where all citizens are ensured a decent, secure pension, because they are required to save a set amount from their salaries in their own private pension accounts, and so invest for their retirement.

Perhaps this is how some other countries in Europe could be five or ten years from now – but this is already a reality in Slovakia.

Slovakia has acquired a fairly good reputation for introducing reform. Indeed, the World Bank has called us 'the world's leading reformer', a reputation we have acquired thanks to a series of radical and far-reaching measures conducted over the past two years.

From a technical or economic point of view the reforms are nothing exceptional, with the exception perhaps of the healthcare reforms. They are simply standard economic solutions being put into practice. When you ask an economist what the most efficient, and most economically fair, tax system is, he will tell you that you need a tax system that is simple, transparent and non-distortive.

So the solution is simple. I think the real question is: how do you put it into practice in Europe? How is it possible for a country to undertake all these reforms in such a very brief period of time? Why were these reforms possible in Slovakia, and what does this mean for the rest of Europe?

Crucial to making these reforms possible was the fact that our country emerged after 50 years from a system that simply did not work – a system where public services were failing, where people were paying taxes but were not getting from the state the kind of services they expected. This is not the case in most western European countries. Problems with the healthcare and pension systems are not at present immediately apparent to the average citizen. These are, however, issues that, because of the ageing population, will become very serious in the coming decades.

In Slovakia, as in most of the other central and eastern

European countries, these services were not being provided and the crisis was self-evident. This made it much easier to convince people that something needed to be done.

In the wider European context, the key issue politically is to explain to people that the systems are not working as well as they should be, and that it is certain that without additional reforms many of them will face serious problems in the future.

The second reason why there was radical reform in Slovakia was because we were going through a very long transition process. These reforms were not just introduced out of the blue, but were seen by most citizens as a continuation of the reforms that began some time in 1990 with the transition from a centrally planned to a market economy.

After fifteen years of a very difficult reform process, it is important to recognise the role that was played by the people of Slovakia, who were willing to accept these sometimes difficult changes. We did experience protests and strikes, but generally they were manageable rather than paralysing.

The third and perhaps most important factor was the political courage of particular individuals. Even now our deputy prime minister and prime minister are facing the spectre of serious social upheaval. The question was: should we actually go through with the reforms and face all these difficulties? Should we implement reform in the social welfare and pension systems, knowing that people would probably resent us for this, perhaps enough to ensure that the government was not re-elected? Or should we take the easy route? Should we just carry on doing things as usual?

The deputy prime minister, Ivan Mikloš, would probably tell you very frankly that he is a member of what at least in 2004 was the most unpopular government in the history of Slovakia. Yet if you look at the opinion polls in February 2005 – six months after most of these reforms came into force – they changed quite substantially. His government is not actually any less popular than many other governments in the region, in spite of the fact that it passed such far-reaching reforms. It seems likely that the popularity of the government is growing because the reforms are now starting to bear fruit. We have a very high growth rate – above 5%. This trend is expected to continue in the next few years. There are almost daily announcements by large international firms that they will be investing in Slovakia, creating new jobs. It is encouraging that investment is no longer concentrated solely in Bratislava but has been dispersed throughout the country. People have noticed that Slovakia is starting to change. The political decision to implement the reforms is no longer looking so suicidal – there is still over a year until the next elections, time for the benefits to filter down to the general population.

So what does this mean for the rest of the EU? Can Slovakia be used as an example to other member states?

There are several reasons for optimism. The first is simply the issue of competition. As an economist I have to believe that competition is a driving force leading to efficient solutions or outcomes that are a force for good. Competition is something that is visible and it is clear that competition is a factor here. If you have a 19% flat tax rate and a 19% corporate tax rate in one country, and across the border you have another EU country with a 35% corporate tax rate, with the same kind of laws and regulations, this will influence where firms choose to invest. The business environment of many new member states

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is making companies sit up and take notice. It is also making existing member states consider their own framework of regulation and taxation. The other member states are facing competition and are under pressure to reform as well.

Another reason is peer pressure, or what might be called a change of collective spirit. For example, in ECOFIN meetings, instead of there being fifteen people around the table there are now 25, of whom a fairly large proportion represent countries that have carried out really dramatic, dynamic reforms. This really has changed the spirit around the table.

This leads me to the third factor: positive experience. Competition from central and eastern Europe is often portrayed in some of the Western countries as something negative – as part of a zero-sum game. I do not think this is the case. In fact, it is certainly not the case with new member states. We are definitely benefiting. We can see that there are new jobs coming in. There is growth and people are optimistic. If you look at the various indicators of public opinion, they are improving quite dramatically – at least in Slovakia.

We have had these really positive experiences. We have imposed a flat tax system and it was not a disaster – in fact we probably now have a much higher degree of tax compliance. We did not end up with a huge deficit. On the contrary, our revenues are higher than we expected, although our original expectations had to be fairly conservative for reasons of fiscal management.

As for pension reforms, personal accounts are a reality in many new member states where the system is working.

We have also transformed the social system and dramatically deregulated the labour market. The number of people who rely on social welfare, even though their eligibility has not changed in principle, has dropped significantly. If you want to receive a reasonably good income from the social system you have to be active, so this measure is also working. These are just some of the positive examples. There are also signs that we are having a positive impact on the old member states.

Look at Austria, for example. Partly in reaction to our flat tax rate, they have lowered their corporate tax rate to 25%. Nobody is complaining. In fact the only people who are complaining are the Bavarians, because a lot of companies are now starting to move to Austria.

Ultimately, the migration of jobs to new member states will free up the highly skilled labour forces of countries such as Germany and France to perform activities of higher economic value. Most of the investment in new member states is creating semi-skilled and low-skilled work, something that longer-standing, wealthier member states can afford to lose.

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Ageing and Ailing Societies: Health and Social Security Reform

Johan Hjertqvist, Pavel Hrobon, Philippe Manière, Matus Petrik

Johan Hjertqvist

Since the days of the ancient Greeks, healthcare has been described as a ‘problem’. In ten years’ time, technology will have advanced to such an extent that you will be able to grow organs in pigs and transplant them into human beings – but you will not be able to get a doctor to make a house call (at least if you live in Sweden). Eventually everybody will become dissatisfied with healthcare provision unless something radical is done. In Europe alone, the public healthcare systems consume roughly 1,000 billion euros a year and employ 10–12% of the total workforce. But what is this money being spent on? Reform is taking place – there have been over 1,500 major healthcare reforms in the EU over the past fifteen years. Slovakia alone is responsible for a large proportion of them.

Something rather dramatic is happening to public perceptions of healthcare. Healthcare is no longer viewed as an elitist topic but has become part of the wider public policy debate. Now we note more and more open meetings addressing healthcare. People are not willing to wait to take action, and are concerned with viewing the healthcare issue from the perspective of the consumer.

If you search for health on the Internet, the number of matches now outnumbers that for a search for pornography. When health becomes more important than sex something serious is happening to public perceptions!

The intensity of the debate is also creating confusion among casual observers, however. This is because we are moving fairly quickly from a top-down system, which is designed to deliver but does not invite the consumer to take part in the process, to what can be described as a kind of partnership. The new system invites the consumer to take part in the decision-making process. It is only by treating the patient as a customer that we can be successful.

The experiences of the newest EU members are instructive when considering healthcare reform. A number of the new member states – Slovakia, as Martin Bruncko has mentioned, but also others – are in the process of healthcare reform. While every country's experience is different, it is impossible not to notice how the trend is generally to do away with the old tax-funded systems. Evidently the state-run, state-funded models of the UK and Sweden are not very attractive any more. What seems to work better is a system of fairly independent social security systems.

After an initially difficult period following independence for the former communist states, there is now a tendency to build balanced social markets. By 'social markets' I mean that the consumer is invited to take part in the funding in a much

more active way than takes place in a traditional, socialised, tax-funded system.

Today there is generally good access to pharmaceuticals in the new member countries; in some there has been a tenfold increase in the number of drugs available to patients. This has given the consumer much greater choice.

Many health systems still lack patient rights or consumer opportunities, and measures of quality control, which can lead to disillusion. But this is also the case for many of the established systems in western Europe – including those of France, the UK, Sweden and Germany. It is not simply a matter of technique or system change, but also of adapting to the political culture.

European integration will create much more cross-border mobility. Decisions made by the European Court already actively support the mobility of patients. This will encourage competition in the field of healthcare, as well as impinging on issues such as taxation and employment law.

My organisation, the Health Consumer Powerhouse, has tried to contribute to the debate by building benchmarking systems. In the summer of 2005 we presented to the European Parliament what we call the 'Euro Health Consumer Index', a tool to allow us to start benchmarking the member systems within the Union from the point of view of consumer friendliness.

