



20 May 2011

## **Position Paper on Macroeconomic Policy, Tax and Tax Administration**

### **1. Executive Summary**

The Latvian economy is back on the road of growth – over the past year recovery has become stronger. Unless the global economy nosedives again, the Latvian economy will most likely continue to report positive growth rates, but without quality and swiftly implemented structural reforms such growth will be too slow to support coherent and across all social groups enjoyed rise in living standards. Job creation is weak, grey economy has grown to unacceptable levels. Tax increases to balance the budget have become increasingly counterproductive. Negative demographic trends are about to kick in putting under pressure sustainability of the social security system, pension system, country-wide regional cohesion and development.

### **2. Recommendations**

In order for Latvia to maintain and improve its competitiveness, we see it necessary to address the following issues jointly and without delay:

- i. Tax system and administration must shift economic incentives towards swift and sustainable growth, strict law enforcement and tax administration, transparency; ensure stability of decisions made; and improve communication;
- ii. Competitiveness and fair competition to be supported via the 2014 euro accession, the government must decisively implement its grey economy and tax evasion eradication plan; public procurement mechanism must become more transparent and efficient; public administration and service quality must be strengthened via introduction of performance related pay, privatising the companies that are of no core interest to the public service provision, introduction of the “money follows” principle in public service provision;
- iii. Structural reforms must take view of demographic trends: administrative reform must be continued by further pooling of human and monetary resources; vocational and tertiary education system to be optimised via a smaller number of infrastructure units and improved quality where financing mechanisms foster innovation; welfare system must be income discriminating and must motivate to find employment.

### **3. Rationale**

Recovery has continued to strengthen and widen. Initially driven by exports and inventory rebuilding, it has spread to household consumption and business investment activity. Since the end of recession in late 2009 the economy has grown by over 4%. But it does not routinely imply fast and sustainable economic growth also in the future – significant part of the current recovery is due to a rebound effect, which conceals substantial structural weaknesses that will obstruct

economic growth in medium and long run. Job creation is very weak and given the business environment quality there is no reason to expect that it will improve sharply. Persistent high unemployment will deplete future growth via loss of labour skills and emigration. The future growth will be weighed down by grey economy, which has grown to unacceptable levels. The post-election opportunity to pursue structural reforms in the 2011 budget was generally missed as most of the consolidation was done via tax increases rather than improved public spending efficiency. Straight forward increases in the tax burden have become counterproductive weakening the government's ability to tax the economy – despite higher tax rates and a wider tax base in 2010 tax revenues as a share of domestic demand constantly fell below the 2009 level.

Negative demographic trends are about to kick in – over the recent years Latvia had the lowest demographic pressure measured as a share of those employed to the whole population. Low birth rates, high unemployment and fierce emigration have turned the trends around putting under pressure sustainability of the social security system, pension system, country-wide regional cohesion and development.

This Position paper centres on three key areas that FICIL sees to be most urgent:

#### Tax and tax administration

There is a strong case to improve the existing tax system in a way that better supports the pace and sustainability of economic growth. We see it necessary to improve economic incentives by reducing the tax burden on labour, strict law enforcement and tax administration, increase transparency, ensure stability of the decisions made and improve communication (see appendix for details).

#### Competitiveness and fair competition

- *Euro introduction in 2014*: a critical target that Latvia must aim for and act timely/ thoroughly to reach. Joining the euro would imply attaining a certain standard in the quality/ efficiency/ sustainability of the economy and provide access to an extended list of competitive advantages such as lower cost of public debt rollover and deficit financing, lower financing and capital costs to the private sector. The Estonian example shows that benefits clearly outweigh any short term costs.
- *Grey economy and tax evasion*: FICIL appreciates the government's action to create the plan to tackle the grey economy and tax evasion, but we see it necessary to become more decisive to implement the plan with no delay in order to cut down the grey economy that is crippling the Latvian economy and social safety net. We suggest following industry-by-industry rather than company-by-company approach to minimise "collateral damage".
- *Public procurement*: Latvia must think big in terms of business opportunities, efficiency and sustainable long term growth. FICIL fully supports the EU-wide initiative of the British Prime Minister following the Nordic Baltic Summit held in London January 2011 to reform and open public procurement to competition (p.21 in the David Cameron's letter to Valdis Dombrovskis on 30 March 2011). For a detailed FICIL view, see the attached Position Paper on Public procurement.
- *Public administration and services quality*: to retain talent and strengthen sustainable long term growth motivation we see it instrumental to introduce in the public sector performance related and remuneration system linked to the level of the private sector remuneration. To

improve efficiency of state and municipality owned companies it is necessary to clearly identify company aims and privatise those companies that are of no core interest to the public service provision (for details see the Position Paper on Capital markets). In providing public services, more freedom must be given to the public in selecting the service provider thereby improving service quality and toughening competition – e.g. via the widespread introduction of the “money follows” principle in education.

