



NATIONAL AUDIT OFFICE OF THE REPUBLIC OF LITHUANIA

PUBLIC AUDIT REPORT

ON THE APPLICATION OF REDUCED VALUE-ADDED TAX RATES

19 December 2006 No. 8000-7P-31
Vilnius

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The audit was carried out under the National Audit Office's assignment No. 8000-7P of 5 May 2006

The audit was carried out by Senior Public Auditor Kristina Vaivadienė

Audit start date: 9 May 2006

Audit end date: 19 December 2006

The report is sent to the Ministry of Finance, the Parliamentary Audit Committee, the Government and the Presidential Office.

I. SUMMARY

Up until now, no detailed assessment of the economic impact of reduced value-added tax (VAT) rates on goods and services has been made in Lithuania, i.e. there is no collection of objective and factual data that would enable an assessment of whether the VAT concessions have achieved the intended objectives and whether there has been a long-term impact upon the market. The public audit was aimed at evaluating the efficiency of the application of reduced VAT rates and the monitoring of impact of these rates. The assessment covered those groups of goods/services which had been taxed at a standard 18 % VAT rate before the reduced 5 % VAT rate was established (hotel and special accommodation services; freshly chilled meat and edible sub-products; freshly chilled, frozen, deep-frozen poultry and edible sub-products; live, fresh and chilled fish; admission to art, culture and sporting events).

Trends in the application of reduced VAT rates. The number of groups of goods/services on which reduced VAT rates are applied has been increasing: at the beginning of 2003, reduced VAT rate was applied to five groups of goods/services, whereas by mid-2006 the number reached twelve. At the same time, the amount of revenue that is not paid to the national budget as a result of the reduced VAT rates is increasing every year: according to the Ministry of Finance, the revenue lost by the state budget in 2003 amounted to LTL 139 million and in 2005 to LTL 215 million. The amount lost by the national budget due to tax concessions totalled LTL 567 million in 2005; it is estimated that the application of the reduced VAT rates will result in a LTL 252 million loss (including reduced VAT rate on meat products LTL 75.5 million, medicines and medical equipment LTL 69.7 million, and poultry meat LTL 25.8 million).

Objectives of application of reduced VAT rates and success in attaining the objectives. The imposition of a reduced VAT rate should be of direct benefit to consumers by lowering the prices for goods and services and by stimulating growth in supply and demand. Otherwise, a tax concession becomes a direct support for and a means of subsidising business.

The National Audit Office commissioned an economic study¹ the purpose of which was to examine, by econometric and statistical methods, the effect of the reduced VAT rate upon prices, supply, demand etc. The results of the study have shown the reduced VAT rate did not produce any direct effect upon product and service prices and consumers did not derive any direct benefit:

- Effect upon product and service prices. The reduced VAT rate had an insignificant indirect impact upon both retail and wholesale prices for poultry and meat products (the imposition of the reduced VAT rate allowed lowering of the prices and slowing down their growth). In QIII 2004, the prices reached the level at which they had been before the imposition of the reduced rate. Prices for other goods and services² were not markedly influenced by the reduced VAT rate: prices for accommodation services have been rising since 2001 and in 2003 the increase (compared to 2002) was most marked during the entire period concerned; fish prices increased by 114 % in QIII 2005 compared to QIII 2004; the prices for admission to art, culture and sporting events did not go down.

- Effect upon demand for and supply of goods and services. As a result of imposition of the reduced VAT rate, profits of undertakings (product sellers or service providers) increased and more funds were allotted for material investment, which, on its turn, influenced growth in supply of and demand for certain groups of goods/services.

- Effect upon number of employees in undertakings of relevant sector. The growth in material investments in certain sectors had a negative impact on the number of workers in meat and

¹ The study was carried out by Spinter Tyrimai UAB.

² Those examined in the course of audit, i. e., hotel and special accommodation services; admission to art, culture and sporting events; fish.

poultry sectors, while growth in the number of workers in the accommodation services sector would have taken place even without applying the reduced VAT rate.

To sum up the results of the economic study, one may conclude that the application of a reduced VAT rate is not an appropriate means to reduce prices for goods and services. Stimulation of supply and demand and increase in the number of workers in relevant sectors could have been achieved by other means, e. g. by reducing the standard VAT rate, increasing real residents' income etc.

Monitoring of application of reduced VAT rates. While drawing up a draft state budget for next year, the Ministry of Finance estimates the amount of revenue to be lost through application of reduced VAT rates. Estimations for other purposes are made on as necessary basis. Monitoring of effects of reduced tax rates does not receive sufficient attention in Lithuania; efficiency of tax concessions is not assessed.

Considering that the reduced VAT rate did not have any direct sustainable effect upon the prices for the goods and services to which such rate was applied, i. e. no direct benefit to consumers, and it creates exceptional conditions for the suppliers/providers of such goods/services, we recommend that the following possibilities are explored: to abandon the reduced VAT rate; not to apply new reduced VAT rates; apply the same tariff rate to all goods and services in accordance with the requirements laid down in the EU legal acts; assess efficiency of tax concessions on a systematic basis; determine, on an annual basis, the actual amount of state budget revenue lost as a result of tax concessions and publish such amounts.

II. INTRODUCTION

Audit Area

The Government may use the taxation system for the implementation of its policy in a certain area of governance with the aim to increase demand and employment and provide support to certain social groups by applying tax concessions (i. e., exceptional taxation conditions, which are more favourable compared to standard conditions, to a taxpayer or a group thereof in accordance with tax laws). The Law on Tax Administration defines “tax concession“ as exceptional taxation conditions established by tax laws to a taxpayer or a group thereof, such conditions being more favourable compared to standard conditions. Exceptional conditions may only be established by relevant tax laws establishing a procedure for the calculation of relevant taxes. Taxation must be implemented according to the principles of equality of taxpayers, equity, universal application, clarity of taxation, and prevalence of content over form.³

The National Programme on Adjustment of the Legal Framework of Taxation establishes six key principles on which the process is to be based, namely, equity, equality, neutrality, clarity, publicity, and efficiency of administration.⁴ There is a risk that tax concessions may distort the tax system, make it less transparent, create incentives for abuse, make tax administration more difficult, give advantages to some producers or service providers and discriminate against others. Economists voice concerns in the press that concessions make VAT increasingly complex, create economic distortions and tax gaps, and make reduction of standard VAT rates more difficult.

In the EU pre-accession period, the provisions of the Republic of Lithuania Law on VAT had to be harmonised with the Sixth Council Directive, which lays down that the standard VAT rate in the EU Member States must be not lower than 15 % by 2011 and allows (but not obligates) the Member States to apply maximum two reduced VAT rates to groups of goods/services specified in the Annex to the Directive. In Lithuania, a 5 % and 9 % reduced VAT rates are applied to twelve groups of goods/services.⁵

VAT is a tax that accounts for the largest part of public revenues: in 2005, VAT revenue amounted to LTL 4842 million (39.9 % of the state budget revenue).

According to the Ministry of Finance, in 2005 the national budget lost LTL 567 million of revenue through application of tax concessions including LTL 215 million from reduced VAT rates (4 % of total VAT revenue) (Figure 1):

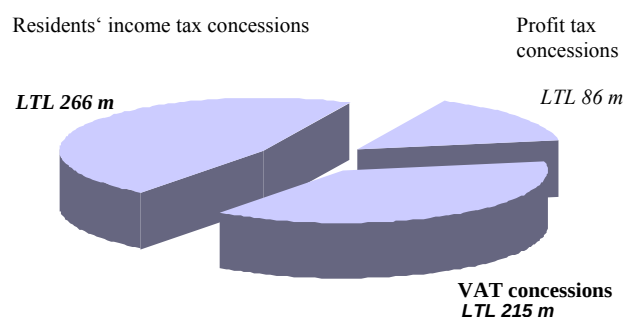


Fig. 1. Effect of Tax Concessions on the National Budget in 2005

Source: Ministry of Finance

³ Articles 2(8), 4(1) and 6 of the Republic of Lithuania Law on Tax Administration of 13 April 2004 No. IX-2112.

⁴ Resolution of the Government of the Republic of Lithuania “Concerning the Programme on Adjustment of the Legal Framework of Taxation” No. 1016 of 11 August 1998.

⁵ Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment (77/388/EEC) as amended.

The number of VAT concessions is increasing. On 1 January 2003 provisions of the Law on VAT establishing the application of a reduced VAT rate on five groups of goods/services came into force. In mid-2006 the number of such groups reached twelve (Table 1).

Table 1

Change in the Number of VAT Concessions in 2003–2006

Data of coming into effect of VAT concession	VAT concession
1 May 2000	1. Scheduled passenger carriage by the established regular routes, passenger carriage by passenger trains; luggage carriage services.
1 January 2003	2. Books, newspapers, magazines and other periodicals except publications of erotic and violent nature. 3. Hotel and special accommodation services. 4. Freshly chilled meat and edible sub-products.
1 February 2004	5. Freshly chilled, frozen, deep-frozen poultry meat and edible sub-products. 6. Agricultural services by agricultural entities provided to their members. 7. Live, fresh and chilled fish.
1 May 2004	8. Medicines and medical equipment according to a list approved by the Government. 9. Dwelling construction, renovation and heat insulation services.
1 January 2006	10. Organic foodstuffs.
17 January 2006	11. Admission to art, culture and sporting events, museums, amusement parks and zoos.
27 July 2006	12. Creative or performing services provided by writers, composers or performers and services for which such persons are paid royalties.

Audit Subject: Ministry of Finance of the Republic of Lithuania (address J. Tumo-Vaižganto g. 8A/2, LT–01512 Vilnius, institution code 288601650).

Audit Object: Application of reduced VAT rates to the following groups of goods/services:

1. Hotel and special accommodation services (took effect on 1 January 2003);
2. Freshly chilled meat and edible sub-products took effect on 1 January 2003);
3. Freshly chilled, frozen, deep-frozen poultry meat and edible sub-products (took effect on 1 January 2003);
4. Live, fresh and chilled fish (took effect on 1 February 2004);
5. Admission to art, culture and sporting events (took effect on 17 January 2006).

The audit covers only those groups of goods/services which had been taxed at a standard 18 % rate before the introduction of VAT concessions.

Purpose of Audit: Assess the efficiency of application of the reduced VAT rate and the mechanism of assessment of the effects of VAT concessions.

Audited Period: 1 January 2003 – 31 May 2006.

