

THE POLITICAL ECONOMY OF LITHUANIA'S PUBLIC FINANCE

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Traditionally Lithuania's public finances are discussed in terms of tax burden and tax administration. Such issues as composition of tax revenues or the structure of public expenditure for some reasons are less attractive both for economists, journalists, politicians and general public at large. The purpose of this article is to fill this gap doing it in the political, cognitive and ideological context existing in our country. The subject is explored in the framework of methodological holism.

Keywords: public finance, public goods, Wagner's law, power centers.

Introductory remarks

From the very declaration of Independence up to now the formation and development of our country's public finance took place in the peculiar cognitive, ideological and political environment. It was marked by the shortage of comprehensive and pluralistic discussion, by domination of mostly implicit ideological assumptions and as a result, by mainly peace meal approach.

We never had truly open and intensive public discussion on what advantages or disadvantages have progressive, proportional or regressive taxation, what could be proportions between direct and indirect taxes, how big could be tax burden and national debt. That doesn't mean that there are no publications on these issues that nobody talks about public finances. The problem is that these publications are dealing mainly within narrow, technical limits, that discussions are sporadic, that mostly only politicians and

journalists are involved—scientists are rather passive—that it intensifies only in the autumn then national budget is discussed in parliament.

From our own personal political experience we know that though many in our establishment discriminate between proportional and progressive taxes, the character and especially consequences of application of direct and indirect taxes for most of them is terra incognita. The same applies to the history of the issue to comparative analysis of European, not to mention other regions, financial systems, which is crucial when we search for “modernity” in our public finances¹.

¹ Having said this we have to admit that there are some signs of improvement of the situation especially on scientific side of the issue – several articles on the public finances appeared recently [see for instance 1;10;18]. Nevertheless we maintain that in general the level of discussion in terms of intensity, diversity (pluralism) and thus quality is not satisfying.

If to add the fact that economic fashion in our country through all the period of independence was dictated by Lithuanian Free Market Institute – the forpost(?), the beacon (lighthouse) of neoliberal economic thinking, which is a priori negative towards public sector, we would have rather full panorama of the environment in which our financial decisions are made.

This environment influences substantially the structure and quality of our economic life at large and any economic sphere in particular. In case of finances it is true as well. The specificity of this environment could be explained by many reasons. We would distinguish two of them – cognitive and political. By the former we understand the prevailing perceptions of public sector and public finance and by the latter – the power structure in the society, the interests and behavior of the main power centers in our country. These two reasons are connected (intertwined). The cognitive climate in the country to the large extent depends on the visions and perceptions of the major power centers like business, mass media, parties, trade unions etc.

The problem of the tax burden

The opinion that our tax burden is too heavy is dominating in discourse on public finances. Some when in the beginning of May the group of politicians, young liberals, centrists drag through the downtown the replica of (the symbolic) “tax burden”, which in their view is too heavy. Some observes are impressed. However if to look at figures, the picture of “tax oppression” is not so gloomy and severe. Public tax revenues comprise less than 30% of our GDP – rather modest figure². In the year 2000 in Poland it seeks al-

² To be precise (exact) tax revenues in 2002 constituted 27,0 % of GDP. It is rather clear tendency of decreasing budgetary revenues in the last several years. In 1999 this ratio was 30,4 %, in 2000 – 28,4 %, in 2001 – 27,4 %, in 2002 – 27,0 % [17]. It is interesting enough

most 34,1%, in Czech Republic – about 40%, in Hungary – nearly 39%.

In Western Europe Scandinavian countries has a heaviest tax burden. Sweden here is a clear leader – tax revenues comprise 54% of GDP. Denmark until recently was the second in this respect – the portion of tax revenues in GDP was approximately 49%. UK and Spain were on the other side of the spectrum with correspondingly 37,4 and 35,2 percent. Figures named give us the possibility to compare and to judge. From figures presented this conclusion follows: Lithuania is the country with one of the lowest, lightest tax burdens in Europe. Nevertheless in our country the idea of reduction of tax revenues is quite popular.

