



1 June 2012

Position Paper on Macroeconomic Policy: From Managing Crisis to Creating Growth

1. Executive Summary

In 2011 Latvian GDP growth was strong at 5.5%. The growth was broad-based, yet major underlying drivers still remain exports and EU funds. Unemployment continues to retreat and incomes have started to grow. The government's fiscal stance continues to improve. The economy has become more competitive, more resilient to shocks. Financial and fiscal stability has been attained; State Treasury has accumulated good liquidity reserves. Yet, not all is done and over. The global environment remains fragile and one must remain cautious. Part of the current recovery in the Latvian economy is due to a post-recession rebound, which conceals structural weaknesses that will obstruct growth in the mid to long-term. It is encouraging that many of the earlier policy taboos have been lifted by the new government as we see more open and genuine discussions on the fundamentals of future growth, but results are still to be seen. The Euro 2014 target is within reach, but decisive actions are necessary to ensure it. The current momentum must be used and policymakers must make a clear shift from managing the crisis to creating growth. Growth that is sustainable, rapid, and inclusive.

2. Recommendations

In order for Latvia to step on a path of sustainable, rapid and inclusive growth, we see it necessary to address the following issues jointly and without delay:

- (i) *2014 Euro accession*: across the board policy and public support must be drawn to ensure that the target is met; short-term economic policy tactics to support the Euro accession shall be sustainable and in-line with overall long-term strategy, e.g. tax policy;
- (ii) *Fiscal discipline and tax policy*: strong discipline to be maintained at all times, labour tax wedge reduced swiftly to at least the level of major competitors;
- (iii) *Demographic trends and regional policy*: administrative reform to further pool human and financial resources, industrial policy to create level ground across the country to correct market and government failures, education system to be optimised via smaller number of infrastructure units and improved quality where financing mechanisms foster innovation, income-tested welfare system to reduce unemployment trap, increase retirement age to address ageing, improve workforce skills and health to foster overall productivity growth;
- (iv) *Financial markets' development*: introduction of advanced credit reporting systems, diversification and deepening of financial markets to improve risk assessment and overall access to finance thereby supporting sustainable economic growth.

Appendix to the position are more detailed Tax considerations developed by The Foreign Investors Council In Latvia Tax group.

3. Rationale

The recovery in Latvia has continued to widen and deepen. Initially driven by exports and EU funds, it has spread to investments and consumption. Unemployment retreats and in certain segments there is an increasing risk that lack of labour is soon to put an undue pressure on wages. Long-term unemployment is high and the risks of it turning structural and entrenching have risen. Preliminary data of the 2011 population census show that most pessimistic estimates have not been far from truth: from 2000 to 2011 the population has shrunk by 13% and close to 200'000 have emigrated; in certain parts of Latgale the population has shrunk by close to a third. This has cut massively into Latvian growth potential. This also shows that the current number of municipalities is way too many and both human and financial resources in many cases are spread too thinly to create adequate critical mass for growth. Labour productivity growth remains positive, but has slowed to very low levels and reforms are necessary to prop it up. If productivity growth will remain poor, also wage growth will be poor thus driving emigration, further reducing growth potential and putting at risk sustainability of, for example, the pension system, regional cohesion and development. It is encouraging to see that many of the earlier economic and social policy taboos have been lifted by the new government as we see more open, genuine policy discussions on such future growth fundamentals as education, welfare, health care, regional development, industrial and tax policies, but structural reforms and results are still to be seen.

Early 2012 has brought an anticipated slowdown in export growth, but retail trade remains surprisingly strong. The government's fiscal position has improved and tax revenues are significantly above the plan, creating demands for it to be assigned to expenditures. This creates the risk that these financial means may simply be "eaten up" rather than invested in reforms to improve budget structure and boost sustainable economic growth. The global oil price rise early this year has pushed up inflation making meeting Maastricht inflation criterion for the 2014 Euro introduction more challenging.