Audit Process:

Audit evidence has been obtained through the use of check (examination of documents), interview (conversations with employees) and analytical procedures, legal analysis, and analysis of statistical and economic data published on the Internet. An economic study has been carried out upon procurement of the service through open tendering procedure. The purpose of the economic study was to determine the effect of the reduced VAT upon prices, demand etc. as well as sustainability of the changes.

Audit procedures have been carried out in the Tax Department and Fiscal Policy Department of the Ministry of Finance of the Republic of Lithuania; data have been obtained from the State Tourism Department under the Ministry of Economy, the Ministry of Agriculture, the State Tax Inspectorate under the Ministry of Finance, and the Department of Statistics under the Government of the Republic of Lithuania.

The audit was carried out on assumption that all the documents presented to the auditor are complete and final and that copies of the documents correspond to originals.

An initiative to carry out audits of tax concessions was raised at EUROSAI⁶ VI Congress in May 2005. Results of these of audits carried out by SAIs⁷ will be summarised and included in the audit report on tax concessions to be presented at EUROSAI VII Congress in 2008.

Evaluation Criteria:

The data and information collected during the audit have been evaluated from the following aspects:

1. Have VAT concessions achieved the objectives pursued?
2. Are assessments of efficiency of VAT concessions being made?
3. Is the introduction of VAT concessions linked to any additional measures (legal, financial, human)?

Limitations:

Considering that no detailed statistical information on the goods/service groups concerned is being collected, the economic study was based on information presented by the Department of Statistics under the Government of the Republic of Lithuania.

This report has been prepared on the basis of audit evidence obtained through sampling.

⁶ EUROSAI – The European Organisation of Supreme Audit Institutions

⁷ Audits of application of reduced VAT rates are conducted by SAIs of Lithuania, Germany, Cyprus, Latvia, Switzerland and Russian Federation.

III. AUDIT RESULTS

1. TRENDS IN THE APPLICATION OF REDUCED VAT RATES AND BUDGETARY COST OF APPLICATION OF SUCH RATES

1.1. TRENDS IN THE APPLICATION OF REDUCED VAT RATES

The standard VAT rate applied in the EU Member States varies from 15 % to 25 %; the minimum allowable standard VAT rate (15 %) is applied in Cyprus and Luxembourg, while the maximum VAT rate (25 %) is applied in Denmark and Sweden. Reduced VAT rates were not applied by two countries (Denmark and Slovak Republic) (see Annex 2). VAT rates applied by the EU Member States are presented in Annex 1.

In the EU pre-accession period Lithuania took actions in two directions in order to harmonise the national legal acts on indirect taxation with the EU *acquis*:

- abolished preferential VAT treatment for certain goods and services (e. g., for passenger and luggage carriage services, books, newspapers, magazines, medicines, medical equipment, agricultural services by agricultural entities); such goods/services became subject to VAT;
- established the reduced 5 % and 9 % VAT rates for goods and services, which had been taxed at 18 % VAT under the Law on VAT that was in force until 30 June 2002. Proposals for application of a reduced 5 % VAT are still being made; at present there are proposals for a reduced rate for bread products, dairy products, fruit and vegetables.

The Measures to Implement the Programme of the Government of the Republic of Lithuania for 2004–2008⁸ and for 2006–2008⁹, respectively provide for the aim to “harmonise the application of the reduced VAT rates on indispensable foodstuffs and medicines with the EU rates”.

Legal acts do not provide a clear definition of which foodstuffs and why are considered to be indispensable. In carrying out the aforesaid measure of the Government Programme, the Ministry of Agriculture has made proposals to the Ministry of Finance¹⁰ for the imposition of a reduced 5 % VAT for the following groups of foodstuffs:

- frozen and deep-frozen meat of domestic animals and edible sub-products thereof, also domestic animals and poultry meat products and partially prepared food;
- potatoes, vegetables, fruit and berries;
- milk and fresh dairy products.

Comparison of taxation of certain goods/services prior to and after the introduction of the reduced VAT rate is presented in Table 2 below.

⁸ Resolution of the Government of the Republic of Lithuania No. 315 of 24 March 2005

⁹ Resolution of the Government of the Republic of Lithuania No. 1020 of 17 October 2006

¹⁰ Letter by the Ministry of Agriculture to the Ministry of Finance No. 2D-(4.17)-1809 of 11 April 2006 “Concerning Application of Preferential VAT Rate to Indispensable Foodstuffs”

Table 2

VAT Concessions and Their Effects

VAT concession	VAT rate prior to introduction of concession ¹¹ , %	VAT rate in effect, %	Loss of budgetary revenue in 2005, LTL million	Forecast loss of budgetary revenue in 2006, LTL million
Scheduled passenger carriage by the established regular routes, passenger carriage by passenger trains; luggage carriage services.	5	5	27.3	31.7
Books, newspapers, magazines and other periodicals except publications of erotic and violent nature.	Not subject to tax	5	20.7	24
Medicines and medical equipment.	Not subject to tax	5	60	69.7
Organic foodstuffs.	18	5	-	0.3
Agricultural services by agricultural entities provided to their own members.	Not subject to tax	5	7.1	8.3
Hotel and special accommodation services.	18	5	8.6	10
Freshly chilled meat and edible sub-products.	18	5	65	75.5
Freshly chilled, frozen, deep-frozen poultry meat and edible sub-products.	18	5	22.2	25.8
Live, fresh and chilled fish.	18	5	3.3	3.8
Admission to art, culture and sporting events, museums, amusement parks and zoos.	18	5	-	1.8
Creative or performing services provided by writers, composers or performers and services for which such persons are paid royalties.	18	5	-	0.5
Dwelling construction, renovation and heat insulation services.	Not subject to tax	9	0.8	0.9
Total			214.8	252.3

Source: Ministry of Finance

In its proposals for the reduced VAT rate the Ministry of Agriculture has indicated that the measure is aimed at making competitive conditions equal for persons trading at marketplaces and similar trading outlets (these traders are not subject to VAT) and for retailers and at promoting consumption of products of higher quality and increasing competitiveness of producers and processing undertakings compared to those in the neighbouring countries. In the Ministry's estimation, budgetary costs from introduction of such conditions would amount to LTL 165 million of annual VAT revenue not received.

Draft proposals for a new VAT law have been registered with the Seimas (Parliament) of the Republic of Lithuania (proposals initiated by Seimas' members) providing for the reduced 5 % VAT rate on the following goods:

- animals, meat and edible sub-products, meat products and prepared meats; poultry, poultry meat and edible sub-products thereof; poultry products and prepared food; fish, fish products and prepared food; bread and bread products, milk and dairy products;¹²
- fresh products (excluding processed products) – potatoes and those species of vegetables, fruit and berries that are traditionally grown in Lithuania.¹³ The state budget would lose around LTL 19.3 million through this VAT concession;

¹¹ According to the version of the Law on VAT in effect on 30 June 2002

¹² Draft proposal for the Law Amending and Supplementing the Law on VAT, 21-09-2006 No. XP-1679.

- vegetables grown in commercial greenhouses.¹⁴ As a result of this VAT concession, budgetary revenue can be reduced by LTL 5-6 million.

The proposed date of coming into effect of the former two provisions is 1 January 2007 and the latter provision from 1 July 2007.

The number of groups of goods/services subject to the reduced VAT rate has increased by more than twice. In September – December 2006, three new draft proposals for reduced VAT rates were registered at the Seimas.

1.2. BUDGETARY COST OF APPLICATION OF REDUCED VAT RATES

Forecasting of loss of budget revenues through tax concessions (including reduced VAT rates) is made by the Planning and Analysis Division (hereinafter referred to as “the Division”)¹⁵ of the Fiscal Policy Department¹⁶ of the Ministry of Finance. According to the data and information provided by the Division, revenue loss is calculated for each tax concession individually. The methods of calculation depend on statistical information available. It has been established during the audit that the budgetary cost of the reduced VAT rate on meat, poultry and fish is calculated based on comprehensive surveys of household expenditure and the average population number; for the purposes of calculation of lost revenue due to the reduced VAT rate on admission to events, an additional coefficient is introduced for non-profit organisations. Revenue lost as a result of the reduced VAT rate on accommodation services is calculated based on the information on VAT returns presented by the State Tax Inspectorate under the Ministry of Finance (“STI”).

According to the Ministry of Finance, the revenue lost by the state budget due to reduced VAT rates increased from LTL 139 million in 2003 to LTL 215 million in 2005. It is forecast that in 2006 the state budget will not receive LTL 252 million of VAT revenues, which is by LTL 37 million more than in 2005. The revenue lost as a result of the reduced VAT rates accounts for over 4 % of the total VAT revenues. The introduction of new VAT concessions (extension of the VAT concession base) is one of the reasons for the increase.

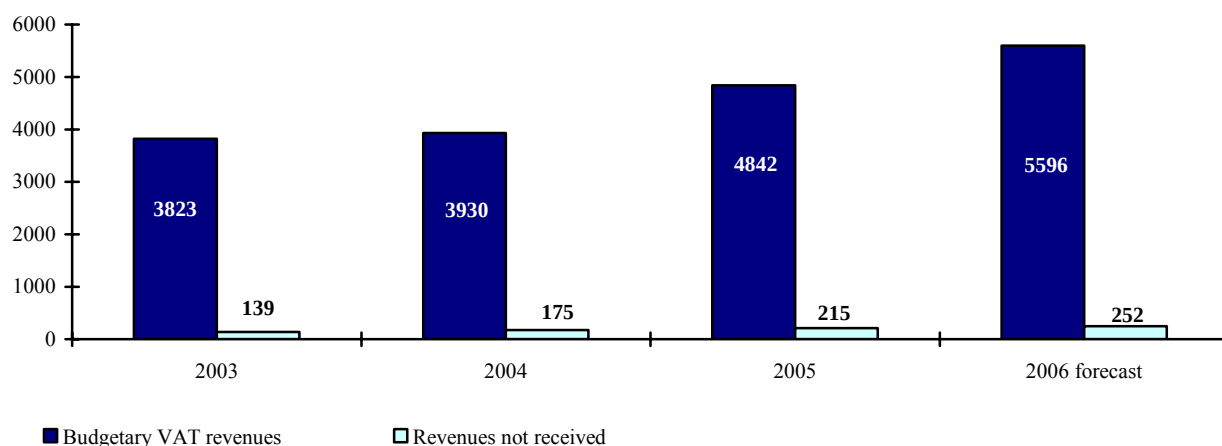


Figure 2. VAT Revenue and Budgetary Cost of VAT Revenue Not Received, LTL m

¹³ Draft proposal for the Law Amending and Supplementing Article 19 of the Law on VAT, 25-10-2006 No. XP-1792.