It is encouraging to note that a number of the new member states have tried to opt for a new balance between an empowered consumer and a viable system by introducing new insurance funding models. When the health consumer becomes more active and obtains more rights, this increased consumer power must be balanced with a responsible attitude towards funding, a balance that must be considered more seriously than it was when the older social systems were created. I see a number of promising examples among the new member systems.

Unemployment was once the big issue in Europe. More recently, taxes supplanted this. I am convinced that tomorrow's big debate will be over the future of healthcare, a make-or-break issue for many governments.

Pavel Hrobon

Before I share with you a couple of facts about the Czech Republic, let me elaborate briefly on a basic question. Why have some new members of the European Union implemented necessary reforms earlier than their western, more developed and more experienced counterparts?

I will offer a complementary view to the experiences of Slovakia, a country that is definitely entitled to set an example to others on this issue. First of all, I do not want to underestimate the personal contributions of all the bright and brave people who stood up for reforms in Estonia, Slovakia and elsewhere, but such people do not exist only in those countries. Why is it that they have succeeded here where others have failed? We could also have a very long debate about whether the citizens in the former communist countries are more or less used to generous welfare systems, and whether they have adapted to change as part of their everyday lives since 1989.

In actual fact, in most cases the countries of eastern Europe initially copied the generous welfare systems common in the West, but found that they did not have sufficiently deep pockets to fund them. The individual irresponsibility that these systems

incorporate, in combination with less efficient public institutions than in the West, is actually bringing our welfare systems close to bankruptcy, even before the effects of an ageing population are fully felt.

The drying-up of public money and the consequent rise in demand for reform among important stakeholders were among the most important reasons behind my decision to help found the think tank healthreform.cz, and why we believe we will be able to implement at least some of our proposals.

Let me share with you a couple of facts about the situation in the Czech Republic. We have a very generous, old-fashioned social security system. There are pensions, fully financed on a pay-as-you-go basis. Our health services are financed through mandatory insurance paid as a percentage of income. But the current left-of-centre government is doing nothing to change the situation.

Coupled with this, we also expect to feel the first impact of population ageing as the post-war generation starts to retire. In the long run, we expect the proportion of people over 65 years of age to increase from 17% of the population today to 43% by 2050. We have modelled the impact of this on healthcare costs and on the contribution rate. Were we to have the projected demographic structure of 2050 today, healthcare costs would jump by 30% – a rise caused solely by the ageing of the population, never mind the development of medical technologies and the increase in expectations of consumers.

If you combine this with the diminishing tax base, you find that the rate of health insurance contributions will more than double from an already high 13.5% of gross salary today. Clearly, substantial reform is needed.

Our goals are to keep general access to necessary health services for the whole population but, at the same time, to provide citizens with incentives for reasonable care consumption, and to change the whole system from one that is provider-centred to one that is consumer-centred.

We believe that there are two solutions to the problem. One is reform of financing. The second is reform of our institutions.

In terms of reform of financing, we plan to reduce the scope of mandatory insurance and to introduce individual health accounts to combine public and private contributions. The money saved on these accounts could be used either to buy supplementary insurance or to pay directly for healthcare not covered by mandatory insurance. We want to leave citizens with a choice. Also, gradually, we would like to turn the individual health accounts into savings instruments.

An equally important measure is reform of institutions. We strongly believe that it is necessary to change the legal statutes of health insurers and healthcare providers with the aim of setting clear roles and bringing clear motivation and transparency into these institutions. We believe that it is necessary to turn most of them into for-profit institutions to create a real market in healthcare provision and health insurance.

Second, we very much want to turn health insurers into real purchasers of care, leading to contractual freedom. The most important thing is to transform the current, very stagnant, health service market into a competitive and vibrant one.

If we achieve this, through institutional reforms very similar to those already carried out in Slovakia, what lessons are there for the West?

The first is the value of practical experience. Countries

should be cooperating to find new approaches to healthcare. The basic challenges and principal solutions are the same for all European countries. Since, as with all reforms, not everything will go as well as planned, the mistakes made in the design and implementation of reform in the East will provide valuable lessons for western European countries contemplating reform.

The second point (and I would like to thank Slovakia here for setting the example) is actually to stand up and demonstrate that it is possible to carry out substantial reform successfully – even in the area of healthcare, which has long been treated as a sacred cow of government activity.

Philippe Manière

The healthcare system in France is bankrupt. The interesting and surprising thing is that it has been bankrupt for many, many years, something that would not make sense in most countries – but it does in France. In France, apparently, you can have something that is bankrupt and yet which lasts. So the question is: why?

The system is indeed bankrupt. We run a deficit of several billion euros, very often several tens of billions of euros, in our health system every year. The system is very complex and extremely unjust. Several million French people are completely exempt from paying anything, while on the other hand many people – and it is impossible to know why one belongs to one category or the other – are unable to establish to what extent they will be covered by the official public healthcare system. It is possible to consult a doctor and be pleasantly surprised to discover that you owe him nothing. Sometimes – for example, in maternity – what you have to pay is truly astonishing. One is left completely confused by the irrationality of the system. Officially, most people will not pay at all because most French people have a card that exempts them from payment – either when they consult a doctor or when they go to the pharmacist to buy prescription drugs.

Another peculiarity of the system is that, as someone living in France – and this applies not just to French citizens, but to everybody living in France – you have a right to consult as many doctors as you want and not pay for it, which of course creates a lot of problems. These problems are not only financial. For example, many people who have nothing better to do consult as many as ten doctors simply because it is very interesting to have a conversation with well-educated people. Everybody likes it. There is no limit. Why not consult a doctor every time you get bored? In this way a lot of people simply go to the doctor as they used to go to see the vicar a hundred years ago. Of course, we pay for this, but the majority of the French people are not conscious of this fact.

I could continue to describe the system for a very long time, but let me just mention one last bizarre dimension: the French system is based on what we call a partnership between employers and unions. Officially, the healthcare system is managed by union representatives and an organisation called MEDEF, the major employers' organisation. Of course, the system does not work, and would not be operational at all if MEDEF were not completely circumvented over any decision they pretend to make. The potential for catastrophe is obvious. It is not very surprising, because the whole system is designed in such a manner that the catastrophe was bound to happen.

What surprises me most is the fact that the catastrophe took so long to occur.

There is also a great degree of lobbying by doctors. A peculiarity in France is that doctors lobby the government based on what they call the principle of '*médecine libérale*' – liberal medicine. They want the right to receive as many patients as they want, and they have an incentive to do so, because each time they receive a patient they also receive funds. On the other hand, there are patients who are getting unlimited funds, because whatever they do it is officially covered. In principle, a system like this should have collapsed much sooner. The miracle is that it has been declining for only ten years.

The need for change is obvious, so why are we so reluctant to carry out reform? Well, there is a belief in France that bad news and unemployment are inextricably connected, and that everything can be explained by this fact. Many people in France, and many politicians I know personally, are absolutely convinced that this system that was so wonderful 50 years ago would work again if only we were able to reduce unemployment.

Of course, any economist looking at the figures could tell these people that one of the reasons we have unemployment is the fact that we have very high taxes, especially taxes on salaries. Labour therefore becomes less desirable, seen from the employer's point of view. But this is something that most politicians do not understand very well.

The second reason, which is much more important, is the fact that the system was created in 1946/47, at a time when everything was being redesigned on a new basis and on noble principles – principles that were enshrined in the constitution. Few people know it, but the present French constitution, which was created in 1958, makes direct reference to the preamble of the constitution created in 1946. In this preamble we had rights to everything – a right to health, a right to a place to live, a right to work, and so on.

The constitution created a kind of myth, and it generated great expectations. In France there is a collective feeling that the founding fathers were very wise, and what they designed was extraordinarily noble. If there is one thing that simply cannot be done, it is abolishing the system they created. France believes that it is a beacon of light for the world to follow. Thus, it cannot just decide that its principles are to be redesigned. It would be political suicide to promise to eradicate the principles and commitments enshrined in the constitution.

France is not alone in refusing to reform its decrepit system. In the rest of old Europe, even if it is not enshrined in any constitution in such a ridiculous manner, there is a belief that the system is based on noble principles, which should not of course be laughed at, and to which people should always be faithful.

The irony is that what we are doing is creating a kind of society that is profoundly unequal and profoundly unfair, but based on very noble principles. The big problem we have, not only in France but across the rest of old Europe, is to make the public conscious of this fact. We need to realise that we have no choice but to change these principles because they just do not work. Principles that are not applied on a day-to-day basis are worthless.

