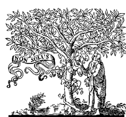
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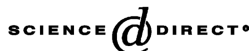

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Corporate income taxation in Lithuania in the context of the EU

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Abstract

This paper explores Lithuania's competitiveness in the area of corporate income taxation. In order to assess how much freedom of action the country has in designing its own corporate income tax policy, the process of EU tax harmonization is analyzed by evaluating justification for tax harmonization, the major developments and the main outcomes of this process. Lithuania's corporate income tax system is compared with the systems in the other EU countries. Following a macro backward-looking approach, the paper calculates the measures of effective profit tax burden. Effective tax burden measures are computed for the whole enlarged EU. Such calculations are still rare in the economic literature.
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1. Introduction

Hardly anyone would dispute the fact that taxes affect the decisions made by companies about the location, foundation or extension of their business. Therefore, the tax system can play a crucial role in a country's economic development. Although taxes are only one of the key determinants of a country's attractiveness for investments, the increasing pace

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of globalization has provoked national tax reform in almost all current members of the European Union. It should be noticed that the new member states from the East have been particularly active in reviewing their tax policies. Lithuania was not an exception.

The goal of this paper is to examine the current system of corporate income tax in Lithuania in terms of both legislation and actual tax burden and to assess its effect on the country's competitiveness. Increasing economic integration in the EU highlights the need to explore this issue in more depth. Although there are many economic studies on tax questions, very few analysts have conducted comparative analyses of the member states within the enlarged EU. This paper conducts such an analysis.

There are a number of reasons why the corporate income[1] tax was chosen as the focus for analysis. First, this is the most important tax levied on companies in many countries. Second, although the EU has stringent regulations in the area of indirect taxes (such as VAT and excise duties), the EU member states have possibilities to design their own (rather than common) tax policies in the area of direct taxes (such as profit tax, personal income tax). Thus, the EU member states are able to influence their competitiveness in this respect. For example, the case of Ireland suggests that tax policy is an important determining factor influencing an economy's capacity to successfully adjust to global conditions and integrate into the EU market. (Ireland has shown a robust economic development in recent years.)

Stringent EU regulations in the field of indirect taxes are a result of tax harmonization efforts. So far, these efforts have failed in the field of corporate income taxes. However, recent signs of intensifying competition among the governments to attract investments by cutting taxes triggered a revival of tax harmonization debate in the EU.[2] By taking this debate into account, the first section of the paper assesses the idea of corporate income tax harmonization. This section also traces the process of profit tax harmonization in the EU. It examines the major outcomes of this process. (The major outcomes are the current EU regulation and legislation on corporate income taxation.) This is done in order to identify how much freedom of action the EU member states have to shape their tax policies.

The second section of the paper compares Lithuania's corporate income tax system with the systems in other EU countries. This section tries to identify the flaws (if any) of this system. This comparison goes beyond a common practice to investigate statutory profit tax rates. It explores the other rules set by law that have a direct effect on the tax base.

Clearly, it is not enough to analyze structural elements of tax systems. Such an analysis does not tell a full story about company taxation in a country because sometimes these structural elements bear little relation to actual taxation. Bearing this insight in mind, the last section of the paper investigates the measures of effective profit tax burden in the EU and dwells on Lithuania's competitiveness in this respect. The measures of effective corporate income tax burden are calculated using the so-called macro backward-looking approach. According to this approach, the effective profit tax burden is measured by relating the realized tax revenues to the relevant macroeconomic variables in the national accounts. The paper concludes by making several general comments about the whole performed research.

[1] This paper uses terms "profit" and "corporate income" interchangeably as synonyms.

[2] In May 2004, the two largest EU member states – Germany and France – submitted a proposal to the European Commission to harmonize the national profit tax systems by setting a minimal tax rate. For more details, see Section 2.2 of this paper.

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