

# Tax System and Conditioning of Business Environment in Lithuania

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*In this article an officially declared direction of a future tax reform is discussed. The main emphasis is put on the examination of a role of a profit tax in conditioning of contemporary economical environment of operating business firm and impact of consumption taxes on a behavior of various participants of market. International practice of imposing a profit tax and a value added tax (VAT) is considered and international comparisons are made. The article argues for introducing a progressive profit tax and reducing value added tax.*

## 1. Introduction to a Problem

The first steps towards forming of Lithuanian tax system were made only in 1991, after the country separated from centrally planned Soviet Union. Transition to market economy was impossible without a cardinal reform of this important field. So in 1991 Lithuanian a new approach to a taxation of business subjects was implemented. In this year there were issued such important laws as "Law of Finance Inspection" and "Law of Budget Structure in Lithuania". In the latter, budgets of municipalities were separated from a budget of a country. In 1991 a very important law of "Profit tax" was issued. Until 1991 all profits, which remained in enterprises (after inner needs were met) were due to trans-

fer to a budget. In 1991 a concrete profit tax tariff of 35% was set. In the same year this tax tariff was reduced to 29%.

Taxation of business subjects was determined before a process of privatization in Lithuania began. According law, the same profit tax tariff was applied equally to large state enterprises and, with very few exceptions, to small newly established private one's. Obviously it was difficult to preset a tax policy appropriate for such a specific situation in national economy. Since 1991 structure of business subjects has changed; over 90% of state enterprises are already privatized, but tax policy concerning taxation of profit, remains quite obscure until now. As the result of a lack of stable approach towards taxation of business subject, some tax laws during 10 years of

country's independence were changed over 100 times. Despite of a great deal of improvements, which have been made, process of changing of tax legislation continues.

## 2. Goal of the Research

Goal of the research is to examine and evaluate declared by government direction of a future tax reform in Lithuania. Considering discussion, which has being held inside republic, the main emphasis has to be put on the examination of a role of a profit tax in conditioning of contemporary economical environment of operating business firm, and examination of an impact of consumption taxes on a behavior of various participants of market.

## 3. Description of the Method

The present article is based on the following approach to the problem: (1) Constructing of any *consistent* tax system has to be based on thorough examination of theoretical views on impact of main taxes on business environment; (2) Theoretical assumptions or views to role of main business taxes has to be verified by contemporary economical practice of various countries; (3) The principal direction of further tax reform in Lithuania should be determined considering international experience and national specifics; (4) The main task of the tax reform is conditioning of business environment determining development and grow of business enterprises, especially middle-sized and small ones.

## 4. An Analysis of the Main Contemporary Approaches to a Construction of an Efficient Tax System

The most important taxes for majority of countries are a corporation tax, taxes on personal in-

come and taxes on consumption. Latter include a value added tax, excise duties and custom duties. The weight of these taxes can differ in various countries because of different tariffs, level of economical activity, level of living and consumption, etc. In Lithuania now VAT and excises constitute 54.8% of a national budget, in the second place is a tax on personal income (13.9% of a budget) is and in the third place a tax on corporation's profit (accordingly constitute 7.5% of a budget) occurs [1].

An official approach to the tax reform has been expressed in 1996 in a Program of Government's Activity for a period of 1997–2000 [2], in which a direction to abolishing of a profit tax was set. Nevertheless the firsts steps towards declared aim were made only in a very end of a cadency of recent government and were restricted to a modest reduction of profit tax by 5% what actually meant a change of a profit tax tariff from 29 to 24% [3]. Admittedly, the lack of arguments and rather wage possible results were those main obstacles, which stopped a realization of latter program.

Choosing of a direction of a future tax reform in Lithuania requires of a thorough examination of impact of main taxes on business environment. At first, a role of a profit tax (some countries call it “a corporation tax”) should be examined. Economists agitating for abolishment of a profit tax as a rule base their arguments on two main assumptions. The first, abolishing of a profit tax should stipulate investments, which would increase an economical activity as a whole. The second, tax system excluding profit tax is more “transparent”, quite simple and consequently easier and cheaper administrated.