¹⁴ Draft proposal for the Law Supplementing Article 19 of the Law on VAT, 05-12-2006 No. XP-1893.

¹⁵ Regulations of the Planning and Analysis Division were approved by order No. 1K-026 of 07-02-2003 of the Minister of Finance.

¹⁶ Regulations of the Fiscal Policy Department were approved by order No. 1K-026 of 07-02-2003 of the Minister of Finance.

Budgetary cost attributable to the five reduced-VAT groups under analysis accounted for 65 % and 47 % of total revenues lost due to reduced VAT rates in 2003 and 2005, respectively. Meat products account for the largest share in the budgetary cost (see Table 3).

Table 3

Budgetary Cost Resulting from Application of VAT Concessions (in the Audited Goods/Service Groups), LTL m

VAT concession	2003, LTL m	2004, LTL m	2005, LTL m	2006, LTL m
Hotel and special accommodation services	8	8	9	10
Freshly chilled meat and edible sub-products	62	63	65	76
Freshly chilled, frozen, deep-frozen poultry meat and edible sub-products	20	21	22	26
Live, fresh and chilled fish	-	3	3	4
Admission to art, culture and sporting events, museums, amusement parks and zoos	-	-	-	2
Total:	90	95	99	118

Source: Ministry of Finance

Every year Lithuania loses over 4 % of VAT revenues as a result of application of the reduced VAT rates. The amount of budgetary cost from reduced VAT rates has increased by 80 % since 2003.

2. OBJECTIVES OF APPLICATION OF REDUCED VAT RATE. ASSESSMENT OF SUCCESS IN ATTAINING THE SET OBJECTIVES

2.1. OBJECTIVES OF APPLICATION OF REDUCED VAT RATES

The effects of tax concessions are diverse. They can create attractive and exclusive tax environment for individual groups of goods/services, undertakings or economic sectors. By creating such preferential conditions of taxation the principle of equality of taxpayers can be infringed. Tax concessions can divert capital in a certain direction thus creating capital surplus or capital deficiency in different areas¹⁷. Therefore, it is both useful and expedient to assess the success in attaining the aims with which the tax concessions were introduced.

VAT is a consumption tax. A reduced VAT rate should result in direct benefits to consumers: prices for relevant goods or services should go down, the supply of and demand for such goods/services should increase, and the number of workers in relevant sectors should grow. The reduced VAT rate should not stimulate growth in profits earned by relevant goods sellers or service providers as in such a case the VAT rate may be treated as subsidy to relevant sectors or suppliers of goods/services.

It is only possible to assess efficiency of application of tax concessions if the objectives of each concession proposed have been clearly identified.

¹⁷ Rūta Vainienė. Mokesčių lengvatos: ištakos, ribos ir pasekmės [Tax Concessions: Sources, Limits and Consequences.] – Mokesčių žinios, 03-04-2000.

For most of the groups of goods/services covered by the audit, the reduced VAT rate has been established with the aim to reduce prices for relevant goods/services, to stimulate consumption of these goods/services, and to enhance competitiveness of Lithuanian producers and service providers in the domestic market. These objectives have been identified in the letters of proposals for draft laws, in some cases – in explanatory notes to draft laws. However, proposals for certain VAT concessions (on meat and poultry products) were made during the discussion of the draft proposals at the Seimas and the explanatory notes to the draft laws contained no information on the objectives of introduction of reduced VAT rates (Table 4).

Table 4

Objectives of Introduction of Reduced VAT Rates

VAT concession	Objectives of introduction of reduced VAT rates	Documents in which the objectives are identified	Position of the Ministry of Finance
Hotel and special accommodation services	• reduce prices for accommodation services; • increase guest number; • enhance provision of other services subject to standard VAT rates (bars, restaurants etc.); • create new jobs.	Draft proposal for new law (letter by the State Tourism Department under the Government to the Ministry of Finance No. 05-0505 of 12 October 2001). No objectives of introduction of reduced VAT rate identified in the explanatory note to the draft law.	Disapprove (position set out in the response to the request for agreement).
Freshly chilled meat and edible sub-products	Not specified.	-	Disapprove (position set out in the explanatory note to the draft law).
Freshly chilled, frozen, deep-frozen poultry meat and edible sub-products			
Live, fresh and chilled fish	• reduce prices; • increase sales volumes; • increase production volumes; • increase employment in the sector; • improve people's health; • increase foodstuff consumption and turnover in the domestic market and budgetary revenue at the same time.	Draft proposal for new law (letter by the Ministry of Agriculture to the Ministry of Finance No 2D-(4.17)-3901 of 24 October 2003). No objectives of introduction of reduced VAT rate identified in the explanatory note to the draft law.	Disapprove (position set out in the letter by the Ministry of Finance to the Government).
Admission to art, culture and sporting events, museums, amusement parks and zoos	• facilitate meeting of people's cultural needs; • improve Lithuania's competitiveness on international scale by organising shows of globally-recognised artists.	Explanatory note to the draft law.	Disapprove (position set out in the letter by the Ministry of Finance to the Ministry of Culture, Ministry of Justice, the Department of European Law and the Government).

Source: Ministry of Finance; explanatory notes to draft laws

In accordance with the Statute of the Seimas of the Republic of Lithuania¹⁸, an explanatory note appended to the text of the draft law must specify what new legal provisions are to be introduced, what are the advantages of the new provisions, and what positive results are expected.

We would like to note that no requirements for draft proposals for laws to be discussed by the Seimas have been established. Therefore, there is a risk that when a draft proposal for the law

¹⁸ Article 135(3)(4) of the Statute of the Seimas of the Republic of Lithuania 17-02-1994 No. I-399

establishing a tax concession is made, no detailed studies will be conducted and no calculations will be made concerning consequences for the state budget and expected benefits.

The Ministry of Finance has not made proposals for the introduction of any of the VAT concessions examined by the audit and has not approved of the imposition of reduced VAT rates on any of relevant goods/service groups, which was indicated in its responses to requests for approval of the proposals, explanatory notes to draft laws or letters to the Government and other public authorities.

The objectives of introduction of VAT concessions are not specified in all the explanatory notes to draft laws providing for the reduced VAT rates. This negatively affects the assessment of efficiency of the application of reduced VAT rates: if the objectives are unclear, one cannot state whether they have been attained and whether losses in the state budget revenues are justifiable.

2.2. ASSESSMENT OF SUCCESS IN ATTAINING THE OBJECTIVES: IMPACT OF VAT CONCESSIONS ON THE MARKET AND CONSUMERS

2.2.1. Results of the Economic Study

The National Audit Office has commissioned an economic study the purpose of which was to examine, by econometric and statistical methods, the effect of reduced VAT rates upon prices, supply, demand etc. An analysis of aggregate statistical data was made using statistical descriptive methods and econometric methods and models. Econometric calculations were made in order to determine indicators significantly affected by the reduced VAT rates; modelling of situations without VAT reduction was conducted.

As the period elapsed since the introduction of the reduced VAT rate on admission to art, cultural and sporting events was too short it was not possible to obtain statistical information on the effect of such rate upon different indicators, therefore, an opinion poll was conducted.

Effect upon Prices for Individual Groups of Goods and Services

An assessment of the effect of the reduced VAT rate upon hotel and special accommodation services made by means of econometric calculations has shown that this VAT preference has not produced significant effect upon prices for such services, however, it helped to slow the growth in prices.

Prices for accommodation services have been increasing since 2001 and in 2003 when the reduced VAT rate was introduced the increase reached 10.3 % compared to 2002 (the largest increase during the period under analysis). Upon introduction of the reduced VAT rate the average price per night rose by nearly 20 % compared to 2001 (see Figure 3).

The price would have been only slightly higher (by 6-7 %) without the reduction of the VAT rate. Econometric calculations have shown that this VAT concession has influenced growth in profits of entities providing accommodation services.

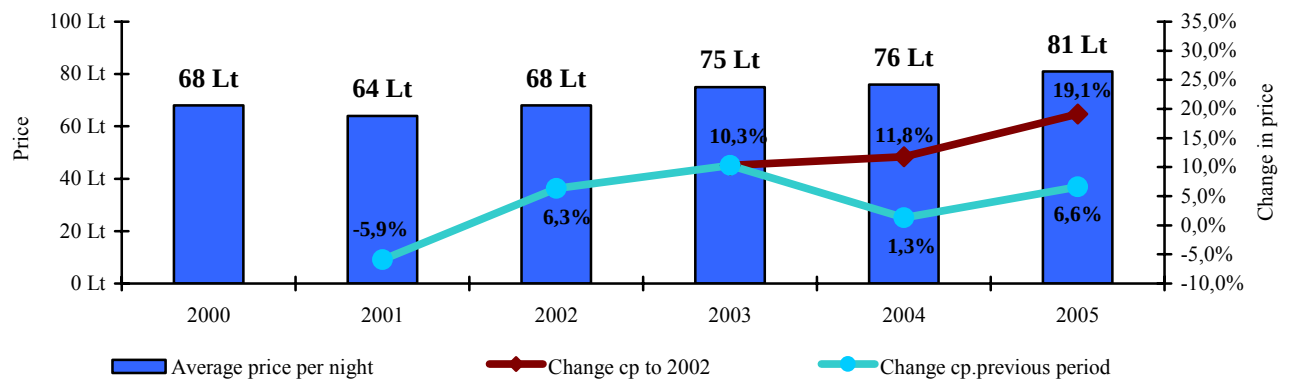


Fig. 3. Average Price per Night at Accommodation Establishments and Dynamics of Average Prices

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

There has been a marked reduction in the prices for freshly chilled, frozen and deep-frozen poultry meat and food sub-products since 1 January 2003 when the reduced VAT rate was introduced¹⁹. Tendencies for the lowering of retail poultry prices have been observed since 2001. There was a slight increase in these prices in the 2nd half of 2004, while in 2005 the price level remained relatively the same as in 2004 (Figure 4).

