TAXATION IN EUROPE

IREF 2008

What did 2007 bring in terms of fiscal reforms in Europe?

IREF, the Institute for Research on Economic and Fiscal Issues, asked eleven experts from the four corners of Europe to report on the main trends in their countries and neighboring countries. All the reports are available on IREF's website. Below you will find the most recent changes in the fiscal policy of **Lithuania** presented by **Ruta Vainiene**.

Pierre Garello

Director of Research, IREF
Aix-Marseille University

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LITHUANIA

Ruta Vainiene
Head of Taw competition and Budget reform team
Coalition for a free Europe
Lithuanian
Free Market Institute

Lithuanian tax system has a short history. As an independent tax system it started his existence in 1990 only after the proclamation of Lithuanian independence from Soviet Union. Since 1990 Lithuania has experienced rapid and multiple changes in taxes, introduction of new taxes and an increase of the tax burden.

Lithuanian tax system should be attributed to the traditional European tax systems. Lithuanians are taxed by almost 28 different taxes, namely VAT, personal income tax, profit tax, social tax, social insurance contributions, excises, property tax, land tax, inheritance and gift tax, tax on natural resources, tax on gas and oil resources, pollution tax, state and local fees and charges, lottery and gaming tax, guarantee fund contributions, customs duties, etc.

There are however two positive (from the competitiveness prospective) distinguishing features that should be mentioned:

1. Lithuania has a fixed (in absolute terms) personal income tax type, called "business certificate", where a natural person can pay a fixed lump sum income tax before starting certain activities (there is a rather broad list). This is the simplest way to pay a personal income tax. Business certificate tax is rather low and regressive and that raises complaints from companies that are engaged in the same activities and natural persons that do the same job having job contract. By essence this tax can even be compared to capitation tax. Since the very introduction of this type of paying personal income tax there has always been a discussion to abolish it and to switch totally to a proportional taxation of income. Fortunately, the business certificate is still applied.
2. Lithuania does not tax immovable property of natural persons (except of land) given that property is not used for commercial purposes. The property tax is imposed only on the real estate of legal entities and real estate of natural persons that is used for commercial purposes. There are intentions from the Government to impose the property tax on all property, and only election's cycles but not deep understanding of damaging effects of this tax can prevent us from that.

Lithuanian are taxed by almost 28 different taxes, with nonetheless some positive features such as a fixed personal income tax (a kind of capitation), or the fact that immovable property of natural persons is not taxed.

LITHUANIA

1.

Tax burden

The tax burden in Lithuania was 38 percent in 2007 (calculations made by LFMI using Adam Smith Institute's methodology to calculate Tax Freedom day as tax revenue share in Net National Product). According to the Ministry of Finance the tax burden is even lower and is 31 percent. This is almost the lowest level of redistribution among the EU member states, lower than in Latvia and Estonia. However, if comparing tax rates (it is complicated to compare tax bases), Lithuanian tax rates are not considered to be low. For example, personal income tax rate is 27 percent, while Latvia has 25, Estonia has 22 in 2007 and will be reducing by 1 percentage point every year down to 18 percent in 2011. The conclusion is that Lithuania possibly demonstrates symptoms of Laffer's curve slop down (high taxes – low budget revenue).

Lithuania has almost the lowest level of redistribution in the EU (tax burden around 38%) although tax rates are not that low. Possibly a Laffer's curve effect.

2.

Value Added tax

VAT is harmonized with the EU directives. Standard VAT rate is 18 percent. There are two reduced rates – 5 and 9 percent. The reduced 5 percent tax is applied to passenger transport by regular routes, by passenger trains as well as transportation of passenger luggage; books, newspapers and magazines, except for publications publicizing eroticism and violence, which have been recognized as such by an institution authorized by legal acts; pharmaceuticals and medicinal products (special purpose food products for children, special medicinal purpose food products and special medicinal body and dental care products, pharmaceutical products, medical devices, compensatory equipment, medical aid devices and articles of personal hygiene); accommodation at hotels and other special accommodation services for tourist activities; organic food products; chilled meat and edible offal (with the exception of meat and edible offal of poultry); chilled, frozen and deep frozen meat and edible offal of poultry. Reduced 9 percent VAT is applied to the housing renovation if it is financed from state funds.

Standard VAT is 18 percent and reduced rate are at 5 and 9 percent.

The ongoing discussion is on abolition of reduced VAT rates. Among the reasons for the abolition there are also circumstances that strong lobbying groups have pushed through rate reductions to certain goods (for example, meat). Lithuanian Free Market Institute supports the abolition of reduced rates. The reduced rate of 5 percent having 18 percent standard rate sometimes is a 13 percent donation from the budget to selected goods and services and harm the neutrality principle of taxation.

The ongoing discussion is on abolition of the reduced rates. Such abolition would be fair and efficient.