It is rather popular worldwide. Well know is the most recent examples of tax cuts – they are made by US administration. Some advocates of easing the tax burden often use this example as an argument for freeing, as they say, business from financial harness. But there are many who see the danger of such tax cuts. Among them is International Monetary Fund (IMF). As “Financial Times” says “The International Monetary Fund has expressed concern that the growing US budget deficit, exacerbated by the recent tax cuts pushed through by the Bush administration, threatens to erode productivity growth, drive away investment and make it more difficult to meet health and pension obligation”[4].

As we see from this quotation, IMF warns against economic and social losses, which could be provoked by sharp tax cuts. We think that it applies not only to US, but to other economics as well. Lithuania’s economy shouldn’t be exemption.

that Lithuanian Free Market Institute gives other figures. Its estimations shows that in 2001 tax burden comprised 37 % – the ratio which in our view is hardly realistic [see 19].

Nevertheless proponents of neoclassical approach argue that if one seeks to improve people's welfare, the narrowing of state functions and tax cuts are necessary [5, 90]. Both aspects, parts of the argument are connected and require further elaboration.

Government expenditure: two competing approaches

The attitude, that state spending should be cut alongside (in parallel) with tax cuts is very strongly expressed nowadays. Lithuania is not exception in this respect. Local mass media, political, business and academic circles either support this position openly and actively or do not resist it consistently though certain signs of impulsive, instinctive, spontaneous opposition to this view exists.

What are arguments for and against lower state spending? Neoliberal school most actively and solidly representing the philosophy of methodological individualism in the country argue that state's activities in general and taxation and spending in particular distort the market, do not allow "invisible hand" to do its job properly, i.e. to properly allocate economic resources, to keep market equilibrium, to enhance economic growth.

State should restrict its functions and should (convey) hand them over to private agents. In other words, as R. Petrella says, they believe in "Holy Trinity" – liberalization, deregulation and privatization [9]. This position is based (on believe) on assumption that state by its interventions hinders economic growth and thereby represents economic evil. This position in it's turn (lives, stands) on the premise that economy and market coincide that they are identical concepts. If it would be proved true, then the whole building, construction of the argumentation would be consistent.

However other economists disagree with this philosophy, paradigm of thinking. They argue that, first, market is not ideal economic regime because it is not able itself to keep automatically an effective equilibrium and because it is "blind" to social and ecological aspects of economic life, that there are market failures. They don't think that there is trade off between economic and social, economic and ecological aspects of development. In short they disagree that the economy and market are identical concepts and they see certain role for state in economic life. They admit that governments, as neoliberals or libertarians say, quite often are corrupt and ineffective. In the same time they argue that the same applies for private sector. The latest corporate scandals in the United States, France, Germany and other countries demonstrate that 'evil' forces can operate in a ("sacred") "holy" market domain as well.

Part of the representatives of this latter strand of thinking widely use the concept of public goods. For neoliberals public good is rare exception or non-existing thing altogether. For their opponents it is widely spread economic phenomenon. Social capital is another concept circulating (often used) in the literature opposed to neoliberal viewpoint.

Mostly for ideological reasons these concepts of public good and social capital didn't obtain "citizenship" in Lithuanian economic discourse, though public goods not only private goods belong to the class of economic goods. It is so because their production adhere, subdue to the principle of economisation. Creation, production of knowledge, laws, education, social order in general requires resources. Most of them are scarce, limited. Therefore producers of these public goods have to economise. On the one side, they produce valuable products utility, on the other - certain costs are involved here. Optimal ratio between utility, and costs is the task of

every agent (actor) participating in this process. In this respect there is no difference between producer of, let's say, clothes and scientific article. Both have to act in accordance to the principle of economisation.