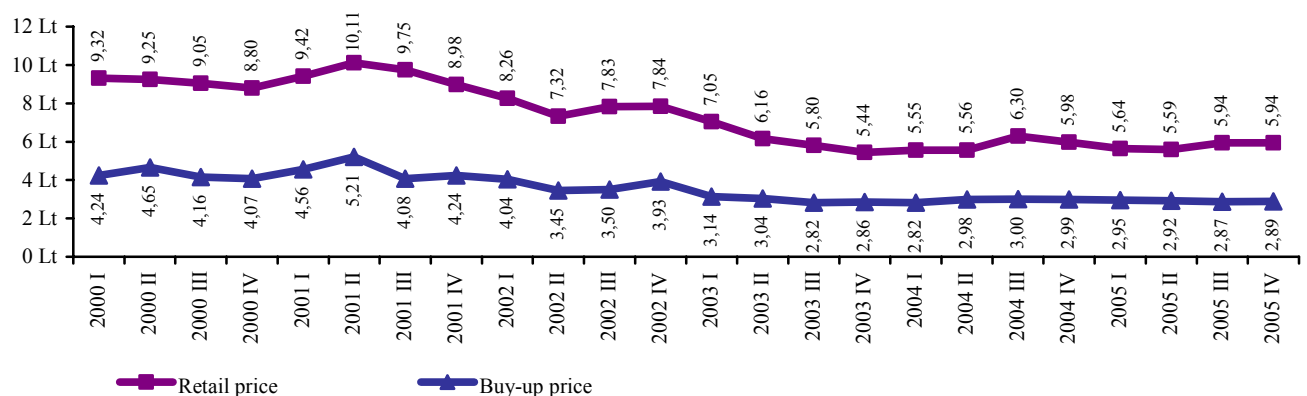


Fig. 4. Retail Prices for Poultry (Broiler Chicken) at Department Stores, LTL/kg

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

Factors that have influenced retail prices for poultry:

- imports of cheaper poultry products;
- decrease in poultry buy-up prices (poultry buy-up price accounts for nearly half of the retail price);
- wholesale prices brought down by the introduction of the reduced VAT rate. The price effect of application of this rate manifested itself through the growth in material investments and production volumes. If no reduced VAT rate was introduced, there would have been no lowering of

¹⁹ Average price for broiler chicken in department stores is presented. The prices are recorded by means of monitoring. This type of poultry products has been chosen as no other poultry production prices are being monitored.

wholesale prices as the undertakings would have attempted to maintain sufficient profitability of operations.

Thus the introduction of the reduced VAT rate produced an indirect impact upon retail prices for poultry.

Upon introduction of the reduced VAT rate (1 January 2003) *for freshly-chilled meat and food sub-products*, there has been a temporary decrease in retail prices for most types of meat. An analysis of statistical data has shown that the decrease started in 2002; this year saw the largest decrease. In the 2nd half of 2003 a rise in retail meat prices was observed. A maximum increase in retail prices for beef ham and veal ribs took place at the end of 2005.

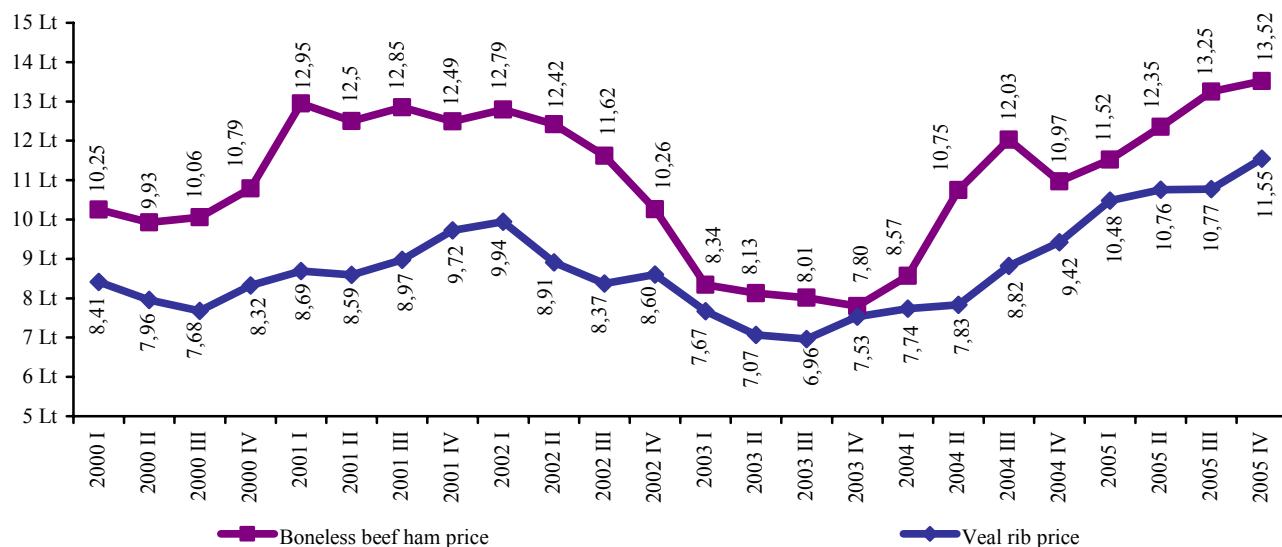


Fig. 5. Retail Meat Prices, LTL/kg, 2000-2005

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

Factors that have influenced retail meat prices:

- animal buy-up prices. Trends in the animal buy-up prices are similar to trends in retail meat prices: in 2003, buy-up prices were the lowest during the period concerned but started increasing later;
- wholesale prices, application of reduced VAT rate and Lithuania's accession to the EU. The introduction of the reduced VAT rate brought down wholesale prices, however, the effect was short-lived.

The introduction of the reduced VAT rate produced an indirect effect upon meat prices, however, the effect was short-lived.

Average price for live carps at department stores was chosen for the analysis of the impact of the reduced VAT rate (since 1 February 2004) upon prices *for live, fresh and chilled fish*²⁰. Monitoring of these prices is conducted.

²⁰ Monitoring of other fish production prices is not conducted

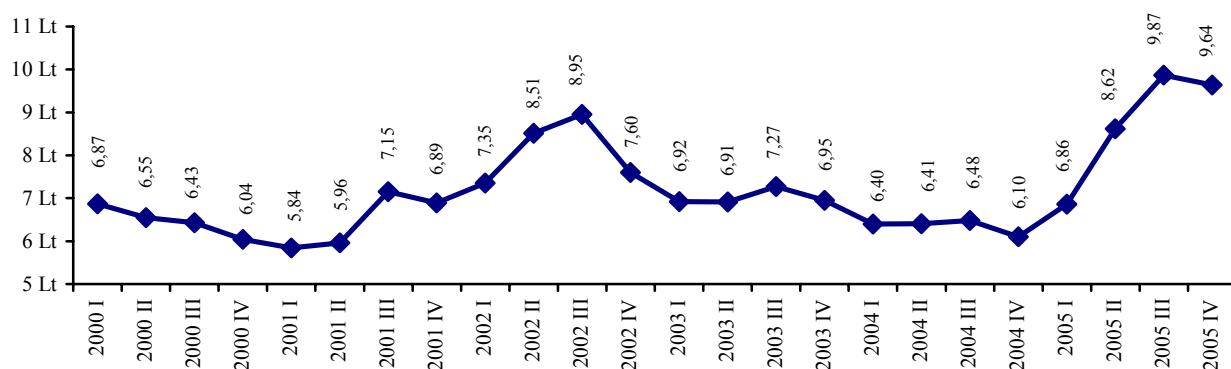


Fig. 6. Retail Fish Prices, LTL/kg (including VAT)

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

An analysis of statistical data has shown that after the introduction of the reduced VAT rate on fish products, in 2004 the prices fell by 12 % compared to 2003; however, they started rising rapidly since the beginning of 2005. It has been established that the reduced VAT rate produced only a temporary influence upon fish product prices. The rate enabled fish producers to temporarily enhance their competitiveness as they acquired an opportunity for competing by price without reducing profits.

No significant impact of the introduction of the VAT rate upon retail fish prices was observed.

The reduced VAT rate did not produce significant influence over prices for admission to *art, culture and sporting events*. A public opinion poll has shown that 33 % of respondents consider that these prices have not changed compared to 2005, 49 % - have risen slightly, 7 % - have fallen slightly. 7 % of the respondents are of the opinion that price changes were caused by the change in the VAT rate. Much larger number of respondents consider that admission prices could have been influenced by changes in event attendance rates, inflation or the events' artistic, cultural or sporting level. According to the survey results, respondents do not perceive any significant changes caused by the introduction of the reduced VAT rate. Therefore, direct benefits from the reduced VAT rate are derived by service providers and not by consumers.

Analysis by the National Audit Office

VAT returns filed to the State Tax Inspectorate by persons registered as VAT payers must state the amount of output VAT brought down by 18 %, 9 % and 5 % rates²¹.

²¹ Boxes 26, 27 and 28 in the VAT Return Form No. FR0600 approved by order of the Head of the State Tax Inspectorate under the Ministry of Finance No. VA-29 of 1 March 2004

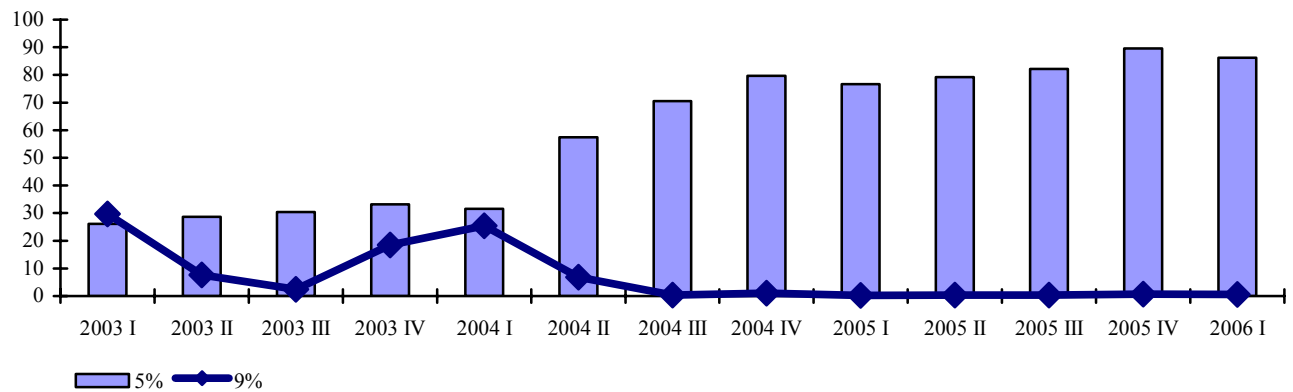


Fig. 7. Declared Output VAT for the Reduced 5 % and 9 % VAT Rates, LTL m

Source: State Tax Inspectorate under the Ministry of Finance

An analysis of these results shows that amounts of output 5 % VAT declared by entities are increasing (Figure 7). As much as 45 % increase is observed in QII 2004 (compared to preceding quarter) when the reduced VAT rate was introduced for medicines and medical products, which had not been taxed before. The declared amounts of output 5 % VAT increased from LTL 26.1 million (QI 2003) till LTL 86.2 million (QI 2006). These trends show that sales of goods subject to reduced VAT rates are growing, which, in its turn, increases profits for entities applying the reduced VAT rate.

