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## THE ROLE OF PUBLIC POLICY IN TAXATION: THE CASE STUDY OF COURT RULING ON THE TAXATION OF ILLEGALLY PRODUCED PRODUCT

*The article demonstrates the importance of interrelation between public economic policy and taxation on a specific example of court case (Lithuania) concerning the appropriateness of taxing the illegally produced product (home-made alcohol). It is grounded that taxation of such and similar products would negatively affect the economic culture of the society and upon the public economic policy, motivating certain individuals get engaged in shadow economy.*

*Keywords: principles of market economy; taxation; alcohol production; alcohol consumption; court ruling; economic ethics.*

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## РОЛЬ ДЕРЖАВНОЇ ПОЛІТИКИ В ОПОДАТКУВАННІ: НА ПРИКЛАДІ СУДОВОГО ПРЕЦЕДЕНТА ЗІ ЗБОРОМ ПОДАТКУ З НЕЗАКОННО ВИРОБЛЕНОГО ТОВАРУ

*У статті продемонстровано важливість взаємозв'язку економічної політики держави та оподаткування на конкретному прикладі судової справи (Литва) щодо коректності стягнення податку з незаконно виробленого товару (самогону). Доведено, що оподаткування та акцизні збори з таких та аналогічних товарів негативно впливають на економічну культуру суспільства та економічну політику держави, мотивуючи окремих представників суспільства залучатися до процесів тіньової економіки.*

*Ключові слова: принципи ринкової економіки; оподаткування; виробництво алкогольних напоїв; споживання алкогольних напоїв; судове рішення; економічна етика.*

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## РОЛЬ ГОСУДАРСТВЕННОЙ ПОЛИТИКИ В НАЛОГООБЛОЖЕНИИ: НА ПРИМЕРЕ СУДОВОГО ПРЕЦЕДЕНТА СО ЗБОРОМ НАЛОГА С НЕЗАКОННО ПРОИЗВЕДЁННОГО ТОВАРА

*В статье продемонстрирована важность взаимосвязи экономической политики государства и налогообложения на конкретном примере судебного дела (Литва) о корректности сбора налога с незаконно произведённого товара (самогона). Доказано, что налогообложение и акцизные сборы с таких и аналогичных товаров негативно влияют на экономическую культуру общества и экономическую политику государства, мотивируя отдельных представителей общества участвовать в процессах теневой экономики.*

*Ключевые слова: принципы рыночной экономики; налогообложение; производство алкогольных напитков; потребление алкогольных напитков; судебное решение; экономическая этика.*

**Introduction.** State tax collection is an economic category, improving the well-being of population. This is one of the most important elements of any economy in any state. However, in some cases, taxes may be collected not from cultural activities, but from the degradation of the state, when immoral and illegal activity is recognized as business, for which taxes are to be paid into the state budget. Specific legal case is considered here as an example of such a tax.

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The ruling of the case into obligatory excise tax by the Supreme Administrative Court of Lithuania is being analyzed. It caused some economic outcomes not only to the trial parties but also for part of Lithuanian society.

We believe that, according to this ruling, the excise tax paid to the country budget is not legally bound.

This article is an attempt to demonstrate, that, while trying to improve the economic condition of the state, state authorities can be used contrary to its purpose in the society.

**Literature.** In this research, the author refers to available references, legal standard documents and economic case.

**Problem.** Contrary to the logic, excise tax is paid to the state budget not from cultural economic activities, not from free market, using demand and supply principles, but from activities, contrary to market economy, in a certain way legitimizing shadow economy.

**The research objective** is to detect the cases and the methods of state authorities in collecting illegitimate taxes on the state level. When the research is made, it would be possible to present conclusions regarding state acting wilfully while collecting taxes and trying to enlarge the state budget.

**Further research** might be carried out to observe and analyze the state authority cases in implementing state unlawful economic policy.

**State economic policy framework distortion while collecting excise taxes.** While trying to reach its economic goals and economic policy realization in tax collecting, sometimes the state is not only using economic lever, the principles of supply and demand, but it also applies its powers to distort the above economic principles. Administrative court can be used to realize this kind of state economic policy. This court can help legitimize unlawful and illogical collecting of taxes, which is also inconsistent with free market.