The final reason why we refuse to change, and perhaps the most important, is what I call the 'age of capital'. Many ministers and cabinet members in France are fully aware of what we are

saying and would like to change things. When you ask them why they do not do so, they point to the president. This person, who began his career in the sixties, lived the greater part of his life in a system that was working by virtue of a miracle (because of economic growth, because of reconstruction, and so on and so forth), and is hence not very keen to change things. We have a problem not only with myths and legends, and so on, but also with the person who is in charge of changing things if they do not work, who is too old to realise that he should reform.

The rest of the population is also part of the reason, simply because it is an ageing population, and it is very difficult to implement change among older people. It is very difficult to tell them that bankruptcy looms, and that they must adjust to reality. The truly awful thing is that with each healthcare reform we pass on the cost to our children.

One small message of hope comes from Alsace, the most eastern region of France, very close to Germany. As a result of the fact that it was occupied by the Germans for four years, Alsace has a completely different system, based much more on competition, with better governance and much better management; nothing is for free. There is almost a system of gatekeeping – no capitation is involved, but they are not too far from it. And of course it works, being better financially balanced than the system in the rest of France.

So to conclude, in France it seems that East knows best. Perhaps we should undertake some benchmarking using this example – a workable exception to the rest of the failing French system.

Matus Petrik

It is almost unbelievable that, only fifteen years after the fall of communism, we are able to discuss topics such as the East's positive influence on the West. I am not quite sure whether this is more a result of the sorry state of public affairs in western Europe, or the supposedly splendid achievements of the free market reforms in eastern Europe that are currently under way. I am afraid it is more the case of the former than the latter.

As much as I welcome the incentives such discussions bring to western European public life, and the pressure they help to create on western European politicians, coming from eastern Europe I am naturally more concerned about the sense of complacency that is spreading around the region.

I hate to spoil the party, but my understanding and perception of Slovakia's reforms is a lot bleaker than those of my co-authors. A case in point would be the much-celebrated flat tax reform. Everybody boasts about the decrease in corporate income tax, the elimination of progressive income taxation and the creation of a 19% flat rate income tax, but the other side of the coin is that actually the biggest tenet of the whole reform was not the decrease in taxes but its fiscal neutrality.

Tax reforms do not necessarily mean a decrease in tax revenues. In fact the opposite can be true. The decrease in tax revenues stemming from the reduction in income tax is more than offset by the increase in Value Added Tax, consumption taxes and the like. Elimination of tax exemptions effectively means that people have less money in their pockets, to spend in accordance with their wishes and in pursuit of their needs. So I would not quite call it a liberal tax reform, even

though some aspects of it are definitely positive.

Moving to the other reforms, such as the pension reforms that are just being introduced in Slovakia, we all can acknowledge that the previous pay-as-you-go system was, as in any other country, a mess. This was especially the case because benefits were calculated on a nonsensical basis, taking into consideration only the last ten years of a person's income; out of those ten years, the five highest-earning years were then used as the basis for the calculation of pension entitlements. This was clearly absurd, and led people to hide their incomes prior to this relevant time period, and then to inflate them at the end, so as to hitch a free ride on the scheme.

As part of the reform of the pay-as-you-go system, this absurdity was eliminated and a more contribution-based system introduced, taking into consideration all previous earnings. The ceilings on pension entitlements were removed, or raised – in my view the next-best solution after the total abolition of the pay-as-you-go system.

The current system is similar to a three-pillar system, but it is too early to assess its impact on future pension entitlements since the process has only just started. But there are several aspects of the reform that remain unresolved and may become a potential liability in the future. One such problem is that there is no clear idea of how the shortfall in financing the pay-as-you-go entitlements, which actually increased as a result of the reform, will be overcome. A lot of the funds will be directed as contributions to the capitalisation pillar, and it is known that the government's plans for making these up can last for only ten years. These funds are coming from privatisation revenues, which are one-time revenues.

We do not know how the rest will be financed – whether by increasing taxes, increasing state debt or via an increase in pension contributions. All these alternatives will have radically different impacts on the outcome of the reform – and on the actual impact of the reform on the population. We cannot even say who the winners and losers will be in the long run.

Another problem associated with the capitalisation pillar is that it does not really address the problem it is supposed to tackle – the adverse effects of demography, and in particular the ageing population. Even the revenues from the capitalisation pillar will be financed from the sale of securities or stocks, which will have to be bought by the productive sector of the population. But these people form a shrinking pool, which will bring down prices and hence potential revenues from the capitalisation pillar.

The introduction of the capitalisation pillar is also quite an expensive enterprise. Hitherto pension fund companies' fee rates have been set at an artificially low rate, and these will eventually have to be increased, because the present system is unsustainable. This will also bring potential liabilities and decreases in the revenues of the capitalisation pillar.

There are also very strict rules concerning investment for the pension fund companies, because of recent defaulting experiences. These will decrease the actual investment yields for these companies. For example, pension funds must invest at least 30% of their revenues in Slovakian stocks and securities, an incredibly high amount given the very small size of the Slovak stock market.

The concept of benchmarking has been introduced, leading to minimum requirements for investment yields as measured

by the average investment yields of other companies in the business. If these are not met the shortfall has to be made up out of the companies' own funds. This eliminates competition because companies working under these strict rules cannot distinguish themselves in the potential competition for customers.

Again, it is too early to assess the potential success of the pension reform, but as it is conceived now, and as it stands in law, it will still have to deal with a lot of unresolved issues and potential problems in the future.

From a liberal point of view, there remains a further, basic problem: the impossibility of opting out of the system. You have to take part in the mandatory savings scheme, which contradicts the wider rhetoric about bringing more freedom and responsibility for their own destiny to the people of Slovakia.

A better case for free market reforms in Slovakia is the case of the recently introduced healthcare reform. The acts were passed in the autumn of 2004 and the reforms are under way right now.

The previous healthcare system in Slovakia was a sorry state of affairs. Costs were rising annually by half a per cent of GDP, which is a very high figure, resulting in mounting debt and a vicious circle of inefficiency and no incentives. The very first step that the government undertook upon entering office was to introduce obligatory payments for each visit to the doctor and for the issuance of drug prescriptions. The payments were only 50 cents, which is minimal, even by Slovak standards. But they contributed to the notable result of helping to balance costs and revenues in running the healthcare system.

The biggest fight over healthcare reform in Slovakia was over the issue of direct payments for the provision of healthcare services. In Slovakia there is a constitutional requirement that healthcare be free, based on the public health insurance scheme. So the constitutional court got around the issue by declaring that the payment was actually payment for services related to the provision of healthcare services. I have to warn my Czech friends that the most emotional debate among politicians centred around slogans such as 'Is health for sale? Is it not too important to be left to the free market?'

I would say that, subsequent to reform, the supply side of the healthcare system is in much better shape than the demand side. As a result of the reforms a form of partnership running both healthcare provision services and health insurance was introduced. It could be adapted so that companies would be able to make a profit, even though there are problems associated with this. For example, health insurance companies were not allowed to buy stakes in or enter the business of provision of healthcare services, which, if permitted, would bring about greater efficiency. But the market will find a way to make this happen indirectly.

The problem is more on the demand side. The scope of healthcare services to be provided under the public health insurance scheme is prescribed by law – there is a list of all the diseases that will be covered by the scheme, regardless of the contributions made to the system by the insured persons, their risk classification, and so on. So I suspect that the Slovak system will retain the problem of moral hazard, which reform was supposed to remove. Financial sustainability of the whole system will not be achieved, but at least it has embarked on a humble step in the right direction.

3

Taxing Times: Tax, Competition and Regulation

Dan Mitchell, Andrei Grecu, Ugnius Trumpa, Stephen O'Connor

Dan Mitchell

Tax competition and tax reform are tools for Europe's salvation. In effect, they are a way to save Europe from itself – especially old Europe.

We should define what these terms mean so we know what we are talking about.

Tax competition is the ability of labour and capital to benefit from better tax systems by crossing national borders and the resulting pressure this puts on governments to implement better policy. A suitable analogy is that of petrol stations. If there is only one petrol station in a town, that station can charge high prices, can offer shoddy service and can operate inconvenient hours. But if there are five petrol stations in town, then all of a sudden the consumer is king, and the consumer can choose which petrol station he wants to use, based on a whole different range of factors he cares about – service, hours, prices. The petrol station owners have to start competing; they have to start ascertaining what the consumer wants and what the most efficient approaches are.

We want the same thing to exist with governments. For too long governments have acted like monopolies. Their so-called customers, taxpayers, are treated as if they were fatted calves waiting for slaughter. Politicians should be afraid that taxpayers are no longer a captive audience and that the goose that lays the golden eggs can fly away.