General trends. The reduced VAT rate did not produce significant influence over retail prices for the goods and services covered by the audit: the prices would not have changed significantly if the reduced rate was not imposed. The effect of these VAT concessions on good/services' prices was of indirect nature.

Effect of reduced VAT rate upon production volumes, supply and demand

One of the aims of the application of the reduced VAT rate to *hotel and special accommodation services* was to increase the numbers of guests at hotels and other undertakings providing accommodation services. The guest numbers have been increasing: compared to 2002, in 2003 the number of guests at undertakings providing accommodation services increased by 12.7 % and in 2004 by as much as 48.8 % (see Figure 8). However, econometric calculations have shown that the increase would have taken place without the VAT rate reduction, although at slower increase rates.

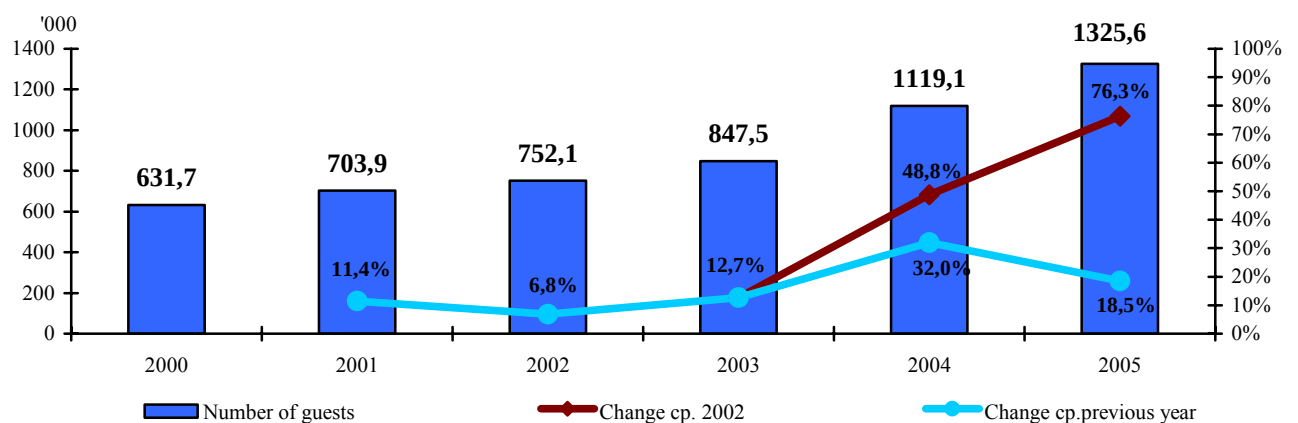


Fig. 8. Dynamics of the Number of Guests of Accommodation Establishments

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

Production of poultry meat has been developing very rapidly in Lithuania in recent years: since 2002, production volumes more than doubled over three years. Lithuanian producers have been rapidly increasing poultry production volumes in order to meet the growing demand both in domestic and foreign markets. In 2005 there has been a 138 % rise in poultry supply and a 124 % rise in demand compared to 2002 (see Figure 9).

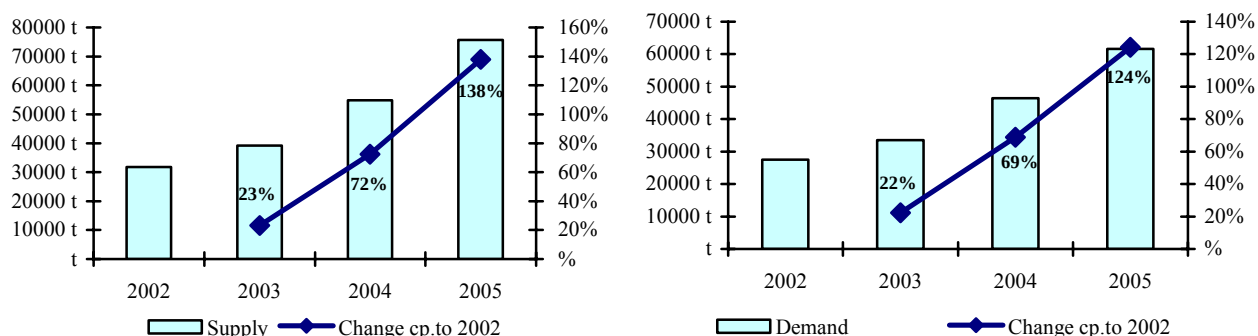


Fig. 9. Poultry Supply and Demand. Dynamics in 2002–2005

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

Supply of poultry is mainly determined by material investments in the sector; these investments were stimulated by the imposition of the reduced VAT rate. Furthermore, EU accession had a positive significant impact upon production volumes.

Results of econometric calculations have shown that demand for poultry was directly influenced by production volumes, which, on their turn, were determined by additional material investments and, indirectly, by retail prices.

2003 saw a growth in *meat production* volumes, however, the growth was slower than in previous periods. In 2002 the annual meat production growth rate was 45.3 % (compared to 2001) and in 2003 it was 24.5 % compared to 2002. Therefore, an analysis of changes in production volumes alone does not allow to conclude that the reduced VAT rate has produced a significant effect upon meat production volumes.

The increase in meat supply was mainly caused by material investments in undertakings of the sector, whose growth has been stimulated by the reduced VAT rate. This means that the reduced VAT rate had an indirect long-term impact (through material investments) upon the supply of meat.

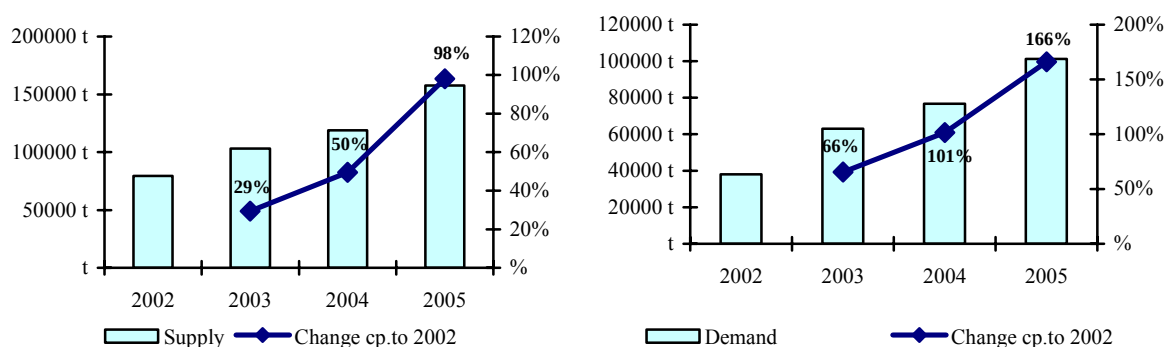


Fig. 10. Dynamics of Poultry Supply and Demand

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

If no reduced VAT rate was introduced, there would have been no significant growth in meat processing enterprises' sales, therefore, one may state that influence of the reduced VAT rate upon demand was not significant.

The Department of Statistics has no information on *fish production* volumes at Lithuanian undertakings by quarters before 2004, therefore, it was impossible to make detailed comparisons of these volumes. Domestic demand for fish products decreased by almost 75 % in 2005 compared to 2004.

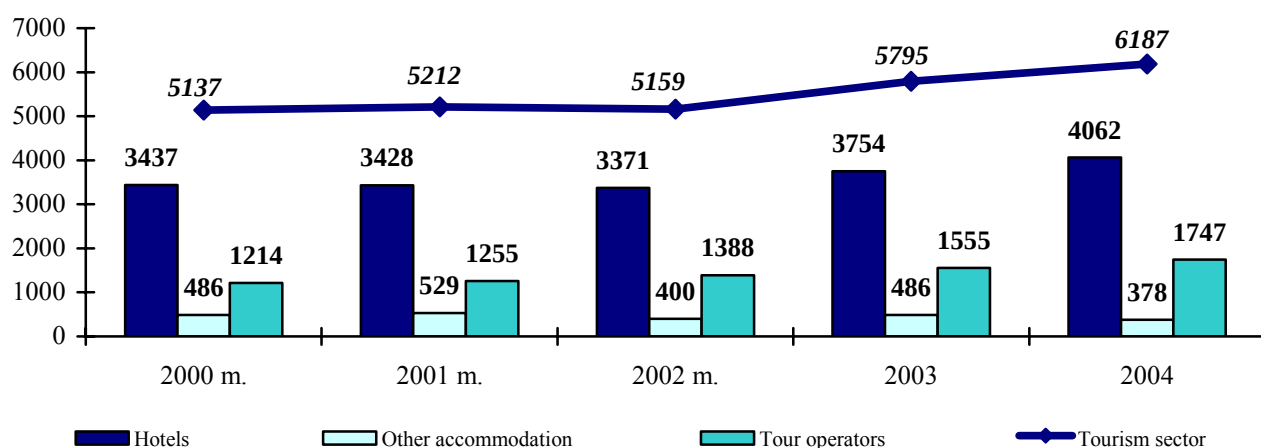
Econometric calculations have shown that:

- the reduced VAT rate has indirectly influenced production volumes and supply in the fish sector: it enabled the undertakings to accumulate funds for material investments in the sector, which provided a basis for increase in production volumes;
- without the reduction in the VAT rate, the demand for fish would have remained nearly at the same level.

General trends. The reduced VAT rate did not produce direct effect upon either supply or demand, although this was the objective of its introduction. Direct benefits from the imposition of the reduced VAT rate were derived by undertakings selling relevant goods/services and not consumers.

Effect of the Reduced VAT Rate upon Number of Workers and Employment

Since 2003 the number of workers in the *tourism sector* has been increasing. This can be explained by both the introduction of the reduced VAT rate and the increased demand for accommodation services. Econometric calculations have shown that the number of persons employed in the tourism sector would have increased also without the introduction of the reduced VAT rate, however, growth rates would have been slower.