#### Sustainable growth and structural reforms

Negative demographic trends are reinforced and brought closer by emigration to the point that cannot be ignored not only in the future but also in today’s policy making:

- *Administrative reform*: it has been a failure. With so fragmented financially small territorial units and shrinking labour supply (via skills loss, aging, low birth rates and emigration) it is unlikely that such administrative units will be able to attract investors to create sustainable and well-paid jobs. Such a set up is likely to set off a vicious circle of financially ever weaker and weaker regions with persistent emigration, which will weaken also currently relatively stronger centres. In FICIL’s view, human and monetary resources, administrative capacity must be pooled around a significantly smaller number of economic centres to build up critical mass, improve efficiency and sustainability of growth.
- *Vocational and tertiary education*: a clear sector reform outlook is necessary by aiming to reduce the number of educational institutions and improve quality, bring them closer to business by creating a financing model that favours innovation.
- *Health care and welfare*: over the past years social burden has significantly risen (i.e. the proportion of private sector employees to population has shrunk) which, given the demographic trends, is expected to rise further – this puts additional pressure on taxes, inefficient social safety net, economic growth and living standards at large. Social benefits system must be income discriminating and motivating to find employment.

## Appendix

### **More detailed tax considerations developed by The Foreign Investors` Council in Latvia Tax Group**

The government should strive to design a clearly communicated, consistent long-term tax strategy and tax policy to promote stability and predictability of the tax system. FICIL suggests that a detailed communication and consultation process be in place to determine how changes in tax laws will affect various industries.

#### ***Corporate income tax***

1. To allow accumulated tax losses to be carried forward and set off against the next year`s profit for an unlimited time period. To allow intra-group loss transfer for eight years. Transfer of losses is still one of the reasons why investors are not interested in investing considerable resources in new production facilities, new fixed assets, or office space. Such large investments require large resources and eight years is a too short period to earn a profit that would be sufficient to write off the investment.

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2. To allow depreciation of goodwill for tax purposes.
3. To allow advance pricing agreements to be concluded between taxpayers and tax authorities.
4. To provide for an exemption from taxation for capital gains if the share holding period is at least one year.
5. To abolish withholding tax on any proceeds from the sale of real estate located in Latvia and the sale of shares in companies holding real estate in Latvia.
6. To provide clearer definitions of business activities in relation to non-profit organizations. To formulate more detailed criteria regarding donation relief and displaying of company`s logos by the donees. To provide a clearer definition and interpretation of the terms “donation” and “sponsorship”.
7. To remove road documentation requirements for administrative transport, which can be done by treating some expenses as non-deductible.
8. To review documentary requirements for the application of/ exemption from withholding tax.

### ***Value added tax***

1. To introduce a special VAT regime for PPP projects.
2. To implement provisions related to the recovery of VAT on bad debts and to provide an option to apply VAT on real estate and financial services.
3. To ensure speedy introduction of a special VAT reverse-charge regime for construction works.

### ***Social security contributions***

1. To reinstate the ceiling of social security contributions. The abolition of the ceiling will bring a short-term positive effect on the revenues of the state social security budget. The long-term effect will be negative because pensions, sickness, maternity and paternity benefits will increase, leading to the growth of additional budget expenses. With the tax burden for employers increasing, Latvia will become less attractive for foreign investors.
2. To introduce discounts from social security contributions for large employers depending on the number of employees or the amount of social contributions paid. Such discounts will promote creation of jobs and reduction of unemployment in the country.
3. To reduce social security contributions to average EU level.
4. To consider resuming transfers of 8% of the contributions into the second tier of the pension scheme.

### ***Excise tax***

1. To determine that all necessary control arrangements to prevent duty-unpaid cigarette and alcohol supplies from CIS countries should be a priority for the State Revenue Service. Potential activities could include:
  - a. Rotation of customs officials;
  - b. Penalties for persons who buy duty-unpaid products.
2. To review the proposed system for excise tax refund on fuel for farmers.
3. To review the guarantee system for excisable goods.
4. To gradually reduce excise tax for soft drinks.

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### ***Personal income tax***

1. To further update the Law on Personal Income Tax and ensure that appropriate clarifications for the application of the law are available, specifically definitions of financial instruments, secondment of personnel, economic activity.
2. To simplify the procedure for declaring and paying tax on capital income and capital gains by allowing tax returns to be prepared once a year instead of the current monthly/quarterly requirement.
3. To provide for an exemption from taxation for capital gains if the share holding period is at least one year.
4. To reduce the personal income tax rate for employment income to 20%.
5. To expand the list of allowable deductions of up to 10% of gross taxable income and include also education expenses and interest paid on real estate loans.

### ***Stamp duty and other obligatory payments to the state and other public officials***

To revise the stamp duty and other obligatory payments' system in Latvia and ensure that the amount of such payments is commensurate and adequate.

### ***Tax administration***

1. Tax audit activity should be focused on grey economy and collection of unpaid taxes. This would ensure larger tax income and prevent tax evasion.
2. Preferred taxpayer status/ tax certification. We believe that the government should co-operate with professionals performing external audits of financial statements of businesses as they possess a large amount of information on potential tax evaders. The government should consider introducing the preferred taxpayer status for companies with long-term record of tax compliance and consider the tax certification requirement for companies operating in areas where tax evasion is more prominent to ensure better collection of taxes. The experience of the Netherlands can be used to create a system, which would work best in Latvia.
3. Inspection of companies employing self-employed persons for statutory compliance.
4. A possibility for a company to apply for advance rulings on behalf of its employees.
5. Education for judges in the tax field.