Thereby different state institutions, schools, universities, municipalities are not only users of economic resources. They produce specific economic goods. And though alongside these – public - goods more or less often appear public bads, it does not serve as a pretext to reduce activities of above mentioned agents to non-economic or anti-economic behavior. It would be the mistake similar, comparable with efforts to reduce activities of private agents to production of private bads. Soviet period of our history when private goods were treated almost as economic bads, proved that this kind of reasoning leads to grave mistakes.

State spending is connected with production of public goods beginning with national security ending with political and legal order. Thus it is not mere waister of resources what at least implicitly follows from neoliberal or libertarian argumentation. It brings benefits in case resources are used prudently, and public goods are of relevant quality, and appearance of public bads is minimized.

Does Wagner's law work in Lithuania?

When talking of the level of government expenditure we should be aware of what is called as Wagner's law. The nineteenth century German economist Adolf Wagner disclosed the tendency of growth of the ratio of state (government) expenditure to national product. He made empirical observation (statement) that in progressive (!) countries – by them he meant mostly Western European countries – the public economy is growing. A. Wagner argued that due to

industrialization market relations become more complex and this complexity requires certain system of regulation. In response to this need legal services, police services and state banks and other institutions develop. The growth of public expenditures on education, health, culture Wagner connected, related to the growth of income: with the rise of incomes public expenditures on these services would rise.

The costs of these services had to be covered by government (state), which in turn had to think how to increase its revenues – the task that was and is difficult to any government. Nevertheless A. Wagner was sure that in the long run the desire for development and progress would overcome people's resistance to “bigger” government, to bigger state expenditure [see 2, 122].

Some researches disagree with deterministic approach used by A. Wagner. They argue, that such approach exclude, ignore public choice. This choice could be between publicly and privately supplied educational cultural and similar services [see 2, 123]. Despite this and other arguments, many scientists value, appreciate insights made by A. Wagner³.

In Lithuania Wagner's law has to be reinvented. It is practically unknown even for the community of economists, though, in our view, A. Wagner's insights could enrich substantially our discussion on public economy at large, and public finance in particular. In the environment unfriendly to the public sector it would be challenging to ask whether Wagner's law is applicable to Lithuanian conditions, what are arguments for and against this doctrine. The limited space

³ It is worthwhile to point out the difference between A. Wagner's and J. M. Keynes's approaches. If Keynesists concentrate on state's fiscal policy directed to regulation of demand and deals within traditionally understood economic parameters, A. Wagner approach allows to extend analysis to the public sector as a provider of specific, non-market goods.

of the article confines us to the formulation of short answer, which, we hope, could enhance further discussion on the issue: hard evidence in form of financial data and facts from the last century show that demand for public goods grew and that modern societies had to spend increasing amount of money on them, or, at least to be very careful in reducing their public spending⁴.

In this respect we support position of E. Terk, who says that attitude according which one of the main advantages of economics of the region was low production cost among them – low labor costs – in the future could prove to be doubtful. Therefore possibilities of saving at the expense of social sector, and, thus, reduction of budgetary expenditure, what in turn means tax cuts, are limited, because it could jeopardize(?)impede economic development and would exceed the limits of social tolerance. We could add: it could cause political troubles as well [13,3].

The structure of tax revenues and its development

Let's take a look at the revenue side of Lithuania's national budget. We will begin with the issue of combination of proportional, progressive and regressive taxes in our country. In this respect we want to make several remarks.

Firstly, our direct taxes are flat, proportional, i. e. they are the same for people with high and low income⁵. Only few countries in the world apply this type of taxes on income. Majorly, among them US, UK, Germany, use the

principle of vertical justice in taxation – those who earn more through taxation contribute bigger amount of money to the production of public goods and to transfer payments.

Elite in our country has a very vague if any understanding of the principle of vertical justice reflected in progressive taxation, or it is driven by the instinct of rapid accumulation of capital. One of the hidden arguments for such a policies is: national business people need money for further privatisation to compete in this respect with foreign investors. More active participation in privatisation process of national capital could save more economic sovereignty to the country.