* Activities of travel agencies and tour operators

Fig. 11. Number of Persons Employed in the Tourism Sector in Lithuania

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

In 2001-2003 the number of workers in *meat production/processing undertakings* was decreasing. The introduction of the reduced VAT rate at the beginning of 2003 did not stop this trend. There has been no direct impact of the reduced VAT rate upon the number of workers in the sector and rates of reduction in worker numbers remained the same as 2002. There was a slight increase in the number in 2004, however, it remained relatively small compared to 2000 or 2001. In 2004, the

number of workers started growing as a result of the EU accession (new export opportunities, availability of the EU Structural Funds' assistance). Econometric calculations have shown that material investments produce a strong reverse effect upon the number of persons employed by meat production/processing undertakings: the investments cause an increase in labour efficiency and intensification of production, which weakens dependence upon shortage of labour force. It should be noted that the imposition of the reduced VAT rate stimulated the increase in material investments in the meat sector. Thus the reduced VAT rate had a negative impact upon the number of workers in the meat sector.

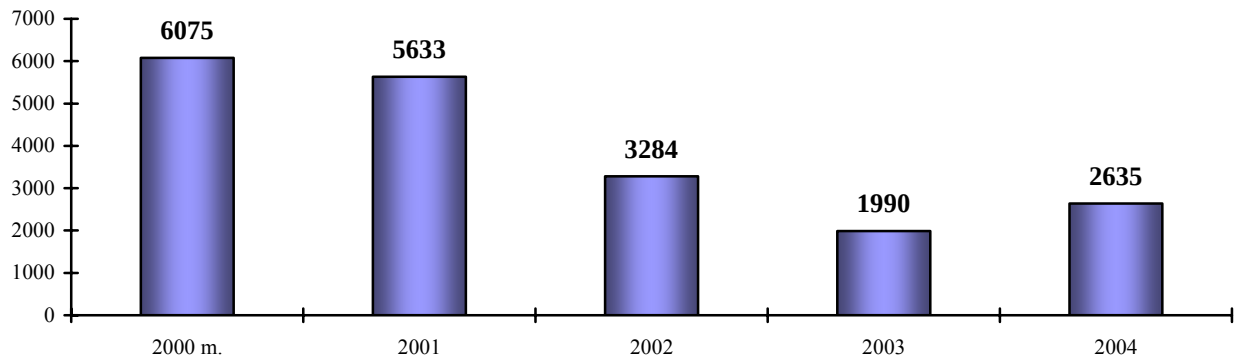


Fig. 12. Number of Persons Employed by Meat Production, Preparation and Preserving Undertakings of Lithuania

Source: Department of Statistics under the Government of the Republic of Lithuania; Spinter Tyrimai UAB's analyses

According to the Department of Statistics, the number of workers in poultry production, preparation and preserving undertakings is not large. The Department of Statistics classifies an undertaking as one engaged in such activities if the income from the activities accounts for the larger part of the undertaking's turnover. Meat processing undertakings also engage in poultry production, therefore, conclusions concerning the effect of the reduced VAT rate upon the number of workers apply also to workers of the poultry sector.

An analysis of employment in fish sector has shown the number of workers increased by 9 % in 2003 and by 7 % in 2004. The Department of Statistics did not provide data on employment in the sector for 2005.

General trends. The introduction of the reduced VAT rate did not produce any direct effect upon the number of workers. It should be noted that the number of workers in the accommodation services sector would have grown also without the VAT concession, while in the meat and poultry production sectors the reduced rate had a negative influence over the numbers of workers due to increased material investments in the sectors.

2.2.2. Opinion of the European Commission and of the Lithuanian Authorities

The Sixth Council Directive²² establishes that the European Commission shall submit reports to the Council, on the basis of which the latter would draw conclusions on the scope of reduced VAT rates and decide on necessary changes. The Commission evaluates the situation in the EU Member States

²² Article 12(4) of the Sixth Directive

and reports to the Council on a periodic basis. Recently attention has been focussed on labour-intensive services to which reduced tariff rates are applied²³.

In 2002 the European Commission examined the effect of VAT concessions in nine EU Member States²⁴. The results of this study were presented in the 2003 Commission's report to the Council and the European Parliament²⁵. The main conclusions made in the report are as follows:

1. Lower rates of VAT are not fully reflected in consumer prices. Part of additional funds received due to reduction in the VAT rate are used to increase service providers' profit margins.
2. There is no evidence of the reduced VAT rate's substantial impact on employment.
3. Lower VAT rates is not the most effective means to attain the desired objective. In addition, losses of state budget in terms of revenue not received are too high compared to the effect of the measures on the economy.

A summary of the Commission's report is presented in Annex 3.

Upon analysis of statistical data on changes in the prices for products subject to reduced VAT rates, the Ministry of Finance concluded that the trends in prices for final consumers were similar to the trends identified in the 2003 Commission report²⁶:

1. In the period since 1 January 2003 when the reduced 5 % VAT rate was introduced for fresh and chilled meat, the prices were lowering only for about six months and afterwards rose again.

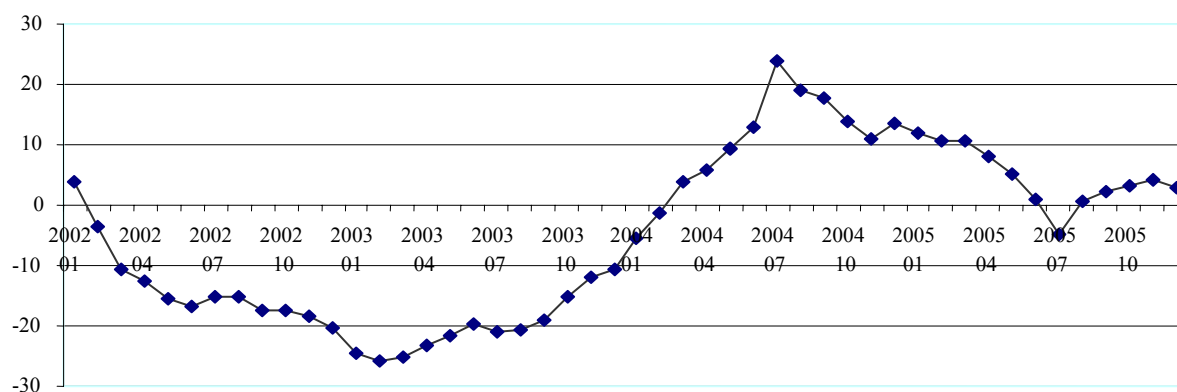


Fig. 13. Dynamics of Prices for Fresh and Chilled Meat Compared to the Same Period during the Previous Year (%).

Source: Department of Statistics under the Government of the Republic of Lithuania; Ministry of Finance analyses

2. Similar trends can be observed in the dynamics of fish prices after 1 February 2004 when the reduced 5 % VAT rate was introduced for live, fresh and chilled fish. There has been no decrease in prices – they were constantly increasing.

²³ Council Directive 1999/85/EC of 22 October 1999 amending Directive 77/388/EEC as regards the possibility of applying on an experimental basis a reduced VAT rate on labour-intensive services; Council Directive 2006/18/EC of 14 February 2006 amending Directive 77/388/EEC

²⁴ Countries subject to evaluation: Belgium, Luxembourg, Netherlands, Greece, France, Italy, Portugal, United Kingdom and Spain.

²⁵ 2003-06-02 Report from the Commission to the Council and the European Parliament "Experimental Application of a Reduced Rate of VAT to Certain Labour – Intensive services"

²⁶ Statement Concerning Application of Reduced VAT Rates to Foodstuffs prepared by the Ministry of Finance on the basis of information received from the Department of Statistics.

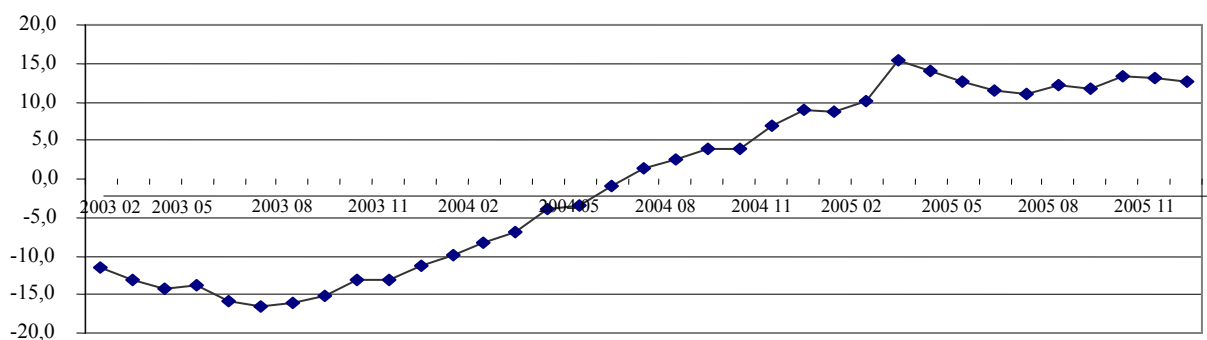


Fig. 14. Dynamics of Fish Prices Compared to the Same Period during the Previous Year (%)

Source: Department of Statistics under the Government of the Republic of Lithuania; Ministry of Finance analyses

In the opinion of the Ministry of Finance, reduction of the VAT rate is not an appropriate measure to reduce prices for individual foodstuffs and thus to increase demand. Increasing real income is a better solution in order to stimulate consumption of foodstuffs. It should be noted that the reform of residents' income tax launched on 1 July 2006 will help to increase real income.

In 2005 the Lithuanian Institute for Agrarian Economics²⁷ was commissioned by the Ministry of Agriculture to conduct a survey and prepare a report on the Effect of the VAT Tariff Rate on Competitiveness of Agricultural Products and Foodstuffs. The rate of VAT on agricultural products and foodstuffs in Lithuania, neighbouring countries and other EU Member States was the subject of the survey. The purpose of the work was to examine the influence of the VAT rate over competitiveness of agricultural products and foodstuffs and to make proposals for the application of VAT rate to these products in Lithuania. The main conclusions of the report are as follows:

- Competitiveness of agricultural products and foodstuffs in the EU Member States are influenced by other factors, not by VAT. VAT rates influence competitiveness only in the case when the other party trades in a tax-exempted market, i. e. marketplace.
- VAT rates produce impact upon consumption of products, therefore, given the present consumption level in relation to other EU Member States, reduction of VAT rates is meaningless.
- VAT influences trading in marketplaces. Competitiveness of major breeders should be determined by factors other than VAT rates. Productivity of major breeders should be higher than that of minor ones. Therefore, reducing VAT rates is not expedient.
- Reduced VAT rate for carcass meat should be established until a set date as meat consumption in Lithuania has approached the EU level.

Studies by both the European Commission and the Lithuanian authorities show that the reduced VAT rate is not an appropriate measure to reduce prices and to increase supply and demand:

- *On completion of its study in nine EU Member States the Commission has concluded that reduced rates of VAT are not fully reflected in consumer prices: part of additional funds received due to reduction in the VAT rate are used to increase service providers' profit margins. Furthermore, it is doubtful whether the reduced VAT rates have a substantial impact on employment.*

²⁷ Ministry of Agriculture is the founder of the Institute.