Tax competition is good because it leads to lower tax rates and to less double taxation. Why do we think that lower tax rates are a good idea? Why do we think that removing the various forms of double taxation and the penalties on capital are a good idea?

We think that these outcomes are good in part because of empirical observation. We see that the US has a lower tax burden than Europe, and that the US economy has grown a lot faster. We see that, even inside the European Union, countries that have lower tax rates, like Ireland, grow faster than countries that do not. We see countries like Hong Kong, which have had low rate flat taxes for a long time, and we understand that they have grown so much faster. There is now a wealth of evidence in the academic community on the importance of lower tax rates. Indeed, we are almost at the point where I think we can say that there is a consensus among public finance economists in favour of lower tax rates and a better structure of tax system – so that savings and investment are not being double-taxed. Even politicians from some of the left-of-centre parties say, 'Yes, in theory it is a good idea,' which is a remarkable development.

It is not just a question of lower tax rates and a better tax system. It is also the case that tax competition is very good

for reasons of sovereignty. Estonia should be able to tell the Germans to go jump in the lake when they are talking about corporate tax harmonisation. I also think the Swiss should be able to tell Brussels to go jump in the lake when they are trying to destroy financial privacy.

Tax competition is, perhaps, even more important in terms of individual sovereignty. An individual taxpayer should be able to escape, or at least be able to put their capital out of the reach of a government that is being fiscally oppressive. Jurisdictional competition also plays a very important role in pension issues, healthcare issues and regulatory issues, and, for the same reason that tax competition is desirable, competition in all these other fields of government policy is desirable.

I always cite three examples that demonstrate why it is a good thing. I cite the Thatcher and Reagan income tax rate reductions, because not only did Thatcher and Reagan turn their economies around by dramatically lowering personal income tax rates, but they also forced just about every other developed nation in the world to do the same thing. I can assure you there are no Ronald Reagans and Margaret Thatchers in most of the other countries that had to mimic these reforms. They did it because they felt they were compelled by what was happening in the US and the UK.

Another example, perhaps even more powerful, is what happened when Ireland slashed its corporate tax rate. Ireland, of course, dramatically improved its economy. It went from being the sick man of Europe to being the Celtic tiger. Unemployment dropped from 17% down to 5% and, perhaps more importantly, this had a knock-on effect on the rest of Europe. We have now seen these competitive corporate tax rate reductions in many countries. It has reached the point where corporate rates have come down so much in Europe that every single European nation, even welfare states like France and Sweden, now has a lower corporate tax rate than the US. This, of course, sticks out like a sore thumb, and shows that much work still needs to be done in the US to fix this problem. In general our taxes are lower, but the corporate tax system remains a significant problem.

Last but not least, we have seen flat taxes implemented throughout eastern Europe. Estonia was the first country to institute a flat tax rate, and it was copied by the other Baltic nations. Eventually that affected Russia, and then Ukraine, Romania, Slovakia, Serbia and Georgia all implemented a flat tax system.

What is perhaps more surprising is that there are lower capital taxes in places like Scandinavia – the epicentre of the welfare state. Tax competition has had an effect there, and they now have dual-income tax systems whereby they are taxing capital at a lower rate because they understand that it can escape. When the goose that lays the golden eggs can fly away, you had better do something to encourage it to stay in your country. In other words, tax competition is driving tax reforms.

For years I have been talking about tax reform. We have made very little progress in the US. Nobody seems to care. I do not think these people have ever read a Dan Mitchell paper. And if they did, would it matter? If I wrote a paper saying that a monopoly petrol station should lower its prices to charge the market rate, the owner of the station would say, 'This guy's a jerk.'

What will actually influence the behaviour of that petrol

station owner is when the four other gas stations move into town and competition ensues. This does work. Likewise, countries are forced to change or, more relevantly, politicians are forced to change when they know they have no choice.

Why does all this matter? Because it is making tax reform a reality.

What are the principles of this reform? The main principle is simple: one low rate, taxing income just once. We do not quite have that in the US. Not only do we still have tax rates as high as 35%, but, between the capital gains tax, the corporate income tax, the personal income tax and the death tax, a single dollar may be cycled through the tax system four times. One of the reasons we are so excited about all the tax reforms taking place in Europe is that it gives us case studies. I used to approach members of Congress and talk about the theory of marginal tax rates and capital formation. People would start to nod off. But now I give concrete examples – what has happened in Russia, where personal income tax revenues have doubled in less than four years. Or this is what has happened in Slovakia. Or look how Ireland has grown since they slashed their corporate tax rate from 50% to 12.5%. Real-world examples are invaluable.

We have made some progress in the US. Tax competition has indeed played a role. When we had the discussion about getting rid of our death tax, much of the debate focused on the belief that 'If we don't get rid of it, people are just going to move their money offshore. Why do we want to drive money out of the US economy just to satisfy this punitive class-warfare tax that is a relic of decades past?'

Then, of course, President Bush has created a Tax Reform Advisory Panel. He wants tax reform. Are we going to go as far as Estonia or Slovakia or any of these other countries? No. Maybe you have to actually be in the depths of communism before you can really clean up your tax system. We never had the so-called benefit of learning that lesson, and so it might take us longer to get to the promised land.

Let me close by giving the outlook for the future and a message of optimism.

If you go back just four or five years, tax competition was under tremendous assault. There was the OECD's so-called 'harmful tax competition' project. There was the European Union talking aggressively about corporate tax rate and tax base harmonisation. There was the EU savings tax directive. There were even people at the UN talking about global taxes and an international tax organisation.

Let us look at what is happening today. The OECD proposal is stymied and dead in the water. Yes, they have got some of the low tax jurisdiction to send so-called commitment letters, but all this was predicated on a level playing field, and since countries in the OECD like the US, the UK, Switzerland and Luxembourg are all tax havens for non-resident investors, there is no level playing field, and so low tax jurisdictions around the world are, for the most part, safe from OECD predation. The EU savings tax directive did eventually come into force, but the US told the Europeans they were not going to participate, and the Swiss basically forced Brussels to water it down so much that it is now called the 'dummy tax', because only a dummy would not be able to structure their affairs to avoid the tax. Brussels had to completely give up on the notion of destroying bank secrecy. The UN proposals never even got off the ground. Even the Clinton administration never agreed to the idea, so I do not

think we have any threat of global taxation or an international tax organisation.

These things are all helping create an environment in which, because of the tax reforms in eastern Europe, because of what Ireland did in the very west of Europe, there is a pincer movement.

Put yourself in the position of a German or French politician. Over time, maybe two years, maybe five years – I do not know how long they can hold out – investment, factories and money will all be leaving these countries and, sooner or later, they are going to be forced to reform. It is the job of every one of us to do everything we can to preserve and promote tax competition, because the lesson that we should all have in our minds, as think tanks, as researchers, as people who follow these issues, is that politicians are never going to listen to us as much as they are going to listen to the real-world pressure of jobs crossing national borders to go to the countries that are implementing the right policy.

Andrei Grecu

I was born in Romania, the most recent country to implement a flat tax rate, at the beginning of 2005. As Confucius said: 'Things should be as simple as possible.' I am going to try to show that the flat tax rate achieves all the aims of a fiscal system through the application of a very simple idea.

As a general principle, a flat tax rate is supposed to tax all income once, and only once, as close as possible to its source. For individuals this means that the flat tax is levied on income – whether from wages, salaries or pensions – minus a personal allowance. That is all an individual has to worry about when completing their tax forms.

For companies, the same principle holds. A flat tax is levied on total revenues minus the cost of purchases of imports from other firms, which have already been taxed, wages and pensions paid to workers, and purchases of equipment.

It is really a consumption-based tax because savings and dividends are not taxed and it gives the individual a 100% right to any investment. Everything taken out of the economy is taxed, and everything that is invested or reinvested is not taxed.

Over the last ten years in eastern Europe, nine countries, starting with Estonia in 1994, have adopted a flat tax rate. The single tax rate has not been uniform across these reformist nations, ranging from 33% in Lithuania to as little as 12% in Georgia. There is a clear tendency, however, for the more recent converts to the flat tax system to set the level at rates below 15%. Of the six nations to introduce a flat tax since 2000, none has ventured over the 20% mark. This downward trend has important implications for theories of tax competition.

Why has this occurred in eastern Europe? After the fall of communism the whole region was confronted with a myriad of problems, ranging from a lazy economic environment to a massive underground economy and a lack of foreign investment. The flat tax has proved to be a solution to all these difficulties.