Secondly, visible, strongly expressed tendency exists to reduce direct taxes. In two steps profit taxes first were reduced from 29% to 24% and later – to 15%. There are plans to reduce the rate of income taxes.

To add to the picture, there are radical proposals to abolish direct taxes on personal and corporate income altogether. The main arguments of such an abolition are: 1) through direct taxes the state interfere with economic processes, with market; 2) they are expensive to administrate. Thus abolition of these taxes means, in their view, liberation of market forces, and thrift, reduction of public spending.

Though attractive from the first glance these arguments are, they cause serious doubts after closer examination of the problem.

It is well known that indirect taxes are regressive by their nature, i. e. they are greater burden for poor than for rich, except taxes imposed on luxuries. Having in mind the fact that we keep proportional taxation for profits and individual incomes, we should admit that our tax system is not fair for (those) worse-off. That in turn means that poor contribute more to the production, creation of such public goods as, for instance, national security, judiciary, state governance than those well-off (better-off).

⁴ In the 20th century many researchers followed the same logic as A. Wagner. Among them were W. Rostow [15], R. Musgrave [7], A. Peacock and J. Wiseman [12] and others. Their views were based generalizations made of experience of a significant number of countries.

⁵ To be exact we have to admit that some elements of progressivity in our tax system exist – there are exemptions from taxation for lowest income earners.

Some argue that reduction of taxes on profits and on individual incomes would increase purchasing power of households. In fact if direct taxes would be lowered and then proportionality would be kept due to regressivity of indirect taxes the high probability exists that households with low income would pay more taxes both in relative and absolute terms. It could mean reduction of their purchasing power and reduction of aggregate demand. In turn it would lead to slower economic growth, greater unemployment. Possibility of emergence of another negative chain of economic events should be kept in mind as well. Families with low and moderate income paying higher (indirect) taxes would have even more limited access to public goods. For instance educational services (schooling) are not absolutely free. Parents pay for transportation, meals, clothes of their children when they attend the school. In addition due to bad financing schools periodically collect money from parents for different common purposes. All this makes the real financial burden of education for poor families increasingly heavy.

The same applies for other public services, for instance health care. It in turn has negative long-term effect on quality of human and social capital as factors of economic growth and correspondingly on the prospects of economic development, international competitiveness of the country.

Talking about international aspects of the issue of the combination, (proportion between) of direct and indirect taxes we should keep in mind some facts.

One of them is negative impact of competition in the sphere of corporate taxation. Proponents of abolishment of profit taxes usually name Estonia as positive example to follow. But usually they ignore the fact that European Commission is unhappy with such practices, because it is afraid that such a competition in the sphere

of corporate taxation aimed at attraction of foreign investment could have negative consequences for financial stability, stability of financial policy itself, stability of budgetary revenues of European countries.

The president of European Commission Romano Prodi clearly stated that Estonia's practice of charging no income tax on reinvested corporate profits "is completely outside the common strategy of European Union countries"[6]. This statement reflects dissatisfaction of some EU countries like France, Italy or Spain with Estonia's liberal tax law, which in their view give their country unfair competitive edge within the union.

In Estonia the considerable fall in budget revenues could mean cuts in government spending. Some analysts say that it is very difficult to imagine the country, which can live without corporate tax for long period of time, because of the shortages on revenue side [11]. They say that one of scenarios is to raise other taxes for instance VAT. Of course if massive foreign capital is attracted, then the step pays, as it was in Ireland. It is very important to make sober predictions whether our country is in the same or at least at similar position in this respect as Ireland. Until now our abilities of prudent self-evaluation, our prognostic power showed to be limited. In many cases our self-analyses usually were one-sided and overly impulsive, enthusiastic, ideology ridden.