Recall, that now a profit tax brings about 7% of revenue to national budget. So if assumption about a low profit tax as the main initiating force

of additional investments occurred unjustified then lowering its tariff would deepen a budget deficit even more. Excluding of a profit tax from a tax system means transferring of all the emphasis on indirect taxes. So the principal influence of indirect taxation on the activity of business firm should be considered as a part of a solid question.

Theoretically, a profit tax is considered as a tax on a capital, which urge latter to move into countries with the lowest profit tariff. To put it into other way, a low profit tariff should stipulate investments. Although applying those theoretical statements to Lithuania we can't ignore a contemporary economical reality, which has been influenced not by a single factor, so actual result sometimes can differ from one, which was expected. So why arguments have been used for a grounding of the most important reform by some economists are seen as "early" ones[4]. It is emphasized that a low profit tax tariff as an economic tool stipulating investments has lost its effectiveness. Even if this gear was highly important several decades ago situation has changed. Developed countries consider themselves as "capital abundant". Market is so overfilled with goods and services that finding of niche becomes a greater and greater problem. In the process of making decision to what country to invest such arguments, as availability of cheap working force (which in Lithuania isn't so cheap) and possibility to sell produced goods, are treated as arguments of a prime importance. So why Lithuania seems attractive mainly for those investors, who see possibility to take guaranteed monopolistic positions. There are a lot of examples which illustrate such a trend: Lithuanian Telecom, Norwegians intention to invest into Vilnius' city car parking system, Swedish businessmen's interest in Kaunas' city

central heating system. All these investments are directed into fields in which consumers have no possibility to choose – they would be enforced to consume good or service at a price, which would be charged.

In such a light lowering of a profit tax and even abolishing of it in the future doesn't seem such an attractive tool of economical policy anymore. Recall, that now in Lithuania profits used for investments aren't taxed at all. Such stimuli in foreign countries are treated as rather powerful. If in our country even they are not sufficiently effective then a logical question should arise: why the lowering of profit tax tariff should result an investment-initiating effect. In such a situation more reasonable expectations seemed as further strengthening of local monopolies but not a general increase of activity. Anyway, enterprises, which occurred on the edge of a bankruptcy, are indifferent if the profit tax tariff is 5 or 50%.

Revising government's intentions to abolish a profit tax tariff we need to stress that such an idea isn't an original invention. Even if tariffs of corporation tax, (which corresponds our profit tax) in most countries are high (Fig. 1)[5], some countries or even zones of countries really have got especially low profit tax tariffs.

In the discussion about further direction of a tax reform in Lithuania an Ireland's example was quoted a lot. Ireland was considered as an opulent country having an especially low corporation tax. Meanwhile, it is necessary to emphasize, that for situation of part of Ireland and similar countries or zones is irrelevant to Lithuania because of different economical context and all exceptions and restrictions. So in these countries (called "tax heavens") for local enterprises such drastic tax advantages aren't applied. In the same quoted Ireland for local

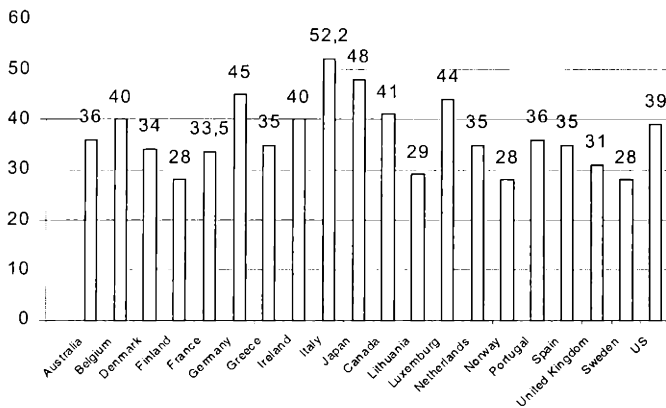


Fig.1. Tax Tariff on a Corporate Income (%), 1998

firms 40% corporation tax tariff is valid. Exemptions are made only for nonresidential companies established by foreign citizens in one of Dublin's areas. If firm is considered residential or nonresidential depends on where the center of management is located and in what territory it operates. If a company is managed by citizens of other countries and it doesn't perform practically in the territory of "tax heaven", it is released from duties. But if the firm posses local land, real estate or another property is used for various transactions, it has to pay all taxes despite who were in charge of it or in which country it operated [6]. To put it in other way, countries of low taxes don't intend to release from taxes investors and so to give up an additional budget revenue. In principal, such countries specialize in providing legal conditions for foreign firms (registered as offshore companies) to transfer funds from one country to another with purpose to escape from national taxes. Of course for legalization of such a possibility a confirmed annual fee is charged.