As an example, we would analyze the Administrative case Nr. A6-238/2007 (28.05.2007), ruling category 9.4; 23.1. "On excise tax for unlawfully made alcohol" by the Supreme Administrative Court of Lithuania.

We believe that this ruling of the Supreme Administrative Court of Lithuania caused some reservations in the community, led to similar legal consequences, and this trend still persists.

In our opinion, similar motivation and solution arguments about tax payment from the Court of Justice of the European Union, used in this case, are not de jure quite logical.

There is a petition for appeal stating that from 1 December 2004 to 31 January 2005 the individual made 14.61 l of 44.5% proof alcoholic drink and 400 l of 10% leaven (ferment), but failed to pay an excise tax.

During the trial of 28 May 2007, the Supreme Administrative Court passed the resolution stating that the declarant made taxable commodity and, according to the Excise Act, must clear the tax (Nr. A6-238/2007, 28.05.2007).

This court resolution was based on motivation and analogy of the Court of Justice of the European Union and similar Excise Act of the Republic of Lithuania.

However, the legal arguments do not seem very convincing, in particular, the application of analogy about tax payments by the Court of Justice of the European Union.

**Legalizing a distorted commercial activity concept in economic activities.** State economic instruments of tax collection start with State tax inspectorate, pass through judicial power and end being realized by State tax inspectorate again. In the petition of the applicant complaint, Vilnius Regional Administrative Court issued a ruling on 3 July, 2006, cancelling the excise tax imposed by the State Tax Inspectorate due to the fact that home made alcoholic drink is an illegal commodity and is not taxable.

Logically, it is hard not to accept the motivation of the Regional Administrative Court in spite of not being taken into account the importance of consumption of such commodities and even if it is to be considered as a consumption commodity. Also, it is possible that such a "good" can participate in the relations of supply and demand.

Given that commodity is made illegally and in defiance of standard requirements, consumption can damage people's health or even be poisonous.

However, the Supreme Administrative Court refuted this ruling and formulated its own.

In accordance with the Excise Tax Act 3, article 10, point 1, in the classified KN 2208 position there is ethyl alcohol, less than 80%; also spirits, liqueurs and other beverages described in the European Commission Regulation Nr. 1719/2005; hence, they are considered to be excise taxable as pointed out in Excise Tax Act 2, article 1, part of point 1 (Nr. A6-238/2007, 28.05.2007).

The Court right away states that this commodity meets the requirements of taxable ethyl alcohol and alcoholic beverages in accordance with the Excise Act (Nr. 98-3482, 2001; Nr. 26-802, 2004; Nr. 45-2174, 2010). Consequently, it can participate in economic market relations, in accordance with the principles of supply and demand.

The Act describes the commodities for sale and official producers.

The point is whether a person with no competence and technical equipment can produce alcohol for consumption and if it matches the standard concepts. Could we call such a product a "good"?

According to the mentioned Act, the Product is either an item or service.

Each item is designed for consumers, can be sold or given without payment in the commerce process regardless whether it is new, second-hand or processed (Nr. 52-1673, 1999; Nr. 64-2324, 2001).

In this case, where economic relations are decided, there is lack of evidence and government arguments concerning the issue whether the product is made for sale or not.

Moreover, the government failed to declare if the item is safe for human health, but it is excise taxable as any consumption commodity, participating in relations of supply and demand.

In accordance to the Product Liability Law, a safe item is any item used in the usual ways described by producers and following the instructions, it does not cause any risks to consumer life and health and is compatible with the consumer safety standards (Nr. 52-1673, 1999; Nr. 64-2324, 2001).

The question arises whether the alcohol liquid made in previously described conditions can be considered safe and pass the legal requirements?

Can we call the person making this liquid a producer, which participates in economic relations of the state?

A producer is a person or a body (or any institution) that can implement activities according to the laws of the Republic of Lithuania or of the European Union (Nr. 52-1673, 1999; Nr. 64-2324, 2001).