It was relatively easy for these countries to introduce a flat tax system because of the vacuum left behind after years of communist rule. For developed economies such as the UK and France, such a switch would prove more complicated owing to their highly complex tax codes.

Economists talk about horizontal equality and vertical equality. All horizontal equality means is that people on the same salary should pay the same amount of tax. It should not matter how you fill out your tax form or how creative your accountant can be in exploiting loopholes in the tax system. As long as people do not have to worry about investing in activities that minimise their tax burden, they can engage in ventures that they believe will provide the best returns.

Vertical equality demands that rich taxpayers should pay more than people on lower incomes. The flat tax rate achieves this goal by giving a generous personal allowance that makes the system progressive. So not only are some of those on lower incomes exempt from paying any income tax, the allowance is more important to the people earning just over the allowance threshold. The real percentage that people pay increases with the amount they earn.

A common criticism levelled at a flat tax system is that it will lead to a reduction in government revenue because higher earners in society are no longer paying an increased rate of income tax. Economic theory shows, however, that you can collect the same amount of tax using a graded income tax system or a flat tax system.

The case of Estonia is instructive. Since the implementation of a flat tax system in 1994, Estonian government revenue has increased steadily thanks to increased compliance with the simplified system and to associated economic growth.

International competition demands that capital and labour move according to changes in market conditions. This principle has been applied to a new investment strategy proposed by Dr Laffer, who advises that we should invest in stocks in companies from lower tax regulation areas and sell stocks in companies in high-tax, high-regulation regions. This can be illustrated by a simple hypothetical example. Between January and August 2004, $4,000 is invested in the four lowest-tax-rate countries in Europe. We put $1,000 into Ireland, $1,000 into Latvia, Lithuania and Malta. This portfolio would have grown to $6,750 in just eight months, yielding a net gain of 69%. Over the same period, German and French benchmarks fell by 40 to 45%. While I would not argue that a flat tax is the sole contributing factor to this outcome, it is clear that it has played an important role.

I have already mentioned a reductionist trend in eastern European tax rates. The best evidence for this is Estonia, which initially started a flat tax reform in 1994 with a 26% rate, but is now proposing to lower the rate to 20% by 2006. This is a clear example of tax competition between the nations of the region as they compete with one another for foreign investment.

Having focused on the East, I would now like to look at the West to determine how it would respond to the implementation of a flat tax.

A flat tax is simple and efficient in terms of filling out a tax form. The only calculation to be made is revenue minus personal allowance, multiplied by the flat tax rate. It takes twenty minutes and it is good for both the government and the taxpayer. It makes policing compliance easier for the government and eliminates the need for citizens to waste time searching for loopholes. Those on low incomes below the personal allowance threshold will not have to pay any tax at all, providing people with a clear incentive to work.

A second advantage of a simplified system is that it will put

a stop to the current process of interest-group lobbying for tax breaks, which takes place across European capitals. Having every company and individual subject to the same principles of taxation creates a level playing field for business and thus promotes fair competition.

So far I have focused on the macro level, but a flat tax would also promote change for individuals. It sounds appealing to say that the government will not have as much power over people's spending and assets, but people would also have to reconsider all the things that are currently deductible under the current system – charitable donations, fringe benefits, entertainment expenses, mortgage payments. In many countries, people are used to deducting their mortgage payments. Under a flat tax system, people would have to understand that the tax rate would offer them more money. But it would also impose on them more responsibility in providing for their future, their pension, their health insurance, and so forth. In this sense, it would really empower the individual.

It is obvious that the flat tax system has succeeded in eastern Europe. Growth rates, levels of foreign investment and a decline in tax evasion are all testament to its success.

In western Europe the attitude is somewhat more sceptical. On the left, the flat tax is opposed because it is thought to reward the rich. High earners are content with the current system because of the wealth of tax deductions that it offers them. Western European societies appear emotionally attached to their systems. Even in the United States, a flat tax would be met with some suspicion as it would prevent home-owners from deducting their mortgage payments from their liabilities.

There may, however, be a solution in the Hong Kong model.

For 50 years Hong Kong has offered a dual system. People can choose between a flat tax of 16% or a graded system of 2 to 20%. One can see why people have gradually moved from the graded system to the flat tax system, because it is so much easier to comply with and carries less risk of one's finances being investigated. I think it might be a useful starting point for Western countries to offer their citizens a choice between the two systems. I am confident that if people take up the flat tax challenge they will not choose to switch back.

Ugnius Trumpa

The motive for reform in the Baltics came not from the foresight of politicians but from the overriding need to increase economic growth from the low levels of the nineties. This was the driving force behind the selection of their reformed economic systems.

After the successful reforms of the Baltic states, European enlargement and the possibility of further expansion of the EU, we are faced with a changing set of circumstances, and I want to focus on a few of these new policy dilemmas.

The first dilemma is between uniformity and diversity – basically between tax competition and harmonisation. Competition is encouraged by diversity. Competition for investment and the business of firms is much higher than a decade ago. The mobility of people, and the larger groups of people with low income, is also higher. We see already from the new member states that people are choosing between countries when selecting the optimal place to work. Today they are choosing between job opportunities, but maybe some day they will be

choosing between tax systems. This will only increase the need for tax competition.

Tax reduction, which we have seen in the last few years in Slovakia and Romania, is the biggest motive for tax competition. It is not just about a flat tax versus a progressive system. It is about a very low flat rate. When we imposed flat tax systems in Lithuania we were highlighted as a pioneer in Europe. Now we look like some older European countries – like France or Germany – because Lithuania still has a 33% flat tax.

Compared with 18%, 16% or 13%, this now looks outdated. In Lithuania, about 37% of household income is undeclared, which shows that a flat tax with a high rate creates more tendencies towards tax evasion than a progressive system, because with the latter you can at least hide yourself in a different tax bracket.

This is good news for those who dream about harmonisation. Harmonisation is happening, but it is not happening in the way people thought it would. It is happening in the way Hayek envisioned: via spontaneous order. Now we are moving towards harmonisation on flat and low tax systems. It has become almost unpopular to talk about tax rates higher than 20%, which shows that we are normalising at very low levels of income tax. I believe that no country that has adopted a flat tax system is discussing reverting back to the progressive model. We also have another dilemma between flat and progressive. I think that progressive taxation, although it was overwhelmingly popular some hundred years ago, and even in the last century, has totally discredited its own principles.

Now we see that the flat tax system not only generates more government revenue, but it also fulfils the major goal of the progressive system. People who earn more pay more. The socialist ideal that those with high incomes should be paying more is fulfilled within the flat tax system more efficiently than in a progressive system, which allows the rich to escape from taxation.

The last dilemma is between having a tax on profits or not. Since Estonia imposed a zero per cent profit tax, there is now a clear tendency to reduce tax on profits. Such a move is a powerful incentive for foreign firms to set up within a state, but is also a positive move for domestic firms.

Estonia demonstrates to the rest of the world that we can live without taxes on profit. It implemented its system five years ago and has not collapsed as a result. Indeed, it is growing as fast as it used to – even faster. This creates a very powerful argument for the abolition of the profit tax.

Today we have more positive news and more positive tendencies towards not only tax competition but towards dismantling existing harmonised taxes within the EU.

Stephen O'Connor

I moved to Budapest, Hungary, in 1992, and I have lived mostly in Budapest and Warsaw for the last thirteen years. I am an entrepreneur – a newspaper owner and publisher – and I have helped to roll out newspapers in Hungary, Poland and the Czech Republic. In Hungary I found a country with a favourable business environment which rewarded success. If the question is 'Does the West know best?' then I believe that the example of Hungary and its neighbours answers it with a firm 'no'.

Publishing independent business news in central Europe has

proved to be an immense challenge. Given the recent history of eastern Europe it was impossible to employ the older generation of journalists, as they had been institutionalised by the communication style of the communist regimes. We had to take on young and inexperienced writers, and we had to train them to deliver impartial, carefully researched information.

When I moved to Hungary, 70% of the economy was in the hands of the state. That figure is now around 14%. Austria had the same percentage of state-controlled economy in 1992, and yet the figure has remained constant to this day. I leave it up to you to decide which country has had a more productive and successful decade.

Does the West know best? Certainly not. The pace and scope of eastern European reform has been breathtaking over the last ten years. More bills have gone through the Hungarian parliament in the last twelve years than in the last 60 years in the UK. Quantity is certainly not the sole barometer of success, and it is true that Britain has not had to deal with 50 years of communism. Nevertheless, Hungary has taken steps to deal with issues that continue to be ignored by British politicians. The implementation of a flat tax has not yet been voted on in Budapest, but the groundwork is being laid for such a move. Western European nations are, by contrast, completely closed to the type of blue-sky thinking needed to countenance a flat tax.