Governments of various countries to such a phenomenon react differently, but as a rule, negatively. No one country encourages its citizens to avoid taxes due to national budget. Nevertheless, concrete direct action against companies, which use advantages of low-tax countries, is excluded because their activity officially is legal.

Revision of a respond of various countries to latter phenomenon showed that it has been more or less similar. Such countries as Australia, Belgium, Canada, Denmark, France, Italy, Japan, New Zealand restricted their reaction to publishing of lists of such countries [7]. USA encountered with a problem of usage of low-taxed countries in a little bit different context. A tendency was traced that most of foreign corporations operating in the United States pay little or no tax to federal budget. The loss was believed to be in a range of tens billions dollars. The economical investigation of 18 Japanese companies (Japan was considered the largest investor) was launched. It occurred that those foreign in-

vestors gained by establishing subsidiaries in various countries and then shifting its costs to a high tax country and income to low tax country. Such a strategy sometimes referred to as *transfer of payments* or *tax-driven transfer pricing*. Attempts of foreign investors to avoid local taxes received a negative evaluation in America, nevertheless any practical steps somehow to interfere with such a practice were considered as illegal [8].

Lithuania's reaction to the same phenomenon was quite different and shocking to a part of local firms. Unexpectedly without any warning in 1997 the 4th of August Government's Resolution No 888 was issued in which all funds of Lithuanian firms transferred to a company or its subsidiary located in low-tax tariff country or zone are kept due to taxation using 24% tax tariff [9]. So comparing a long-term tax policy announced for the 1996–2000 period, in which direction to abolishing of profit tax have been chosen and latter Resolution we can only regret for lack of consistency of our government.

Examination of low-tax countries leads to a very important conclusion: lowering of a profit tax tariff doesn't mean stipulating of an investment process. If other factors conditioning economical environment don't stimulate investments in its turn, then a low profit tax by will be rather used for a tax-driven transfer pricing but not for investments into national economy.

Tax policy directed to a sharp diminishing of profit tax inevitably means a transferring of a hub of taxation towards indirect taxes. Theoretically indirect taxes are those included into a price of a good or a service and though paid by a consumer at the moment of a purchase. Indirect taxes include excises and VAT. VAT should be considered as extremely important tax, at first, because of especially wide taxable base. Despite of all the

superficial simplicity and "transparency" of this tax, before putting a main emphasis on it, it is necessary to make thorough analysis of its effect on various participants of a market.

In Lithuania VAT was introduced in 1994 without any more serious preparation or a deeper analysis of conjectural results. 18% tax on value added for business agents meant a shock. In other countries like, for example, Great Britain VAT after its introduction was increased gradually. Introduction of VAT in 1973 in Great Britain was connected with entering of country into European Economical Community. Tax tariff of 8% was set for the major part of goods and services. The larger tax tariff equal to 12,5% was applied only for some goods of luxury. In time VAT tariff was being increased and in 1979 it reached a limit of 17,5% (with some exceptions) [5]. For energetic resources (for fuel, electricity) VAT tariff is fixed at 5% with a purpose to increase competitiveness of national industry. By the way, house building in Great Britain isn't taxed at all [11].

The influence of VAT on business environment should be examined from the two points of view. On the one hand, how this tax affects economical results of any firm's activity, and, on the other hand, if the tax is neutral to a financial stability and growth of an enterprise.

