The More the Better: but not Taxes!

Tax and spend is hardly the recipe for economic success

By Rūta Vainienė, Vice-President, LFMI
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Let us take quick look at the pocket of an ordinary Lithuanian citizen. According to the Lithuanian Department of Statistics, an average Lithuanian household spends roughly 43 percent of their expenditures on food, almost 11 percent on housing and utilities, and 7.5 percent on clothes and footwear. Other needs absorb even less. The data of the Department of Statistics lack one item of expenditures, one large portion of people's outlays. I am talking about taxes we pay to the state. The amount of money we give away in taxes is best reflected in the share of the country's gross domestic product that is redistributed through the state budget, or the tax burden.

How much we pay

The Lithuanian Free Market Institute has calculated the tax burden for nine years now. In 2001 the tax burden comprised 37 percent of Lithuania's gross domestic product. This means that an average Lithuanian taxpayer works a total of 134 days a year to pay off the demands of the state and finance its obligations.

So in 2001 the Tax Freedom Day – the day in a year when people stop working for the government and begin to enjoy the full benefits of their labour – came on May 15th. In 1993, for example, this day fell on April 13th.

In 1995 Lithuanians turned over to the government all income they earned until April 27th, with the Tax Freedom Day moving still later in the calendar. In 1999 and 2000 we worked until April 16th to pay the total tax bill imposed by all levels of government.

In some countries the Tax Freedom Day occurs earlier than in Lithuania. In the Unites States, for instance, people stopped working for the government on April 23rd. In most European countries, however, the Tax Freedom Day comes later than in Lithuania. Germans worked until June 21st to pay off their obligations to the state. In Spain the Tax Freedom Day occurred on May 28th. The taxpayers in Sweden sweat under the tax burden until as late as August 20th to maintain their "welfare" state.

Although the share of income paid in taxes is quite sizeable, very few of us really know how much money we hand over to the state in the form of taxes. The reason for this is quite simple.

In Lithuania the tax system is constructed in such a way that people do not pay taxes themselves. It is companies that do it for them. Companies deduct and pay personal income tax; they collect and turn in to the government value added tax. All other taxes, such as the corporate income tax or excise duties, the burden of which is carried by ordinary citizens in the final analysis, are in general unseen and hidden in the prices of goods and services.

Although people do not know the precise amount of money they pay in taxes, they all agree that the level of taxes is all too high in Lithuania. But when the Lithuanian officialdom is asked to appraise the tax burden, they answer in unison that it is among the smallest in the world. So why is this seemingly objective indicator viewed so differently?

First of all, while one sector of the population pays taxes, the other lives off them. Second, when the taxpayers compare the level of taxes in Lithuania and in other countries, they take into account the difference in the amount of income they receive.

Politicians and state officials, however, have a proclivity to compare Lithuania with countries where redistribution is even higher. They seem to disregard the fact that that the share of money that remains after all taxes have been paid does not suffice to satisfy even basic human needs.

Higher taxes: a better life?

It follows that those who live off taxes regard a higher redistribution as a value in itself. They point out that taxes are higher abroad and people live better there.

Both these statements are correct. Yet, there is no connection between them. People in Western countries enjoy higher living standards not because they pay higher taxes. They are wealthier because they have lived under a market economy for a longer period of time and because they work better.

More importantly, they live better because at the time when Western European countries flourished, their taxes were much lower than today and much lower than in Lithuania. These nations are simply reaping the benefits of the acceleration they achieved when Lithuania did not even take the road to capitalism.
True, this acceleration is decreasing, so countries with high taxes are quite apprehensive about the competition they face from tax heavens. They also unjustifiably label it as unfair.
The link between high taxes and people's well-being is opposite. The surveys of freedom conducted by such organisations as the Heritage Foundation, Freedom House and the Fraser Institute indicate quite explicitly that the more freedom a nation enjoys and the lower the taxes it pays, the more wealth it creates.
If countries in transition follow the advice of international organisations and raise taxes, they will hardly reach the level of developed nations, save and except at the cost of the latter's economic decline.