In this case, we can hardly consider the person who made the liquid with ethyl alcohol as a producer whose activities are regulated by the law and who is participating in the relations of supply and demand.

Economic consequences after legalizing an unlawful excise tax. By rendering such a judgment, the Supreme Administrative Court cited the precedent of the European Community Justice Court imposed in Tullihallitus case against Kaupo Salumets and others, Nr. C-455/98, 29.07.2000.

This case scrutinized the smuggling of the imported ethyl alcohol into the Community territory and its excise tax.

The Court of Justice of the European Union noted that, in accordance with the accepted practice, fiscal neutrality principle bans any difference between legal and illegal transactions.

If a certain transaction is reputed as a legal violation, it does not imply it is tax-free (Nr. A6-238/2007, 28.05.2007).

However, in this case The Court of Justice accepts the transaction.

In the Article 63 of Lithuanian Civil Code, transactions are described as party activities to create, change or cancel civil rights and duties.

According to the Code 97, generally the objects of civil rights are goods, money, valuables, other assets and rights, outcomes of intellectual activity, information, actions and their outcomes as well as valuable or not valuable property (Nr. 74-2262, 2000; Nr. 77, 2000; Nr. 80, 2000).

In our case, the Court attempts to identify an illegal activity with a civil transaction in order to justify its decision on excise tax.

However, is it justifiable to implement the justice and in the meaning of free market – supply and demand?

According to prof. V. Mikelenas (2009: 85), the court interpretation does not make sure if "black is white or vice versa".

And the taxes thus collected to the state budget bring in a disbalance into free market relations.

The Court of Justice emphasizes that broadly speaking ethyl alcohol is not a product whose sale is essentially banned due to its specific unacceptable properties.

Fundamentally, a legal product such as ethyl alcohol cannot be compared with drug substances (Nr. A6-238/2007, 28.05.2007).

It is important to highlight that the Court of Justice of the European Union is concerned with health requirements and an appropriate item for human consumption, i.e. alcohol, which is codified in the Product Safety Law of Lithuanian Republic.

Therefore, we raise a question: can a product produced in unsanitary conditions and using an uncertified equipment be compared with legally produced final product of ethyl alcohol traded in official markets?

The Court of Justice of the European Union admits there is a competition between smuggled and legally distributed alcohol, so in this respect the market of legal sales is a target for smuggled goods.

Therefore, customs duty and other taxes are imposed on all contraband alcohol, which is a usual taxation procedure in the European Union (Nr. A6-238/2007, 28.05.2007).

In other words, The Court of Justice describes the legally produced and safe to people health product, which might be sold exempt from taxation.

A similar example is illegal trafficking of alcohol from Republic of Belarus to Lithuania and the attempts to avoid tax payments in such a way. Official product like this, which is for human usage, could fully be present at supply and demand relations, even in illegal trade.

In accordance with the decisions of the Court of Justice decisions as well as common logic, it is evident that excise tax is payable in agreement with Lithuanian legislation.

As mentioned above, in our case it is an unlawfully produced product, which might be harmful to human health or even poisonous, thus it cannot be consumed.

Moreover, the Court included the quote which has nothing in common with the case, namely, Council Directive 92/12/EEB on general procedures of excise taxation as well as product storage, movement and control, also Council Directive 92/83/EEB on the excise for alcohol and beverages, which should be applicable in the Community territory if imported by contraband (Nr. A6-238/2007, 28.05.2007).

In this quote, legally produced alcohol smuggled into another country has nothing in common with the reported case.

Another interesting fact is that the Supreme Administrative Court fixed excise tax not only on ethyl alcohol but also on ferment, which is not a final product; it serves as a means to produce alcohol and is supposed to be 10% proof.

The advanced meeting of the Supreme Administrative Court emphasized that neither EU laws, nor excise laws do not single out lawfully produced alcohol.

In our opinion, it would be legal and logical to incorporate into Lithuanian legislation the rule about home-made alcohol and ferment that would legalize the excise tax for their production.

Naturally, neither Lithuanian, nor EU legislation contain such illegal standards, because "law cannot appear within outlaw", and in this case, its result is the product, that is inappropriate for human consumption and cannot take part in market relations and be charged with taxes.