- *In the opinion of the Lithuanian Ministry of Finance, reduction of VAT rates is not an appropriate measure to lower prices for individual foodstuffs in order to increase demand. Increasing of real income is a more suitable solution for increasing consumption of foodstuffs.*
- *According to the Lithuanian Institute for Agrarian Economics, reducing of VAT rate for agricultural products and foodstuffs is not expedient as levels of consumption of these products is already close to those observed in the EU Member States.*

3. MEASURES RELATED TO THE APPLICATION OF REDUCED VAT RATES

3.1. ALTERNATIVES TO REDUCED VAT TARIFF RATES

Establishment of tax concessions must be preceded by an assessment of whether the tax concession is the most suitable and most effective measure to achieve the set objectives. Should assessment of efficiency of measures implemented show that the measures have not yielded the expected results and benefit, the issue of abandonment of the measure or of its replacement with an alternative, more effective measure should be considered.

The Methodology for Assessment of Impact of Draft Solutions approved by resolution of the Government of the Republic of Lithuania No. 276 of 26 February 2003 states that, in order to propose the optimal solution for a problem, promoters of a draft solution shall examine the situation *status quo* (what would happen if the problem is not solved) and any alternatives to the solution of the problem. Project promoters must carry out basic assessments of all the alternatives presented.

As it has already been mentioned, an economic survey has shown that the introduction of the reduced VAT rates did not produce direct effect on prices, consumption or production. Similar results could have been achieved through the application of other measures, e. g.:

- application of a lower standard VAT rate to all goods and services. In such a case VAT taxation would not be distorted, equal competitive conditions would be created for all payers and consumers and equal treatment would be ensured, without sectors or undertakings being singled out. Furthermore, this measure would facilitate VAT administration;
- lowering of the residents' income tax rate in order that that people have more money at their disposal;
- reduction of the profit tax rate in order to stimulate production growth and to attract investments.

As VAT concessions create exceptional, more favourable conditions of taxation for relevant groups of goods/services and individual undertakings or sectors and that the objectives set for the VAT concessions audited have not been attained, application of alternative measures whose administration and control is easier should be considered abandoning the reduced VAT rates.

Tax concessions may create unequal competitive conditions (i. e. undertakings that supply goods or services to which reduced VAT rates are applied enjoy more favourable market conditions), therefore, application of concessions is only expedient if there are no other more effective measures to attain the set objectives. The results obtained with the VAT concessions could have been attained by other measures whose administration and control is easier.

3.2. ADDITIONAL MEASURES RELATED TO THE APPLICATION OF REDUCED VAT RATES

VAT concessions make tax administration more complex. The introduction of reduced VAT rates has imposed additional responsibilities upon authorities in charge of their administration and control and upon undertakings applying them:

- appropriate legal framework for the administration and application of VAT concessions had to be developed;
- types of activities and goods/services subject to reduced VAT rates had to be defined. Application of such rates to groups of such goods/services has been indicated in the Comments to the Law on VAT. National standards for individual goods and services have been approved. Undertakings that wish to apply the reduced rates must comply with the standards.

The State Tax Inspectorate as the administrator of VAT concessions must allot additional time for the:

- familiarisation with new legal acts regulating the application of reduced VAT rates;
- checking, as part of taxpayers' inspections, whether a taxpayer has correctly and properly applied the reduced VAT rate.

Amendments to tax legislation force undertakings to implement certain measures. This also applies to the imposition of the reduced VAT rate upon new groups of goods/services. In order to ensure correct calculation, declaration and payment of VAT, undertakings had to, e. g., reorganise VAT accounts, train employees, update information system software upon introduction of the new reduced VAT rates.

Additional difficulties were related to the fact that the two VAT concessions came into effect immediately after the publication of relevant legal act in the Official Gazette *Valstybės Žinios* and not after six months from the publication date as established by the Law on Tax Administration²⁸. The laws on the application of the reduced VAT rate on admission to all types of art, culture and sporting events and on creative or performing services provided by a writer, composer or performer took effect upon publication of the laws in Official Gazette *Valstybės Žinios*, i. e. on 17 January 2006 and 27 July 2006, respectively. In such cases, tax payers and tax administrators encounter additional problems related to the application of the new tariff rate.

New tax concessions make tax administration more difficult; both public authorities and economic entities have to undertake additional measures such as, respectively, drafting regulations for the implementation of the new tax preference and preparations for the application of new tax rates.

4. EVALUATION OF MONITORING OF THE APPLICATION OF THE REDUCED VAT RATES

Effective management of processes or phenomena requires that appropriate control and monitoring system is implemented, i. e. an analysis of attainment of the objectives set for the reduced VAT rate and of effectiveness and efficiency with which the tax concession operates has to be made.

The Ministry of Finance has been charged with responsibility for the implementation of public policy in the taxation area and for making proposals to the Government for tax and tax

²⁸ Article 3(3) of the Law on Tax Administration states that the Seimas of the Republic of Lithuania is responsible for ensuring that Lithuanian tax laws that establish new types of taxes, new tax rates, tax concessions or sanctions for violations of tax laws or that make substantial amendments to the taxation procedures or principles of legal regulation and application of taxes would take effect not earlier than six months after the date of promulgation.

administration policies.²⁹ To carry out these tasks, the Ministry of Finance implements public policy in the tax and tax administration area and fiscal policy and analyses and evaluates the effect of fiscal policy upon priority sectors, other areas and macroeconomic indicators.

The Ministry of Finance uses calculations of the budgetary cost from tax concessions in drawing up the state budget for next year. Such calculations are made for other purposes on as necessary basis.

Lithuanian legal acts do not specify an authority responsible for the monitoring and evaluation of effects of the reduced VAT rate and for reporting on these matters. There are no reports on state budget losses due to different tax concessions or exemptions.

Considering that VAT concessions are provided in various areas of the economy falling within the scope of competence of different ministries (Ministry of Agriculture, Ministry of Economy, Ministry of Culture etc.), legal provisions should obligate relevant ministries to conduct monitoring and evaluation of the effect of specific concession and to report on results to the Ministry of Finance. In our opinion, such practice is justified as relevant ministries or institutions subordinate to it collect (or are in a position to collect) information on areas within the scope of their competence.

In our view, the Ministry of Finance should be obligated to summarise, on a periodic basis, information provided by competent authorities engaged in the monitoring and evaluation of tax concessions, and to submit reports on the effectiveness and efficiency of tax concessions (including VAT) to the Seimas, the Government and public at large.

Foreign countries' practice shows that efficiency of both application of tax concessions and tax expenditure can be analysed. Tax expenditures³⁰ are various deviations from the standard taxation system that reduce tax revenues, encourage certain behaviour by consumers and economic, social and cultural activities, e. g. tax exemptions, tax concessions, permissible deductions (depreciation, amortisation), reduced tax rates, income not subject to tax etc. These deviations can be replaced by direct expenditure (under different programmes, direct payments etc.). As distinct from direct budget expenditure, evaluation of tax expenditure is not subject to separate regulation. In order to ensure transparency of tax expenditure systems some foreign states have established various forms of reporting on tax expenditure, e. g. an obligation to submit information together with the statement of execution of annual budget or similar document (Annex 4).

Monitoring of application of VAT concessions should be improved: Lithuanian legal acts do not specify an authority responsible for the monitoring of application of tax concessions and neither public authorities nor public at large are informed about efficiency of tax concessions.

²⁹ Regulations of the Ministry of Finance approved by resolution of the Government "Concerning Approval of the Regulations of the Ministry of Finance" No. 1088 of 08-09-1998.

³⁰ Christian Valenduc. Tax Expenditures Reporting and Effectiveness Analysis, 2006.

IV. CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS:

1. The number of groups of goods/services on which reduced VAT rates are applied has been increasing: at the beginning of 2003, reduced VAT rate was applied to five groups of goods/services, whereas by mid-2006 the number reached twelve. The Introduction of new tax concessions encourages proposals for the application of reduced VAT rates to groups of goods/services that at present are subject to standard 18 % VAT. (*See Section 1.1 of this Report.*)
2. In 2005 Lithuania lost LTL 567 million as tax revenues as a result of tax concessions. Such losses have been increasing from LTL 139 in 2003 to LTL 215 million in 2005. (*See Section 1.2 of this Report.*)
3. Explanatory notes to draft proposals for new laws establishing reduced VAT rates do not always contain clearly defined objectives of the concessions proposed. Insufficiently specific formulation of the objectives is an obstacle to evaluation of success in attaining the objectives. (*See Section 2.1 of this Report.*)
4. Application of reduced VAT rates should be of direct benefit to consumers. An economic study has shown that the reduced 5 % VAT rate did not produce effect, or had only indirect insignificant effect upon prices, supply, demand and employment. As a result of introduction of the reduced 5 % rate undertakings supplying goods and providing services subject to such rate could increase their production volumes and allot more funds for material investments. The reduction of VAT rate was of greatest benefit to such producers and service providers and not to consumers of the goods/services. (*See Sub-Section 2.2.1 of this Report.*)
5. Monitoring of the effects of the reduced VAT rates was insufficient in the audited period. Monitoring of application and efficiency of reduced VAT rates lacks regulation: intervals at which and methods by which the effect of tax concessions is to be assessed have not been set and institutions responsible for the monitoring and evaluation of trends in this area have not been appointed. (*See Section 4 of this Report.*)

RECOMMENDATIONS:

To the Government

1. Considering that the introduction of the reduced VAT rate has not had any direct long-term impact upon prices for the goods and services subject to such rate and covered by our audit, i. e. there has been no direct benefit for consumers, and has created exceptional conditions for providers/suppliers of such services/goods, we propose to examine these opportunities: to abandon the reduced VAT rates; not to introduce new reduced VAT rates; apply uniform tax rate to all goods and services in accordance with the provisions of the EU legal acts. Amendments to legal acts should be initiated on as necessary basis. (*See Sub-Section 2.2.1, Section 3.1 of the Report.*)
2. Efficiency of tax concessions should be assessed on a systematic basis. If a tax concession does not achieve objectives that have been set for it, abandoning the tax concession or replacement with alternative measures should be considered. (*See Sub-Section 2.2.1, Section 3.1 of the Report.*)

To the Ministry of Finance

3. Develop a procedure for the assessment of the degree of attainment of objectives by tax concessions and the actual effect upon national budget revenues and the environment. (*See Section 4 of this Report.*)