There is a quite unique rule on not deductible input or import VAT in the Lithuanian Law on VAT. Input or import VAT on a passenger car designed for the transportation of no more than 8 persons (excluding the driver), or a motor vehicle of the said class attributed to the category of off-road vehicles, provided this car is not supplied or leased, or it is not used to provide services of passenger transport for reward or driving instruction services is not deductible. The same limitations shall apply to the deduction of input VAT on the lease of cars of the specified categories. These limita

5.

Corporate income tax is 15 percent. The corporate income tax was reduced from 24 to 15 percent in 2003. It should be mentioned that corporate income tax was 35 percent when it was introduced in 1990, there were reductions down to 29 from July 1991 and to 24 from 2001 (for the 2000 tax period).

Social tax was introduced in 2006 and is applied to the same tax base as corporate income tax. Social tax is temporary and it is only applied to corporate profit for the years 2006 and 2007. It equals to 4 and 3 percent respectfully for the tax periods of the years 2006 and 2007. Social tax was introduced as a temporary measure to soften budgetary impacts of reduced personal income tax.

LFMI was the first to initiate the discussion on the abolition of corporate income tax as such and taxing profit (dividends) by PIT when it is distributed to private owners in 1991. The result of the discussion was the abolition of the profit tax on reinvested profit from March 1997 (before this the acquisitions of long term real assets were taxed at 10 percent). This rule was abolished from 2003. However, under the pressure from international competition, low productivity, and large emigration the discussion started again to introduce a zero percent profit tax on investment in the so-called "high end" technologies.

There are discussions on fairness and equality of the tax burdens on legal entities and natural persons. The proponents say that labor is taxed more heavily (which is true) than capital and propose to increase the profit tax. The alternative solution to reduce the personal income tax down to 15 percent is also on the table, however it is not gaining much support from politicians.

Corporate income (profit) tax and Social tax

Corporate income tax is down from 35% in 1990 to 15%.

the normal tax rate of the value added tax increased from 16% to 19%

A temporary social tax was levied on the same based in 2006-2007.

The question remains whether to abolish taxation on reinvested profits.

6.

Excises are harmonized with the EU requirements. Lithuania received a transition period until the end of 2009 for excises on cigarettes. The excises on cigarettes are increased gradually.
The actual excise rates on fuel and alcohol are higher than minimal excises stated in the EU directives. The Parliament passed a law that increases excises on strong alcohol by 20 percent and 10 percent on beer starting from 2008.
The LFMI carried out research on the impact of increasing excises on tobacco. There is evidence that the increase of excises correlates with increased smuggling and reduced consumption of legal production. In 2 years period the consumption of legal production reaches the same level as it was before the increase of excises.

Excises

A law was passed to increase excises on strong alcohol by 20% and 10% on beet starting from 2008.

Studies show this will not reduce consumption but increase smuggling.

7.

Taxes are administrated by a central tax administration office. The tax administration is rather classical, duties and responsibilities of tax administrators and tax payers are not leveraged. However we have to admit that the culture of tax administration has increased and taxpayers do not complain much about corruption or rude behavior of tax administrators any more.

The most critical and dangerous points in tax administration are the application of arms length principle among related persons and precedence of content over form. It is stated in the Law that in respect to taxes, the content of the activities carried on by the participants of legal relations shall take precedence over their form. That means that tax authorities may voluntary calculate the tax due without ignoring formalities of the contracts.

Tax administration

the culture of tax administration has increased.

The most critical points are the application of arms length principle and precedence of content over form

8.

State finances are heavily centralized in Lithuania. All taxes can be introduced by the law issued by the Parliament only. There is a closed list of local taxes (fee and charges) which local councils may introduce and set the rate. Local councils set the "business certificate" tax rate. Municipalities may also set a fee for the use of public land in its territory; however, all land lease agreements are concluded on the central level. All taxes are administered on central government level as well, so municipalities cannot influence the effectiveness of the administration. Municipalities are very dependent on central institutions as the PIT is redistributed among "rich" and "poor" municipalities by the central government. There are no discussions on decentralization of public finances.

Decentralization of public finance

State finances are heavily centralized and there is no sign this will change in near future

9.

To conclude:

1. The trend to reduce corporate tax rates and personal income tax rates prevails in Lithuania. Historically corporate tax rate was reduced more than twice, personal income rate was reduced less significantly, by 9 percentage points.
2. Tax competition has clearly contributed to the development of Lithuanian tax system. If it was not for international tax competition, Lithuania would impose progressive personal income tax, higher corporate income tax. There would be no discussions on social security contributions ceiling.

To conclude...

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1. The tax competition works poorly in the field of tax base. This is the hidden side of high taxes. The rate may be low, the base may be broad. That may lead to heavy tax burden.
2. From the political side the tax increase intentions prevail. The tax reduction wing wins mostly due to tax competition and political cycle reasons.
3. Lithuania experiences the phenomenon of "high taxes – low revenue" known as Laffer's law (curve). Every reduction of tax rates does not harm budget revenue, opposite, the budget increases steadily.
4. Most of the reforms in Lithuania are internally supported either by professional bureaucrats or influential interest groups. Economic logic plays a role when it is comfortable with the previous.
5. There are no discussions on decentralization of public finances.

LFMI@freema.org