In Lithuanian economical literature impact of VAT on economical results of a business enterprise and its financial stability actually is ignored. In the newest literature recommended for higher schools one can find a lot of comments emphasizing that "VAT has no connection with an activity of enterprise <...>, VAT shows only transfer of funds, it is reflected only in a flow of funds and doesn't influence final results of an enterprise: revenue (profits) or loss." [7]

For foreign economists a role of VAT in an economy doesn't seem so clear and simple to estimate. In contrary, they point out that "technically VAT is an transferable sum for an enterprise. But despite that we can't conclude that the tax is neutral in point of view of enterprise's revenue. Introduction of VAT, through growth of prices and appropriate shifts in demand and amount of employed, may result a huge decrease of an enterprise's revenue, which in its turn, could be much greater than that resulted by direct taxation. <...> An increase of VAT leads to a drop of enterprise's revenue and therefore VAT loses its indirect content." [12]

Lithuanian experience supports the latter approach towards a role of VAT in conditioning of business environment too. After introducing VAT as a new additional tax in 1994, level of contribution a profit to national budget decreased from 23,4 to 13,7%. Data showed that volume of business firms' profits diminished. The next year this trend strengthened even more: input of profit tax to budget dropped to 9,6% [1]. So economical reality obviously denies statements about VAT as unrelated with financial results of a business firm.

Tax, which is transferred on consumers affects economical environment in a following way. Introduction of VAT increases prices of goods and services, what in its turn diminish a purchasing power of consumers. A diminished purchasing power means diminished consumption and therefore lower sales of business firms.

Another important characteristic feature of VAT is to put the greater tax burden on a part of society with the lowest income. The lower income, the higher part of it has been spent on consumption. When consumption is taxed that means that the most vulnerable group of society suffers the most. Keeping in mind this feature of

VAT some foreign economists characterize this tax as a regressive one [5] (the higher income, the less part of it is spend on consumption, the less volume of tax is paid).

So VAT not only affects demand but also interferes with a principal of social equity, but in Lithuanian economical literature these moments haven't found proper response.

Anyway, despite all shortcomings, this tax is especially appealing to a government. Budget's revenue is guaranteed after any transaction takes place. The entire hazard is transferred to an enterprise. According valid rules a firm pays VAT to budget for all goods and services it uses for the production of a final product, which it offers in the market. The more funds for production are required, the larger sum of the tax is paid to a budget in advance. A firm receives already paid tax on costs of production back and so reduces amount of tax paid to a declared level only after it sells its product to a consumer. As everyone realizes, some part of production can be never sold or be sold at price that are lower than costs of its production. In both cases costs of an enterprise inevitably increase. Even in a case of firm's bankruptcy government doesn't suffer because taxes are already paid. Results occur with some delay, in a long run, when due to difficult business conditions a volume of production and sales begin to diminish and development of whole economy slows down.

Controversial effect of consumption taxes on development of economy resulted quite different official approaches of governments of various countries towards VAT. For example, USA introduction of VAT has treated as interfering with economical environment favorable to development of business. Introduction of consumption taxes was restricted to generic tax on turnover, which in various states could vary in approximate limits of 5% [8].

European countries, in contrary, widely apply VAT. Because of its shortcomings a lot of exemptions are introduced. For example, even in a such high-tax country as Sweden, main VAT tariff is 25% but for a food VAT is only 12%, for medical care- 0%; in Finland main VAT tariff is 22% but for health care only 8%; in Ireland VAT is 21%, but exemptions are made for food, water, health care etc. (Table 1).

It is necessary to keep in mind differences of GDP (Gross Domestic Product) when making comparisons between Lithuania and European countries. According the latest estimations of World Bank, GDP per capita in 1998 in Lithuania was \$2 540, while in e.g. Denmark – \$33 040, Belgium – \$25 380, Germany – \$26 570, France – \$24 210, Italy – \$20 090, Ireland – \$18 710, Luxemburg – \$45 100 etc.[13].

So if tariffs of taxes sometimes could seem quite near it doesn't mean that they affect a

business enterprise equally. Burden of direct taxes calculated as percentage of Gross Domestic Product (GDP) in European countries in average equals to 13,6%, while indirect taxes correspondingly make 11,3% [14]. So direct taxes actually dominate. In Lithuania, in contrary, burden of indirect taxes much greater than burden of indirect ones: correspondingly 11,8% and 6,7% [1]. That actually means that majority of business firms in our country isn't able to generate appropriate volume of profits.