4. Calculate and publish, on an annual basis, actual public or budgetary cost of tax concessions. (*See Section 4 of this Report.*)

Jolita Korzunienė, Director, Audit Department No. 6

Kristina Vaivadienė, Senior Public Auditor

VAT RATES APPLIED IN THE MEMBER STATES OF THE EUROPEAN COMMUNITY³¹

Member State	Exclusively reduced VAT rate	Reduced VAT rate	Standard VAT rate
Belgium		6	21
Czech Republic		5	19
Denmark			25
Germany		7	16
Estonia		5	18
Greece	4,5	9	19
Spain	4	7	16
France	2,1	5,5	19,6
Ireland	4,4	13,5	21
Italy	4	10	20
Cyprus		5 / 8	15
Latvia		5	18
Lithuania		5 / 9	18
Luxembourg	3	6	15
Hungary		5 / 15	20
Malta		5	18
Netherlands		6	19
Austria		10	20
Poland	3	7	22
Portugal		5 / 12	21
Slovenia		8,5	20
Slovak Republic			19
Finland		8 / 17	22
Sweden		6 / 12	25
United Kingdom		5	17,5

³¹ 01-02-2006 Report of European Commission “VAT Rates Applied in the Member States of the European Community”

Annex 2
to Public Audit Report
on the Application of Reduced VAT Rates

**APPLICATION OF REDUCED VAT RATES TO THE AUDITED GROUPS OF
GOODS/SERVICES IN THE EU MEMBER STATES³²**

Member State	Foodstuffs	Admission to cultural events	Admission to amusement parks	Services by writers/performers	Accommodation services	Admission to sporting events
Belgium	6 / 12 / 21	N / 6	6	6 / 21 / N	6 / N	6 / N
Czech Republic	5	5	5	5	5	5
Denmark	25	25	25	N	25	N / 25
Germany	7 / 16	N / 7	16	7	16	7 / 16
Estonia	18	5 / 18	18	18	5	18
Greece	9	4,5	9	9	9	9
Spain	4 / 7	N ⁽¹⁾ / 7	7	7	7	7 / 16
France	5,5 / 19,6	5,5 / 19,6	5,5 ⁽²⁾ / 19,6	5,5	5,5	19,6
Ireland	0 / 4,4 / 13,5	N / 13,5	13,5	21	13,5	N
Italy	4 / 10	10	20	N / 20	10	10 / 20
Cyprus	0 / 5 / 15	N / 15	15	5	8	15
Latvia	18 / 5 ⁽⁴⁾	N	18	N	5	5
Lithuania	5 / 18	18 ⁽⁵⁾	18 ⁽⁵⁾	18 ⁽⁶⁾	5	18 ⁽⁵⁾
Luxembourg	3	3	3	3	3	3 / N
Hungary	15	15	15	15 ⁽⁷⁾ / 20	15	15
Malta	0 ⁽⁸⁾	18	18	15	5	18
Netherlands	6	6	6	6 / 19 / N	6	6
Austria	10	N / 10	20	20 / 10	10	20
Poland	3 / 7	7	7	7	7	7
Portugal	5 / 12 / 21	N / 5	5 ⁽³⁾	21 / N	5	5
Slovenia	8,5	8,5	8,5	8,5	8,5	8,5
Slovak Republic	19	N / 19	19	19	19	19 / N
Finland	17	8	8	N	8	8 / N
Sweden	12 / 25	6	25	6	12	N / 6
United Kingdom	0 / 17,5	17,5	17,5	17,5	17,5	17,5

N- not subject to tax

(1) – where services are provided by entities subject to public law or other organisations nationally recognised as providing charity

(2) – amusement parks without cultural significance are subject to standard 19.6 % VAT rate

(3) – except for erotic shows and gambling which are subject to standard 21 % VAT

(4) – products for babies

(5) – a reduced 5 % VAT rate was introduced on 17 January 2006

(6) – a reduced 5 % VAT rate was introduced on 27 July 2006

(7) – artistic activities, artistic and literary creation

(8) – certain confectionary products are taxed at a reduced 5 % VAT rate

³² 1 February 2006 Report of European Commission “VAT Rates Applied in the Member States of the European Community”. (Goods/services groups according to the Sixth Directive, Annex H)

SUMMARY OF THE REPORT BY THE EUROPEAN COMMISSION

In 1998 the European Council concluded that promoting employment, economic growth and stability was one of the four subjects most relevant to Europeans and called for rapid and effective action. On 22 October 1999, Council Directive 1999/85/EC amending Directive 77/388/EEC as regards the possibility of applying on an experimental basis a reduced VAT rate on labour-intensive services was adopted. This Directive permitted certain Member States to temporarily³³ apply reduced VAT rates to the labour-intensive services listed in Annex K to Directive 77/388/EEC.

Table 4

Services and States that had Applied Provisions of Directive 1999/85/EC

Item No.	Areas	Member State
1.	Small repair services	
	- bicycles	Belgium, Luxembourg, Netherlands
	- shoes and leather goods	Belgium, Luxembourg, Netherlands
	- clothing and household textile articles (including repairs and remaking)	Belgium, Greece, Luxembourg, Netherlands
2.	Renovation and repair of private dwellings except for materials accounting for a large share of supplied value	Belgium, France, Italy, Netherlands, Portugal, UK, Spain
3.	Window cleaning and cleaning premises of private households	France, Luxembourg
4.	Domestic care services (e.g. help at home and care for minors, elderly people, patients and disabled persons)	Greece, France, Italy, Portugal
5.	Hairdresser's services	Spain, Luxembourg, Netherlands

The Member States that have implemented the measure laid down in the Directive were obligated to make a detailed assessment of the effect of the measure on job creation and efficiency³⁴. The European Commission assumed responsibility for the implementation and monitoring of the experiment.

Main statements and conclusions presented in the Commission's report³⁵:

1. *New job creation.* The link between reduced rates of VAT and job creation is an indirect one. For the experimental mechanism to work, a reduction in VAT must lead to a fall in the price charged to the consumer of the service concerned. The price must fall sufficiently to generate increased demand for the service. Increased demand should, in turn, lead to increased production. The

³³ The measure was launched on 1 January 2000 and had to end on 31 December 2002 at the latest.

³⁴ The Member States permitted to apply reduced VAT rates by the Directive had to draw up detailed reports containing an overall assessment of effectiveness of the measure in terms of job creation and efficiency. The Commission had to submit a global evaluation report to the Council and the European Parliament by 31 December 2002.

³⁵ Report from the Commission to the Council and the European Parliament – Experimental application of a reduced rate of VAT to certain labour – intensive services, 2003-06-02.

increased production must then be covered by hiring new staff, and not by raising productivity³⁶ or increasing the working time of the staff already employed.

If the fall in the VAT rate is used by the vendor to increase his profits, the mechanism can no longer work as intended. In this case the reduced rate of VAT acts as a subsidy for a particular sector. To avoid this undesirable the Directive stipulates that there must be a close link between the lower prices resulting from the rate reduction and the foreseeable increase in demand.

2. *Reduction of the black economy.* This measure can only have an impact on firms which already have legal status but which operate partly in the black economy. For businesses whose very existence is not declared, reducing the rate of VAT does not offer an incentive to leave the black economy.

3. *Lower rates of VAT not fully reflected in prices.* While conducting price surveys the Member States found that reduced rates of VAT were never fully reflected in consumer prices. Part of the VAT reduction is used to increase the margins of service providers.

4. *No substantial impact on employment.* The Member States' reports do not identify solid evidence of reduced VAT rates having an impact on employment.

5. *Measure's effectiveness is entirely relative.* Empirical studies of the effects of reducing VAT rates show that such measures are never the most effective and that the cost to the budget is high in relation to any impact the measures may have on the economy. Reducing VAT rates is more costly in budget terms than other measures that directly target labour costs. Calculated for the EU as a whole, reductions in labour charges create 52 % more jobs than reductions in VAT rates for the same cost to the budget.

³⁶ Increasing production or service volumes without increasing number of workers.

TAX EXPENDITURE REPORTING (INCLUDING TAX CONCESSIONS) IN CERTAIN FOREIGN STATES³⁷

State	Purpose/usage	Legal requirement	Relationship with budget	Frequency	Method of estimation
Australia	Facilitating assessing tax expenditure alongside direct expenditures: contributing to the design of the tax system: informing the public debate	Legally obliged	A separate government document.	Annually	Revenue foregone on accruals basis
Austria	Tax reform and facilitating budget process	Legally obliged	As an annex part of “Subsidiary report” to the budget documents	Annually	Revenue foregone on accruals basis
Belgium	Assessing the impact of various tax measures on revenue	Legally obliged	An annex to budget	Annually	Revenue foregone method, on cash basis
Canada	(1) analyzing federal income tax and VAT tax systems (2) pre-budget consultations	No statutory obligation.	Not linked to budget process, but for pre-budget consultation	Annually	Revenue foregone method, on cash basis
France	Facilitating the budget process	Legally obliged	Appended to budget bill	Annually	Revenue foregone on cash basis
Germany	Subsidies/expenditure reduction	Legally obliged	As a part of budget, called “Subsidiary Report”	Biennial	Revenue foregone on cash basis
Italy	(1) Evaluating tax expenditure on the basis of its cost, objective criteria, and its consistency with budget; (2) Evaluating its effects for particular sectors and geographical areas, compared with their original aims; (3) Being in line with EC tax expenditure policy guidance	Legally required	Not linked to budget process, nor as annex to budget document. But an independent document	Sporadically	Revenue foregone on accruals basis
Netherlands	Providing the Parliament with insight into budgetary cost of tax expenditures, and possible budgeting	Not legally obliged	As an annex to the Budget memorandum. Not directly linked to the budget but serves as additional background information for the Parliament	Annually	Revenue foregone on accruals basis
United	Facilitating annual budget	No statutory	Not linked to	Annually	Revenue

³⁷ Christian Valenduc. Tax Expenditures Reporting and Effectiveness Analysis, 2006.

State	Purpose/usage	Legal requirement	Relationship with budget	Frequency	Method of estimation
Kingdom	discussion/debate	obligation, but as a recommendation from the Expenditure Committee	budget process, nor as annex to budget document. But as part of statistical supplement to Autumn Statement (revenue)		foregone method, on accruals basis
United States	(1) Shaping tax reforms (2) deficit reduction	Legally obliged	As part of annual budget documents, but is not integrated into the budget process	Annually	Revenue foregone outlay equivalent, and present value methods, on cash basis