Hungary attracted the most foreign investment of all the countries in eastern and central Europe (including Russia!) during the first seven or eight years of transition. The lion's share of foreign investment went into a country with a population of 10 million and a graduated taxation system. While

Hungary can be proud of her early success there is now a danger that she is resting on her laurels. The country's reticence in moving towards a flat system of taxation is testament to this phenomenon.

Hungary has got it right in other areas of tax law, however. Corporate tax rates are 16%, among the lowest in Europe. Real action was taken with the Bokros austerity measures, policies that are similar to those proposed by Mr Balcerowicz in Warsaw. These two people realised early on what they had to do and they did it, but they have been painted as the Devil ever since.

Despite the relatively low corporate tax rate, VAT in Hungary is 25%, one of the highest rates in Europe. The costs of employing people, including all the taxes and social security costs, are preposterous. For example, to employ somebody on a basic 700 euro monthly salary costs around 2,000 euros. This is because there are five different business taxes. There is a curious 2% tax on total revenue, not profit, an 18% tax on employees, a healthcare contribution, an 11% pension contribution, a 3% employer tax and an additional 1.5% fee that goes into a state training fund. This has, unsurprisingly, led to a burgeoning shadow economy for labour. I believe it is time to accept that lower taxes make people more honest.

Yet other areas of the social economy provide many different challenges, and it is telling that there is a game on the Ministry of Finance website which allows players to manipulate the country's spending priorities in order to demonstrate the difficulty in cutting expenditure. The game demonstrates deeply ingrained attitudes about the role of the state in Hungary. This is further illustrated by the fact that the game does not even entertain the notion that people would enjoy better lives if the state stopped taxing them into the ground and allowed private service providers to develop. The healthcare system, for example, is the stuff of local legend. Though private investors now operate within Hungary, they are mostly choosing to set up private hospitals rather than take the risk of engaging within the public sector because of the current regulatory burden.

But hope does exist. In 2003, a 15% flat tax on the profits of entrepreneurs and small business was implemented, allowing them to escape the existing web of employment taxes. At present this remains a voluntary option for just this one sector of the economy. Its implementation reveals, however, that the Hungarian government has realised that small businesses are essential to the future vitality of the economy, and its popularity augurs well for the future.

Hungary has been a regional leader in terms of economic growth and scope of reform, but there is a danger that it will be left behind by its neighbours. Romania has become the latest state to implement a flat tax, and I believe it is vital that the powers that be in Budapest do likewise. Western Europe offers a timely example to Hungarians of the dangers of failing to reform ageing and inefficient tax and social systems. It is time for politicians in both East and West to act if they are to create a prosperous Europe for future generations.

4

Robust or Rigid? The Future Labour Market

Christofer Fjellner, Miroslav Mikolasik, Johnny Munkhammar, Gabriel Calzada

Christofer Fjellner

This short speech unfortunately covers a very large theme: 'What impact would health and social security reform and greater tax competition have on Europe's labour market?' Conversely: 'What effect will a shrinking and more mobile labour force have on the prospects for social and economic change?'

I will focus on the problems I think we will have on the way to actually creating a more mobile labour force and to binding together the labour markets of the East and West. Among the problems that we have to tackle is that of the shrinking workforce.

I would like to start with a few personal observations about what I think we have to deal with in order to be able to arrive at a joint European labour market. First of all, we have to deal with a fundamentally sceptical population when it comes to labour mobility in Europe. I think we have to find some kind of magic antidote to the poisonous mixture of protectionism and xenophobia that Europe still suffers from.

My understanding of how sceptical Europe could be towards labour mobility started during the Swedish referendum on joining the European Union in 1994. A satirical radio programme made a prank call, which was received by a friend of mine, at the campaign office of Yes to Europe. My friend was told that if we joined the European Union there would be 40,000 gay men from Germany in leather and chains who would end up moving to Sweden. After a small debate, my friend, who is an honest person, said, 'OK, the basic idea of the European Union is freedom of movement, so honestly I cannot say how many gay men in leather and chains will move from Germany to Sweden. It could be one, but it could also be a hundred thousand people.' The caller then replied, 'A hundred thousand gay men in leather and chains. Wait until I tell my friend. He thought there would be no more than forty thousand.'

The next time the same attitude emerged was prior to the enlargement of the European Union. Then we were told that our borders would be stormed by people who would come to Sweden just to benefit from our social systems, take our pensions, use our unemployment benefits, and so on. Our prime minister, Göran Persson, talked about social tourism. 'They would all come from Poland,' I think he said, 'and we need large restrictions here on the freedom of movement.'

Now obviously we have another debate going on in Sweden at the moment. The worries are the same, but now the debate is in relation to the services directive. Now, though, there are no gay men from Germany, or lazy people from Poland. Now it is 40,000 Estonians who really want to come to Sweden to work.

The scapegoat keeps changing but the basic problem remains the same.

Obviously, I should be honest and say that I cannot imagine why so many people would want to come to Sweden. We have quite low real incomes, the highest taxes in the world and, to be honest, the weather is really pretty miserable.

Eventually, though, I think out of necessity we have to adopt another attitude in Sweden and in other parts of Europe, because I know that this is not an exclusively Swedish problem. The specific accession rules, when we had the enlargement of the European Union, were not actually implemented in Sweden. Sweden is one of very few countries that did not have specific limitations on movement of labour after the enlargement of the Union.

I think we will be able to overcome the attitude problems, but there are still very many other challenges that we have to meet.

This leads me to my second observation – that we still have a very long way to go before we can say that we actually have some kind of common labour market. There are many reforms that need to be enacted but, after being a member of the European Parliament for around six months, I can say that the will to achieve these reforms is lacking. It is still much easier to send a hammer over the Baltic Sea than it is for a carpenter to go over the Baltic Sea and to drive in the nail.

I was actually reminded of this fact recently. A Latvian construction firm was asked to build a school in Vaxholm, a small town outside Stockholm. The problem was that the trade unions demanded that this Latvian firm have a collective wage agreement with the Swedish trade union, and this firm only had a collective wage agreement with the Latvian trade unions. It all ended up in a blockade of the construction site, and many people from the trade unions standing around shouting, 'Go home. Go home. Go home.' The Latvian firm lost the dispute and went back to Latvia.

Who will suffer from this? The taxpayers in Vaxholm, who are the ones who will pay for the school. The children, of course, who will have to wait longer before they have a school ready for them to go to. And not least the Latvian construction firm and its employees.

Many of the large reform projects were supposed to deal with these problems, but I believe progress is very slow, if indeed it is happening at all. The thing that people talk most about in the European Parliament at the moment is probably the Lisbon Agenda. I would say that the Lisbon Agenda to me sounds more and more like some kind of empty mantra used by politicians, who repeat it like Buddhist monks. It is repeated over and over again until they hopefully reach some kind of nirvana.

Yet the situation at present is far from heavenly. There is a focus on social cohesion and environmental improvements, and all those things that economic growth hopefully could lead to, but these things are at the moment more important and are often put before economic growth. What is not talked about enough, in this context, is what I would like to see as part of the Lisbon Agenda, a functioning services directive.

I believe that the most important European reform for better labour mobility would be a good services directive. The sad thing, though, is that in the European Parliament supporters of such a directive are becoming an endangered species. Most MEPs at the time of writing seem to be trying to get rid of different sectors of the services directive. It has become like a Swiss cheese – full of holes.

The first thing that many people want to take out of the service directive is obviously healthcare. I would say that healthcare is the last thing we should take out. I cannot think of any other area that needs competition more than healthcare.

Through a good service directive in the healthcare area big government monopolies would face competition that really would benefit many European citizens. Demographics teach us the same thing. We need patients, nurses and healthcare institutions that move across borders. From this perspective it is rather strange that people in Sweden are worried about 40,000 Estonians willing to work, perhaps in the health sector. What they should really be worried about is what will happen to Sweden if nobody wants to work here.

The statistics are very clear on this. Today, on a normal day, only 3 out of 9 million Swedes go to work. When those born in the 1940s start to retire, we will have a real demographic problem in Sweden. When the Swedish retirement age was set at 65, life expectancy was 59. Now, when the average retirement age is 58, life expectancy is 80.

The problem is the same across much of Europe. To say that a European common labour market would be the sole solution would be disingenuous. Clearly, the problems are more complex.

There was actually one intelligent comment made in the European Parliament – and even more surprisingly, it was made by Kofi Annan. He said: 'Immigration should not be described as one of Europe's problems, it is a part of the solution.' I think, when talking about this subject, we have to consider labour markets in a much broader perspective.