This Position paper puts forward four key areas that FICIL sees to be most urgent:

- *2014 Euro accession*: a top priority target to aim for and act timely/ thoroughly to reach. Joining the Euro would imply attaining a certain standard in quality/ sustainability and provide access to an extended list of competitive advantages such as lower cost of public debt rollover, lower financing and capital costs to the private sector, it would also reduce vulnerability to international financial market volatility. To this aim, across the board policy and public support must be drawn. Short-term economic policy tactics to support the Euro accession shall be sustainable and in-line with overall long-term strategy, e.g. tax policy.
- *Fiscal discipline and tax policy*: in contrast to the previous years of tight fiscal austerity, now improving fiscal balances and above-the-plan tax revenues create pressures to ease expenditures. FICIL upholds that strong fiscal discipline is to be maintained and extra expenditures are either invested in reforms to boost sustainable growth potential, or assigned to (i) activities where structural reforms have already been carried out ensuring efficiency of such expenditures, and (ii) social support mechanisms to less well off strata of the society ensuring that this support is precisely targeted. It should not be allowed that budget discipline slips back to the "old habits" of spending recklessly and excessively. Labour taxes must be cut swiftly in clear-cut and well communicated steps both by means of reducing the personal income tax rate and increasing tax free allowances so that the labour tax wedge decreases at least to the level of Latvia's major competitors by early 2015. Employee contributions to the second pension pillar must be increased from the current unsustainably low level of 2%. Transparency of public expenditures must be improved.

The extent of grey economy is not tolerable and shall be reduced sharply in cooperation with the non-governmental sector to promote fair competition at all levels thereby facilitating foreign investment and economic growth. Excise goods industries represent one such area where commensurate, effective and well-communicated measures have to be implemented to reduce the illicit market. Furthermore, it is necessary to ensure that excise tax revenues are earmarked for socio-economic programmes such as health protection deliver measurable, high quality, and evident results.

- *Demographic trends and regional policy:* with shrinking labour supply (via skills loss, ageing, low birth rates, and emigration), fragmented and financially small territorial units will be unable to attract investment and create sustainable and well-paid jobs. The current set up fosters a vicious circle of financially-ever-weaker regions with persistent emigration, which will weaken currently-strong centres. In FICIL's view, both human and financial resources, and administrative capacity must be pooled around a significantly smaller number of economic activity centres to build up critical mass, improve efficiency and sustainability of growth. Industrial policy should strive to create level ground for all major regions of Latvia, both correcting for market and government failures. The education system is to be optimised via smaller number of infrastructure units and improved quality where financing mechanisms foster innovation. The welfare system is to become income-tested and motivate to find employment to reduce labour loss via unemployment trap. Similar to the situation in other countries, the retirement age must be increased. Effective access to quality health care must be ensured to reduce the costs of work absenteeism and overall relatively poor health condition as only a healthy workforce can produce sustainable improvement in productivity and living standards.
- *Financial markets' development:* the scope and coverage of credit information in Latvia must be expanded to support sound resumption of credit. Accurate and timely credit information allows financial institutions to reduce risks, loan processing times, costs, and default rates. Credit information available to creditors should include all relevant information available to provide a comprehensive view on client payment track records (including financial and commercial liabilities) and improved access to public databases. Combined with a legal framework ensuring consumer rights protection and protection of personal data, this will enable the operation of private credit bureaus in Latvia. Credit bureaus support responsible lending practices, reduce lending rates to responsible borrowers, and help borrowers avoid over-indebtedness. To improve access to funding it is also necessary to diversify and deepen the development of financial markets by supporting the functioning of a more efficient stock market, debt market, venture capital, and others. These benefits all combine to support broad and sustainable economic growth.

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Appendix 1

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

FICIL would like to thank the Ministry of Finance for the constructive dialogue on tax considerations developed by FICIL Tax Group held at the end of 2011 and for implementing a number of significant amendments in Latvian tax law (extension of tax loss carry forward period, introduction of holding company regime in Latvia, VAT reverse charge mechanism for construction works) and for continuing work on a number of other significant developments (new VAT law, etc.).

Going forward, the government should focus its efforts on combating grey economy and tax smuggling, maintaining efficient consultation process to determine how changes in tax laws and administrative requirements will affect various industries and improve communication of various tax policy aspects.

FICIL proposal for CIT incentive for R&D costs

The research and development is one of the priorities defined in Latvian strategic development plan for the years 2010. – 2013. In order to facilitate achievement of this goal, concrete actions should be taken thus allowing entrepreneurs develop their research by granting tax reliefs. It is evident that when investors are considering location in the Baltic region, all three Baltic states are valued, that is why it is worth to compare tax conditions in Latvia and its neighbours.

Different options for encouraging R&D activity in Latvia are possible and, if implemented, could make Latvia more attractive for foreign investment. Thus, we propose to introduce tax incentive for CIT purposes with respect to R&D costs incurred by a company. For additional information on schemes applied in other countries, please see Appendix 1-1.