Ominously low taxes

When Lithuania was creating its tax system, there were various options to choose from. They ranged from a pro-liberal tax reform proposed by the Lithuanian Free Market Institute, with the abolition of the corporate income tax being the cornerstone of the reform, and tax cuts to progressive income taxes and the like.
One important thing that must not be ignored here is that those who determine the rates of taxes – politicians and government officials – have panic fear of low taxes. They say that low taxes will get Lithuania into the bad books, while the tax rules will be recognised as having a detrimental effect on competition. In order words, they are scared Lithuania will become a tax heaven, which will result in jeopardising interstate political relationships.
Similar arguments accompanied the adoption of a new law on the corporate income tax in December 2001. It was feared lest a 15-percent tax rate should turn Lithuania into an offshore, in spite of the fact that the tax base was expanded in order to double budget revenues from the tax.
Why are tax heavens so terrifying? First, growing tax burdens in developed countries bolster incentives to take advantage of a more favourable environment offered by tax heavens. The higher the tax rates in other countries, the more attractive the tax heavens.
It could be said that the rise of tax heavens is directly proportional to, and completely consequent upon, tax policies pursued by other countries. Tax hikes there are a direct contribution to the prosperity of tax heavens.
This explains why almost every large corporation has branches in tax heavens. Over one thousand new companies are started there every year. It is estimated that some two thirds of the world's transactions are concluded through entities operating in tax heavens. Impressive, isn't it?
Being quite small in terms of territory and population as well as not influential politically, tax heavens manage to outrival large nations by virtue of their tax policies, by draining the budgets of these nations on the one hand but enriching their residents on the other. Running business in a tax heaven means saving a considerable amount of taxes, which makes it possible to reduce costs, to boost sales and so to make more profit.

Is competition harmful?

Tax heavens are being accused of unfair competition because they offer a more favourable tax environment. Different political and economic measures are being taken against them. Political relationships are being terminated. Countries with high taxes are introducing discriminatory tax regimes for residents, employees or anyone connected with tax heavens.
Lithuania reacted in a similar way when it imposed a 29-percent tax on various types of payments to tax heavens. (It should be noted that the tax rate was lowered to 15 percent later on.)
The new law is targeted at the taxation of positive income. It is intended to restrict relationships with tax heavens and, in the case such relationships do exist, to expropriate an adequate share of taxes to the Lithuanian budget.
It is useful to note that all attempts, including those taken by Lithuania, to outrival tax heavens in one way or another end up in a fiasco. They do not only fail to generate additional proceeds to national budgets and to curb relationships with tax heavens. Quite the opposite: they make tax heavens even more attractive. It does not take long to find a way round a new restriction imposed on relationships with tax heavens.
Countries that impose discriminatory tax rules against tax heavens maintain that they do so as a reaction against unfair competition. But is this kind of competition harmful and reprehensible?

Competition is dangerous only when certain rules are inflicted in a coercive manner. Tax heavens charge low taxes only on companies that are registered on their territory. They do not force or require other nations to follow their rules.

More importantly, coercion goes in the opposite direction as all possible measures are taken to make tax heavens raise their taxes. A leader of one tax heaven once responded to recommendations to increase taxes by saying that he did not see the need to do that as the existing tax rates completely satisfied the needs of the state.

Indeed, if taxes were eliminated from the area of interstate competition as its most significant and powerful instrument, countries would be deprived of their identity. Applying the same policies in the field of private competition would be tantamount to imposing a requirement that all restaurants offer the same menus or all stores offer only the most expensive goods.

A third way

The fear of politicians that their countries will become tax heavens is quite groundless. It appears that being a tax heaven takes more than simply charging low taxes.

According to the OECD, the distinguishing features of tax heavens are low effective tax rates, an inadequate exchange of information, a lack of transparency and an absence of a real business activity. The application of distinct, privileged rules to companies established by non-residents is the hallmark of tax heavens.

So, if Lithuania introduces lower direct taxes on all enterprises that pursue a business activity on its territory as compared with other countries, it does not necessarily follow that it claims to become a tax heaven.

Those who see only two options – high taxes of the European standard and nominal taxes charged by tax heavens – should be reminded that there is a third way. It consists of low taxes for residents, transparent rules and an open economy, qualities that must be attractive to emerging market economies and developed countries alike.