On a more basic level it is scary that the so-called European social model has created a society in which the fact that people live longer is looked upon as a problem. In Sweden, to tackle this problem the most commonly proposed solution seems to be higher taxes. The Social Democratic government has just declared that in next year's election campaign one of their main policy issues will be a demand for higher taxes in Sweden. Can you imagine?

I think that we have to have real reforms in many different areas, not only the types of reforms that we are talking about in the European Parliament, because many of these reforms are just trying to fix existing problems. Göran Persson, Sweden's prime minister, thought that the welfare system would be a motive for people to move to Sweden. I actually think the welfare system as such locks people to their own countries. I can change my car insurance when I move to another country, but when it comes to my state pension plan the situation is rather different.

I believe that great opportunities exist. The prospects for economic growth and social improvement are real for Europe. There are two important reasons, however, why we have a problem at the moment: the lack of labour mobility and population demographics. But to deal with these we have to tear down many of the cumbersome systems connected to health and social welfare. We need real reforms, often at national level, and we also have to admit that we need more immigration. If we were really to challenge the European social model, I would say that the future looks bright, so bright we might have to wear sunglasses.

Miroslav Mikolasik

The conservatives are currently in the lead in Europe, at least as far as numbers of MEPs are concerned. We are colleagues in the same European party and yet we are from very different countries. Slovakia and the nine other accession states may have a thing or two to teach our longer-standing counterparts, and I will try to outline some of these today.

Slovakia is fortunate to be entering the second term of a centre-right coalition government, unlike the other members of the Visegrad Four country grouping. The Czech Republic, Poland and Hungary, by contrast, have all experienced a change at the top. Continuity has allowed Slovakia to implement a comprehensive system of reforms, the results of which are starting to become apparent. The World Bank recently declared Slovakia the number-one reformist country in the world.

The topic under discussion is labour market accessibility. The pre-accession EU fifteen had already taken some steps towards the deregulation of the European labour market. Despite this there have been calls from some quarters to impose a seven-year transitory period on accession states such as Slovakia to prevent the much-hyped flood of cheap labour moving from east to west. Yet this has failed to materialise. On the contrary, companies and specialists are moving to Slovakia to take advantage of the favourable business environment.

The chief contributor to this change in climate has been the steps taken towards reform of the tax system. I will attempt to outline briefly the most important of these.

But before I come to tax reform, I must first touch upon the changes to the state pension and health systems. One of the

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legacies of the communist regimes of eastern Europe was that they created an unrealistic cultural attitude towards healthcare. People were led to believe that because it was free, it also cost nothing. This attitude has led to resistance, particularly among older elements of the population, towards reforms instituting charges for some pharmaceutical products or for contributions to general health expenditure. While unpopular, these reforms are vital – especially given the current birth rate of 1.3/1.4 children per couple, which is dramatically below the replacement rate for any society.

Having explained some of the problems Slovakia is facing, let me return to the issue of tax. I would argue that tax reform has been the most important action of the Slovak government in creating a highly competitive and non-distortive market environment.

In its manifesto, the government pledged to reduce income tax rates and consider the possibility of implementing a flat rate of tax. In reality, actual reform went beyond these original ambitions. The government's ultimate goal was to transform the Slovak tax system into the most competitive in the entire EU, and maybe even in the OECD area. 'Competitive' does not merely translate into low rates of taxation. It also stands for efficiency, transparency and a non-distortive system.

Designed to be fiscally neutral, the reform is intended to achieve the following growth objectives:

➤ creation of a business and investment-friendly environment for both individuals and companies;

➤ elimination of existing weaknesses and distortionary effects of the tax law;

➤ achievement of a high degree of tax fairness by taxing all types and amounts of income equally.

These goals should be achieved by careful implementation of several simple principles on which the tax reform is based:

➤ shifting the tax burden from direct to indirect taxes, from taxing production to taxing consumption;

➤ introducing low standard tax rates and eliminating all exemptions regimes;

➤ introducing flat tax rates in personal income tax, replacing the regime with different tax brackets;

➤ eliminating the distortive role of tax policy as an instrument for achieving non-fiscal goals;

➤ eliminating, as far as possible, double taxation of income.

A central plank of this reform has been the implementation of a flat rate of income tax on individuals and corporations of 19%. This came into law on 1 January 2004.

The new legislation eliminated 21 different types of taxation, including five different personal income tax rates of 10%, 20%, 28%, 35% and 38%. This radical change has several major advantages. First, the flat rate tax still maintains the progressive nature of effective tax rates, as all personal incomes of up to 1.6 times the poverty line are exempt from any form of income tax.

Also implemented on 1 January 2004 was a new rate of corporate tax, reduced from 25% to 19%. Value Added Tax has also been set at the magic figure of 19%. These reforms have attracted the interest of observers from all over the world, who are coming to learn from the Slovakian example. There were fears that the reduced rate of income tax would lead to dramatic falls in government revenue, but because the uniform rate of 19% has enhanced entrepreneurship and the prospects for small to medium-sized enterprises, people are happy to come to Slovakia to do business. The government eliminated some other forms of taxation as well, such as real estate transfer tax, donation tax and inheritance tax.

The future of Slovakia depends on the development of human resources. With a population of 5.6 million, Slovakia is roughly comparable to Denmark or Scotland. We have led Europe in terms of tax reform, and it is likely we will again set a trend by encouraging immigration to meet increasing demand for labour in the years ahead.

Johnny Munkhammar

The simple answer to the question 'Does the West know best?' is no. As is the case with most answers, however, there is more to be said than merely rejecting the proposition out of hand. In fact, nobody knows best. The constant exchange of ideas, experiences and competing beliefs provides a foundation that enables us to learn from each other.

We now live in an age of globalisation, and with it an enlarged European Union. In this context there is a wealth of experience to draw from to ensure that the policies of the future improve on the outcomes of the past. Is institutional competition, which Dan Mitchell refers to, at work? Failing to recognise the faults of outdated systems seems a sure-fire way of hampering a nation in the 21st century.

What happens if the West does not reform – if we close our minds, if we close our borders and if we stick to the status quo? I think the point is made well in the famous slogan 'Reform or Die'. We are faced with a clear choice where one of the options is to do nothing. Yet I believe that this would be to deliberately choose a path whereby Europe would become a kind of museum for the rich Indian tourists of the future.

With particular reference to the labour market, not reforming would lead to fewer people in work; more people dependent on government; fewer new and well-paid jobs; slower growth; and, overall, poorer living standards. Much of this can already be seen in Europe.

The average American in every American state is richer than the average European in almost any European state. So western Europe has already been led astray, and the time has come to provide it with new direction.

We all want companies to move here. We all want new, well-paid jobs. We all want more people working and less people dependent on governments. But it takes courage to take the steps necessary for these goals to be achieved.

What do we have to do? Why do we have to do it? What will happen if we reform?

First, we must avoid being counter-productive. Government decisions forcing us to work less, such as shortening the working week from 40 to 35 hours, naturally lead to less work being done, clearly something that would not aid stagnant economies.

Raising the highest levels of taxation in the world, which the Swedish kamikaze government is now proposing to do, would also clearly be a bad idea. It would lead to a sluggish business climate, and slower growth.

Creating new borders for labour mobility within the European Union and stopping tax competition would be a terribly protectionist idea, the worst idea for five hundred years. If Europe is to prosper, we have to avoid these ideas.

What do we have to do to improve the situation?

I think the main challenges in western Europe have names. They are: pensions, social security, welfare and taxes. Let me focus on necessary reforms in these fields and their consequences for the labour market in particular.

The first necessary reform would be to abolish the public pension age. When public pensions were introduced in Sweden the pension age was 67 and life expectancy was 55. Now we retire at 58 and live until we are 80. Under the current system, the working population of ageing Germany will decrease from 56 million to 41 million by 2050. In Italy it will decrease from 39 million to 22 million. The costs of this demographic shift are astronomical. In Spain today 50% of total public expenditure goes on pensions. In 2030 it will be 80%. This is obviously unsustainable.

Attempts at reform have been made. We have had reform in Sweden but the reforms fell short of anything substantial and have had little impact on the impending crisis.

Let me be clear. I do not want to force anyone to work, but the choice not to work must be paid for by oneself, not by government. Consequently, nobody should be forced to retire at a prescribed age either. We could replace the current pension age with a system that offers a basic public pension based on the principle that the earlier a person retires the lower it gets. We do not have to have any pension age at all. And, of course, you could also buy into a private scheme to supplement this

income. A pension reform such as this would lead to more work being done, fewer public pensions expenses and lower taxes.