It is true that nowadays European Union is concentrated on common strategy in the field of indirect taxation, and direct taxes are left mainly in the national domain. Nevertheless there are some signs of efforts to seek more coordination in the sphere of direct taxation as well to avoid competition in the sphere of taxation.

Creation of tax heavens, or tax quasiheavens sometimes gives certain, relative advantages for individual country, but in general they create,

augment problems both nationally and internationally (as well). Some scientists are especially critical of competition between nations in terms of their fiscal attractiveness to foreign capital. One of outspoken critics is Riccardo Petrella. We cite: "There is a strong competition between the nations – especially European – to reduce taxation. A war has to be waged against the ever-growing competitiveness between national fiscal systems. The European integration to be socially worth and politically democratic must go through a fair and redisplaying common fiscal policy and not through a growing competitiveness on the unique market between national fiscal systems..."[9]

It is indicative that not only individual economists, EU officials, but some other international organizations all well cautions us against risky decisions in the field of public finance. To mention only one of them – OECD. The Center for Co-operation with Non-members prepared Regional Tax Programme for the Baltic Countries. This programme among other things says: "...the Baltic countries are faced with the international problem of harmful tax competition, and tax policy assistance is needed to avert these countries reacting to this pressure by making themselves tax havens"[14]. It seems to us that this warning and suggestion is as if unheard by our policy makers, media not to mention general public.

Returning to the national level we would like to emphasize the need for more open and more intensive discussion of the questions of progressivity, regressivity and proportionality of our tax system. The proportion between direct and indirect taxation should be part of this discussion.

Today we have the situation, which remind us the term (concept) of "obfuscation strategy" introduced by P. Pierson and later applied to the description of the situation in the sphere of pen-

sion reform in Central Europe by K. Müller [8]. Avoidance to discuss all existing arguments, the reliance only on some power centers and ignoring others, one-sided propaganda compain in favor of the decision already made by these power centers lowers visibility, transparency of the problem, and gives advantage for interest groups, which push the decision. It is usually done at the expense of public interest. The process connected to the reform of our pension system went exactly by this scenario. Similar strategy is used viv a vis the sphere of public finance. Only one group of arguments is represented, publicised, others are instinctively or consciously neglected, ignored. It is, of course, incompatible with the principles of objective, critical scientific research and discourse. Not only arguments in favor of proportionality and reduction of our direct taxes, for abolishment of corporate taxes, should be publicised. Arguments for progressivity of our tax system, for keeping prudent level of direct taxation and against international tax competition should be visible and heard (audible) as well.

Power structure and Lithuania's public finance

The purposes, structure and means of any economic policy is by large extent determined by cognitive and political environment (conditions) in the country and around it.

By political conditions (environment) we mean power structure as well as intensions, motives and behavior of the main power centers.

Country's political parties, business, trade unions, media, church, intellectuals have different goals and capacities to influence the course of country's development in general and partial policies like public finance. Here one should discriminate between formal and real power. Formally, officially political institutions have the

biggest decision-making power. In reality these decisions are significantly influenced by other power centers. Mass media and business are to be named as the most powerful sources of influence. Trade unions, churches, universities with their intellectual resources are substantially less influential and less vocal on the issues of taxation and distribution of budgetary revenues in our country. Except some cases then their interests are directly involved.

Business community advocates for low direct taxes. Under its influence profit taxes were lowered to the margin of 15%, and proportional (flat) taxes on income are kept until now, despite the fact that center left coalition is in power. Knowing that progressive taxes are more social-ly just than proportional, we should be surprised. All the more we should be astonished, surprised realizing that on the 14th year of re-established statehood universal declaration of income is absent, does not exist. Even more surprising is the fact that mass media, which is glamorous, active in many other cases, keeps silence... Mass media being business itself and acting, (living) under influence of ideological swing from social (or socialist) fundamentalism to market fundamentalism is more or less openly pro-business⁶. Few exceptions don't change the general picture of ideological environment.