In such a context shift of a hub of all tax system towards indirect taxes could be evaluated as quite dangerous. On the one hand, it is likely that abolishing of a profit tax wouldn't activate national economy through additional investments and, on the other hand, emphasis on indirect taxes could even more weaken firms and instead of an economical recovery result even a deeper recession.

Table 1. Main VAT tariff and some exemptions, 1998

Country	Main VAT Tariff	Food	Water	Medicine	Books	Hotel
Denmark	25	25	25	25	25	25
Sweden	25	0,48	25	25/0	25	12
Finland	22	17	22	8	22	8
Belgium	21	6/12/21	6	6/21	6	6
Ireland	21	0/12,5/21	0	0	0	12,5
France	20,6	5,5/20,5	5,5	5,5/20,6	2,1	5,5
Italy	20	4/10	10	4/10/20	4	10
Austria	20	10	10	20	10	10
Greece	18	8	8	8/18	4	8
Netherlands	17,5	6	6	6/17,5	6	6
United Kingdom	17,5	0	0/17,5	0/17,5	0	17,5
Portugal	17	5/12/17	5	5/17	5	5
Germany	16	7/15	7	15	7	15
Spain	16	4/7	7	4/16	4	7/16
Luxembourg	15	3	3	3/15	3	3
Lithuania	18	18	18	0/18	18	18

## 5. Conclusions

Considering inconsistency of proposed reform of tax system with purpose of initiating of development business' firms the following improvements would be suggested.

At first, it would be necessary in principle to admit that the formulaic approach to VAT as the main acceptable tax does not provide for strengthening of enterprises and accordingly for activating of national economy. So turn of economical policy to lowering of VAT up to a limit of 8–10% stipulated more initiating business environment. Even European Union, despite it's recommendations for members to orient to 15% VAT tariff, at the same time admits that, nevertheless, concrete tariff of VAT in a particular country should correspond level of it's development.

The second, experience of other countries shows that abolishing of profit tax doesn't automatically mean sufficient stimulus for foreign and local investors. In contrary, abolishing of a

flat rate of profit tax and turn to progressive system of taxation of profit and revenue would let to pay smaller taxes for weaker firms and at the same time restricted incomes of monopolies. Setting of nontaxable limit could let to solve problem of stimulating of small firms. Such tax policy has been widely applied in various countries and already proved its effectiveness.

The third, considering concrete situation of Lithuania, where VAT and excises serve as main sources of national budget' revenue, suggested tax reform should be implemented gradually by setting very precise terms of changing tariffs of valid taxes.

Suggested direction of improvement of tax system wouldn't result instant increase of budget revenue but would condition economical environment orienting business firms to further development. A top priority in countries tax policy must be given to achievement of this purpose, because increasing of national economy could be achieved only on basis of vital, financially strong national enterprises.

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## MOKESČIŲ REFORMA IR VERSLO APLINKOS FORMAVIMAS LIETUVOJE

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### Santrauka

Straipsnyje aptariamos planuojamos mokesčių reformos kryptys Lietuvoje. Analizuojama, kaip skirtingos mokesčių sistemos lemia ūkio subjektų verslo aplinką. Prognozuojama mažo pelno mokesčio tarifo, kaip ekonominio svėro, įtaka investicijoms atsižvelgiant į teorines prielaidas ir į konkrečius veiksmus: Lietuvos patrauklumą investuotojams ir šalių, turinčių nedide-

lius pelno mokesčius, specifinę patirtį. Nagrinėjami įvairūs požiūriai į netiesioginių mokesčių vaimenį. Argumentuojamas neigiamas pridėtinės vertės mokesčio poveikis įmonės veiklos rezultatams ir finansiniam stabilumui. Siūloma tobulinti mokesčių sistemą atsižvelgiant į būtinumą formuoti verslo aplinką, lemiančią įmonių finansinį stiprėjimą ir plėtrą.

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