Another necessary reform for western Europe is reduced benefits from public social insurance schemes. European countries have similar systems of mandatory public social protection for sick leave, unemployment and early retirement. In Sweden there are in practice no limits to how long you can live off these systems. The basic public level of contribution is 80% of your salary, but most people have even higher contributions than that owing to mandatory negotiated benefits on the part of the employer.

A person in Sweden with an average income earns 5 to 10 euros extra a day by going to work instead of living off the public benefit systems. This, of course, means that many people choose not to work. Indeed, only 3 million out of 9 million people actually go to work. Over 60% of the adult population is dependent on the government to some extent.

This is a huge, highly destructive problem. If you want to encourage people to enter the labour market, you cannot punish workers while rewarding the unemployed. There should be a limit on how long you can live off the state. There should be a substantial reduction in the levels of contributions so that there is actually an incentive to go to work – much more than 5 to 10 euros a day. Perhaps benefits should be cut in half. Incentives to work would then be of a totally different nature. Public expenses would be substantially lower. The labour supply would increase. In turn, less government intervention would open up a new market for private insurance.

Introducing free enterprise into welfare services is yet another sorely needed reform. In western Europe, the government finances most welfare services such as schools, hospitals and universities. In many countries these services are almost entirely provided by government. This is a form of planned economy: the same people that finance the system run the system – in other words, it is a total monopoly. Thus the result is lines of people waiting for treatment, inefficiency and a waste of resources. In the context of the labour market the result is people working in the public monopolies on low salaries, with little influence in the workplace, and without the prospect of working in the non-existent private sector.

Today's public services attempt to be all things to all people but end up falling short. The resources would be better used if a clear line were drawn between what government should and should not provide.

The basic services paid for by the government should always be procured in a market environment. This would lead to better-functioning services and a vast market for private welfare companies. A new service sector could emerge and competition would lead to higher standards for the consumer. The staff would receive better salaries since they would get to choose between various employers, and they could also start up their own welfare service business.

Introducing lower taxes is one of the most essential reforms needed in western Europe, where taxes are the highest in the world. Naturally this makes our climate for creative business and work less attractive, not least from a global perspective. In Sweden the average wage per hour for a worker in industry is 20 euros. In China it is 1 euro. This is not matched by a difference in productivity, and taxes are of course one explanation for the difference. One in three of Sweden's major companies have

outsourced production in recent years. China, India, Brazil and others present a serious challenge to the West.

Several taxes have already been lowered. Capital taxes have been lowered, because otherwise capital flees to other countries. Corporate taxes, for example in Austria, have been lowered, because otherwise corporations flee. This will have to continue. The total tax take, however, remains stubbornly high and harmful.

The reforms of pensions, social security, insurance and welfare systems that I have described would make radical tax reductions possible. Particularly harmful taxes to business could be abolished totally and tax pressure lowered, inspired by the reforms in eastern and central Europe. This would make work more attractive, improve the business climate and increase economic growth.

These are four reforms necessary in western Europe.

Government is not the solution to our problems. Government *is* the problem. Government is the main obstacle standing in the way of more jobs, more companies, higher growth and consequently better living standards. Our goal must be the reduction of big government; the reduction of the European social model towards a state with small government, low taxes and private welfare. These are the conditions that could release the creative force of humanity.

In creating big government on the European social model, the West did not know best. Some, such as Hayek, said so from the start. They were right. An open world with numerous success stories shows us the best foundation for a prosperous society.

Gabriel Calzada

How does EU enlargement affect the labour market and the social security systems of existing EU members?

Economic theory suggests enlargement should have at least two positive consequences. Since Thomas Aquinas's writings, or at least since the late Scholastics, we have known that a larger labour market produces greater satisfaction of the needs of all individuals in society through the division of labour and knowledge. In the words of Juan de Mariana's educational book for the Prince of Spain, known as *De Rege*: 'If men had been strong enough to live in relatively isolated communities, we would still be living at the bare level of subsistence, satisfying a very reduced number of wants.'

A second reason to view enlargement positively is that the new countries have different and sometimes more market-oriented systems of social security. We will have the opportunity of watching the competition between systems, allowing for an assessment to be made of their relative merits.

I would now like to focus on the consequences of enlargement for social security systems.

Western European social security systems are nearing bankruptcy. It is possible that the addition of new countries into the European project, with new ideas and new people, will provide fresh impetus for reform. By witnessing the failings of an ageing system alongside a dynamic market-oriented alternative, I believe nations will be converted to the cause of reform.

Enlargement could also gloss over the current failings of social security, however, because of an influx of labour from the accession states into the countries of western Europe. Such

immigration would help to stave off the effects of needing to support an increasingly ageing population. A stay of execution would probably be celebrated by a great majority of politicians, but for most of us the extension of social security should never be celebrated as a success. To elaborate on this I would like to take a look at the pyramid financial scheme for social security in most of the western European countries.

Pyramid selling is illegal in most developed countries because it is rightly considered as fraud. In the 1990s, the implementation of the near-perfect pyramid banking system in Albania stole the savings of hundreds of thousands of families and left the country on the verge of civil war.

These fraudulent systems typically promise to make a huge profit without risking anything. All you have to do is to purchase the last position on the list by paying a small sum to the first person on the list, who, in return, abandons the list in favour of the second-ranking person, and the process continues in this way. The newcomer would recover their money by selling two copies of the list to two new people occupying the last two positions. At least, this is what new investors are told will happen.

In the scheme, designed in its modern version by Mr Ponzi, the people situated at the bottom of the pyramid are financing the people situated at the top and cannot ascend the structure of the pyramid unless they find enough buyers to occupy their places and expand the base of the structure.

The fraud is self-evident. There is always a great mass of sellers who will not find buyers. This scheme, which is rightly considered fraud when an individual or private company launches it, is considered to be a social good when the state is its organiser. As Frédéric Bastiat, the great French economist, said: 'If you want to know something about the moral status of a state action, you have to think, "What would we think about it if a private person did the same thing?"'

The best-known, large-scale frauds based on the Ponzi scheme are the social security systems of western Europe. In this context, the arrival of thousands of eastern European immigrants into Spain and other European countries has provided fresh oxygen to an ailing system. The eastern newcomers, together with a young generation of domestic citizens entering the social security system, are not saving or investing anything of value. They are not capitalising on their efforts or contributions. They are just coerced into the pyramid with a vague promise that the state will find another large cohort of new victims by the time they become old.

Let me now turn to the consequences of European enlargement for the labour market.

Ideally, the extension of the market will allow a greater division of labour and, thus, an increase in productivity and enrichment of all Europeans. This only holds, however, under free market conditions. In Cuba, for example, an enlargement of the labour market would not be of great consequence, except for the black market.

The Spanish labour market, as well as other European labour markets, is far from being completely free. In fact, an even more regulated European labour market is a possibility if the president of the European Parliament, Josep Borrell, has his way in introducing an EU minimum wage. His desire is to avoid competition between western and eastern European workers competing for jobs and reducing wages post-enlargement.

It is almost unbelievable that Borrell was once an economics professor. If employers are obliged to pay the same monthly wage in countries where, for institutional or economic reasons, the productivity of labour is different, the only thing you are going to attain is massive unemployment in those countries where the productivity of labour lies below the minimum European wage.

This will condemn hundreds of thousands of people, if not millions, mostly in the East, to choose between long-term unemployment or emigration: an emigration that would also serve to prop up the welfare states of the West.

Since I have not yet met a politician who wants to establish a minimum wage that is below the minimum market wage, let us suppose that Borrell and his friends establish a European minimum wage of around 600 euros a month to be implemented in Spain.

The Polish or Slovak employer whose workers earn more than 300 euros per month is not going to raise his wages up to 600 euros because of the whims of Mr Borrell and other interventionist politicians. What the Polish employer is going to do is to fire everybody who does not produce at least 600 euros a month. He is going to do this not because he is evil but because the consumer is not going to pay for those wages.

If significant numbers of workers cannot be that productive he will have to close down the business and try either to get a public job or come to the west of Europe where, thanks to the high accumulation of capital, the productivity of labour may allow him to contribute more than 600 euros a month to the production process. Such a situation would see capital along with labour fleeing from the East to the West, leaving behind a sorry state of unemployment and economic stagnation.

I would like to conclude on a more positive note. Enlargement could lead to the abolition of social security systems and the complete liberalisation of labour markets throughout western Europe. By learning from eastern European societies, Western leaders may be convinced to embark on a course of reforms. If, however, they fail to take heed of the examples laid before them there is potential for enlargement to disguise the failings of the welfare state from the European public as a whole.

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