

TAXATION IN EUROPE

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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**.



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LITHUANIA

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.



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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.

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1.

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).

2.

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.

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.

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

Tax burden

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.

Value Added tax

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

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

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tions shall not apply to motor vehicles of the specified categories, provided they are attributed to special purpose motor vehicles under legal acts regulating the classification and coding of vehicles.

This rule caused multinational companies to transfer the purchase of “light” vehicles to the neighboring countries, mainly Latvia. When that became very visible in direct terms (Latvian number plates of new cars), the Parliament changed the law and abolished this discriminatory rule. However, due to improperly held procedures, the President of Lithuania put his veto on the law. The changes did not come into force. There are intentions to repeat the voting in the Parliament by properly following all necessary procedures.

3.

Personal income tax rate is 27 percent and 15 percent for certain types of income; there is an option to pay PIT as a lump sum tax by acquiring business certificate. The rate is flat; however the tax itself is progressive due to existing tax exempt income. The tax exempt income differs according to personal data of the taxpayer (for families with 3 children and more, handicapped, etc). The tax exempt income makes the effective tax rate progressive, varying from approximately 15 percent to approximately 27 percent. The nominal tax rate will be reduced down to 24 percent from January 1, 2008. Five ongoing discussions need to be mentioned:

1. To make a personal income tax progressive by using different tax rates. Ruling social democrats propose to introduce 3 brackets tax rates. From the free market point of view this shift would be considered as a big step backwards. Lithuania was among the first European countries to introduce flat tax rate from May, 1994. Lithuania introduced the flat rate of 33 percent after years of high inflation which caused that all taxpayers were on the upper bracket. Before Lithuania had progressive personal income tax which rates varied (18 (10), 20, 24, 28, 33 (35)). Lithuania followed Estonia which introduced flat rate earlier and its solution was based more on understanding the benefits of flat taxation. Latest news is that social democrats changed their intentions and keep on hold for their progressive tax rates proposal.
2. To leave the existing 27 percent personal income tax rate, i.e. to change the Law on Personal Income Tax and to refuse from the planned reduction down to 24 percent starting from 2008. The argument for this proposal is increasing budgetary needs. As of today, it seems that this proposal won't be accepted. If it would Lithuania would be on the tail of the EU member states that are now racing in PIT reductions (for example, Bulgaria introduced only 10 percent personal income tax).
3. To lower the personal income tax more radically. To reduce the personal income tax rate down to 20 or 15 to make it equal to profit tax (15 percent at present).

A specific rule on input or import VAT is about to be abolished. This rule had the adverse effect of pushing companies to purchase vehicles in neighboring countries

Personal income tax (PIT)

The rate is flat at 27% (15% for certain types of income) with an option to pay PIT as a lump tax by acquiring a business certificate. This basic rate should be reduced from 27 to 24% January 1, 2008

There are however discussion to bring back progression into the scheme.

Some oppose the rate cut from 27 to 24%

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4. To limit or to abolish the possibility of business certificate. Small businesses strongly object to these proposals as the abolition of business certificate will lead to the increase of tax burden.
5. To review the types of income that are taxed at 15 percent, particularly, royalties. Main argument is that the current two different rates allow manipulating source income and avoiding the higher rate. The contra argument is that one rate may be supported if that rate is 15 percent admitting that two rates provide for manipulations.

Important facts: 30 percent of personal income tax goes to Health insurance fund automatically. Every reduction of personal income tax immediately reduces financing of health care. The demand for health security is increasing due to multiple reasons such as defective state health care system, aging population, new expensive healing techniques. So, every reduction of PIT makes it socially very sensitive. The second reason for rather complicated process of reducing the PIT is that it finances municipal budgets. Municipalities object to any reductions of PIT protecting their budgets.

Laffer's effect of the increase of budget revenue after the tax reduction was visible within half a year's time. Lithuania reduced PIT significantly by 6 percentage points from 33 percent to 27 percent in July 2006, budget revenue from PIT remained at the same level as in 2005 (inflation not adjusted, the average annual inflation in 2006 was 3.8 percent).

To conclude on the personal income tax, there are political intentions to increase the revenue from PIT significantly in two ways: to broaden tax base and to increase (not to reduce) tax rates. Only international tax competition (race for lower PIT) prevents Lithuanian lawmakers to move on the latter. However, international tax competition pressure is not as visible on the tax base field, so it may be projected that officials will proceed on the tax base question more intensively.

4.

Social security contributions are paid to State Social Security fund that operates on pay-as-you-go principle. Social security contributions comprise of two parts: employer's contributions (31 percent), employee's contributions (3 percent), that is, totally 34 percent. 5.5 percentage points of the contributions may be paid to private pension fund. The insured person has an option whether to stay in the state social security fund or voluntary transfer a part of compulsory contributions to private pension fund. There are no ceilings for SSC, however there are ceilings for pensions paid from the fund. The SSC makes labor force very heavily taxed in Lithuania.

The ongoing discussion is whether to introduce income ceilings for SSC or not, and if yes, at which level. The reason for this proposal is that social security contributions do not correlate with pensions paid from the fund. Tax competition also plays its role here – neighboring Latvia, Poland, Russia, also Czech Republic, Hungary, Bulgaria, Slovak Republic and other EU member states have ceilings for SSC.

Others would like to reduce further to 20 or 15%

There also proposals to abolish business certificate or to suppress the special treatment at 15%.

Lowering personal income tax is difficult since 30% of tax revenues helps finance health care and another part finances municipalities

There is, however, clear sign of a Laffer curve effect: lower tax could bring higher tax revenues

Social security contribution (SSC)

Social security contributions are heavy, especially compared with other EU countries, and a ceiling for SSC is debated.

Taxpayers can, if they wish, shift part of their SSC to a private pension fund

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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 respectively 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.

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.

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.

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.

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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.

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.

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.

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

Decentralization of public finance

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

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. 



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