The Supreme Administrative Court claims that indirect taxation and fiscal neutrality principle do not authorize the divide between legal and illegal transactions of goods.

This rule is invalid if commodities containing some attributes which ban their circulation in the member states of the European Union, so that they will not legally appear at the market, since there is no competition between legal and illegal economy sections.

The Court claims that ethyl alcohol is not an absolutely banned product and may be circulated as a commodity (Nr. A6-238/2007, 28.05.2007).

It should be emphasized that commodity is an element of marketing involved in decisions and activities. There is a number of commodities ([www.pajamos.lt](http://www.pajamos.lt)). Commodity is always interrelated with purchase; in our case, it is not clear if an offender planned to sell his produce, which made the court ruling questionable.

The offender was detained for stocking the liquid and ferment, but not for selling, hence, could his property be named a commodity, that can be traded at a market?

Besides, can we state that unlawful liquid of uncertain composition is a product for civil circulation, in particular, how might it influence people's health if they decided to taste it?

Moreover, we can imagine that some people would consume the liquid by drinking it, but would they buy the ferment, which as a commodity was an object of excise taxation?

If we approve the Court's arguments in this case, then drugs would definitely become the commodity and the object of civil circulation, and would be able to participate in free market relations, based on the principles of supply and demand.

By the end of the trial the Court concluded that ethyl alcohol may be the excise object in spite of being made unlawfully.

Besides, the Court discriminates the liability for offences generally and the liability to pay taxes.

However, offences are not equally treated, though, for instance, contraband traffic of an item, i.e. alcohol, produced in another country, and produce of alcohol in inappropriate conditions and equipment.

Is it possible to compare absolutely different things? The law theory claims that liability for offences is a human duty as well as amends for damages.

The duty emerges from the law, and breach of justice cannot legitimize it and economically admit possible outcomes, for example, pay excise taxes.

Unlawful and in inappropriate conditions made alcohol mean that some standard regulations have been violated. In this specific case, unharmed value of produced product is not denied.

Illegal production of alcohol and ferment in inappropriate conditions means its unlawful production, and products can hardly be named as consumption items because of being harmful to people health. Consequently, the described item can hardly be an object of excise taxation, according to Lithuanian and the EU legislation.

Given the mentioned arguments of the Court, it would be essential to levy incomes of people, who get illegal revenues.

In our case, there are no facts that a person intended to have profits from unlawful activity or by other means in market relations.

Thus, some questions can arise from this. First, did the Court use non-intervention policy and independent justice implementation principle? Second, could the Court be "politically engaged", in prof. V. Mikelenas (2009) words? Third, did court apply with the principle of analogy correctly? Fourth, can society, participating in the relations of supply and demand, be satisfied by the Court decision? Fifth, can it pose an economic disbalance in general? Finally, would not it break the balance of taxation system? How does the state look like, what is its economic authority, when persons, participating in shadow economy are charged excise taxes by the State tax inspectorate?

#### **Conclusions:**

1. It is essential for Lithuanian economy that courts implement the doctrine of practice used in the European Union and do not deviate from institutional motiva-

tion and argumentation and perceive the contents of practical doctrine, used in economic relations. This authoritative institutions practice analogy must be applied in the way, that economy authenticity and essentiality would not be distorted with its decision analogue.

2. Unjustifiable excise disbalance in economy can be caused by the latest instance court decisions in tax relations, when taxes are paid to the state budget, and are not based on the principles of free market.

3. In the court economic trial Nr. A6-238/2007 by the Supreme Administrative Court, excise tax was legitimized, and that is inconsistent with free market relations. It has become an unreasonable result for some part of society, in particular, for the participants of shadow economy, which has been charged with excise tax.

**Recommendations.** In order to avoid unlawful taxation, it is recommended to the President of the Supreme Administrative Court of the Republic of Lithuania, in accordance with the proceedings of the Law, Article 154, to analyze critically the background of the case Nr. A6-238/2007, which was completed and validated on 28 May 2007. It is recommended to re-new this case, in accordance with Article 153, and to invoke the analogy, justice, the principles of reasonableness and logic.

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