This is one of explanations that political parties, even from the center left are pursuing neoliberal or quasineoliberal economic policy. Cuts in direct taxes, negative suspicious attitude to the public sector as a pure consumer not producer of economic resources, mesmerizing(?) markets are the most vivid features of economic thinking or/and actions of our political elite. In some cases these actions are prompted by sincere believe, in others – by understanding that other-

wise one could be punished, ostracized, reprimanded, sidelined. Media's role here is tangible.

Conclusions

Lithuanian public finances developed in peculiar gnoseological and political environment. Community of economists after reestablishment of Lithuania's statehood had to deal with avalanche of challenging problems, connected with systemic changes in economy. Public finances was one of such problems. With advice and pressure of international organizations, following examples of other countries, some essential, fundamental changes in taxation, tax administration and expenditure policy were made. Introduction of value added taxes (VAT), customs taxes, relatively rapid though not ideal learning in tax administration, uneasy progress in municipal finance are examples of those badly needed changes and achievements.

In the same time some major problems remain unresolved. One of them – transparency and comprehensiveness of considerations concerning proportionality, progressiveness and regressiveness of our tax system. Another – ratio between direct and indirect taxation (taxes). The third – the amount of tax burden.

In present circumstances the drive for lessening and even abolishment of direct taxes is somewhat weaker than several years ago. Probably on the eve of Lithuania's accession to EU it does not sound realistic even for the most adamant proponents of the idea.

In the same time the prospects of introduction of progressive taxation are not thoroughly discussed in public.

The same applies to the issue of tax burden. In present situation it is much safer and more fashionable to claim that tax burden is too heavy, though comparative statistics shows different picture.

⁶ More about these kinds of economic fundamentalism see [3].

But in our view it would be a mistake to confine financial efficiency with minimization of total financial input to the public sector, in other words – with minimal tax burden. The total utility produced by this sector should be taken into account. For neoliberal school it is almost a heresy to talk about economic utility supplied by public institutions, but for part of economists – the number of them in the world is not decreasing – it is proved postulate. Following the latter logic one should talk not about minimal but about optimal financing of the public sector. We hope that with

time our power centers – first of all media, business and politicians – will realize that cheap public sector is not necessarily effective public sector, that private sector can not provide everything needed by business activities. Unfortunately today (nowadays) our main power centers are not fully aware of the importance of specific public good – prudent and balanced fiscal policy. Other forces – trade unions and intellectuals first of all – which are most sensitive to fiscal imbalances and which would like to see some changes are on the weak side of the political spectrum.

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LIETUVOS VIEŠŲJŲ FINANSŲ POLITINĖ EKONOMIJA

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Santrauka

Tradiciskai viešieji finansai nagrinėjami pajamų ir išlaidų apimtys, struktūros, valstybės skolos klausimų kontekstu. Šiame straipsnyje viešųjų finansų objektas išplečiamas į jį įtraukiant tokius klausimus: politinis ir nosocologinis klimatas, kartu svarstomi ir spręsdžiami

viešųjų finansų klausimai, viešojo sektoriaus vieta ekonomikoje, Vagnerio dėsnio taikymo galimybės mūsų šalyje ir pan. Straipsnio autorius mano, kad dabar Lietuvoje diskutuoja viešųjų finansų klausimu yra nepakankamai intensyvi ir visapusiška, pagrindiniai šalies

galios (ne tik valdžios) centrai nepakankamai suvokia tokios viešosios gėrybės – subalansuota ir demokratiškai aprobuota viešųjų finansų koncepcija – svarbą. Todėl dabar sprendimai viešųjų finansų srityje dažnai

yra padiktuoti buvusios praktikos, taip pat pagrindinių galios centrų – verslo ir žiniasklaidos, kai kiti galios centrai – profesinės sąjungos, akademiniai sluoksniai ir pan. lieka labiau procesų stebėtojai nei jo dalyviai.

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