FICIL proposal to revise the criteria for application of large investment relief

According to the information available for us, only two companies - AS Dobeles Dzirnavnieks and SIA Baltic Crystal - have been able to fulfil the criteria to apply incentive for large investments as defined by Law on Corporate Income Tax. Thus, we believe that criteria defined in Law on Corporate Income Tax are hard to fulfil. Namely, the required increase in production volumes, production efficiency and employment growth resulting from intended investment is disproportional to the dynamics of increase in respective ratios of enterprise.

We recommend revising the criteria included in the Law on Corporate Income Tax in order more companies would be able to qualify for them and apply the large investment incentive as defined in Law on Corporate Income Tax.

Additionally, in FICIL's view, the relief should be product-oriented (products with high added value), not applied on an industry basis.

FICIL proposal on social security contributions relief

Taking into consideration government's efforts in fighting the high unemployment level it is of essential importance to employ recently graduated youngsters without related experience. Nowadays youngsters' faces difficulties to enter the workplace due to lack of experience and decide to move abroad. From our point of view, in order to support initiative to employ youngsters in their field of education, government should grant benefit for the employer in the form of tax reliefs.

We suggest reducing social security contributions by 50% when employing recently graduated youngsters without work experience. In order to avoid fraud we suggest introducing law which requests entrepreneurs to submit their application to apply the tax relief after 12 month of employment only when 18 employment months has been ceased.

We also suggest applying similar tax relief for the employer when employing long-term (its up to tax authorities to decide) unemployed person. This would also contribute into states aim fighting high unemployment level.

Maximum amount of the social security contributions

Taking into account the existing recovery of the economy, we propose to adopt Regulation issued by the Cabinet on minimum and maximum amount of the object of the social security contributions with effect from 01.01.2014 by amending the existing formula of the maximum amount of the social security contributions to be paid with the one which is more suitable for current economic situation or explain the criteria included in the mentioned formula, specially coefficient 9. For additional information on former calculation method of maximum amount of social security contributions, please see Appendix 1-2.

FICIL proposal for roll-over relief for business owners-individuals

If an individual sells qualifying shares or qualifying business assets of unincorporated private businesses which he/ she has held for at least 12 months, then the capital gain is not taxable to the extent that sales proceeds are re-invested in other qualifying shares or qualifying business assets within 12 months (with proper anti-avoidance rules). Proceeds may be invested both in the same or another type of business activity.

Such relief would develop investment environment in Latvia and make the country more attractive for business owners. Individuals would be more willing to retain wealth (cash generated on sale) in Latvia and not structure sale of business assets (especially, shares) through foreign jurisdictions. Wealthy individuals would be more willing to report their income to tax authorities. For additional information on terms used in this proposal, please see Appendix 1-3.

FICIL proposal for promotion of capital investment in Latvia

In order to promote the economic growth and competitiveness in Latvia, the well developed capital market is of essential importance. Thus, in order to promote private individuals to invest in Latvian local companies which are traded in stock exchange, government should apply similar taxation regime as for other investment possibilities.

Thus, we propose to harmonise tax regime applicable to long-term investments in shares and long-term cumulative life insurance either by allowing to deduct from the taxable income for personal income tax purposes long-term investments in shares in initial public offering or by gradually

reducing the tax rate which is applied to such investments (e.g. by 5% for every year of holding). Additionally, we propose to reduce capital gains tax applicable to sale of shares invested in initial public offering if shares are subsequently held for at least two years.

FICIL's position on adoption of Law on Value Added Tax in Latvia

Currently, the Law on Value Added Tax has been amended for 34 times, thus the layout of the Law is complicated. Additionally, certain definitions provided in Latvian Law on Value Added Tax are not fully in line with the Directive 2006/112/EC on common system of value added tax. Thus, the Ministry of Finance was considering introducing new VAT law already in Year 2008. However, this date has been postponed for several times and currently, the set date is 1 January 2013. Currently the new project of the Law on Value Added Tax is submitted to the non-governmental organizations to provide comments on respective Law.

It is important for the business and also investors that Latvia has clear and understandable legislation that is in line with the EU Directives. We consider it would be important to adopt the mentioned law as of 1 January 2013. Thus, we recommend dedicating necessary amount of resources in order new Law on Value Added Tax would be adopted in the currently planned term.

FICIL's position on excise tax on soft drinks in Latvia

Industry sees the existing tax on soft drinks in Latvia being unjustified, resulting in the loss of competitiveness for local industry and in the decrease of jobs and business investments not only for the producers, but due to the multiplier effect across the entire supply chain, particularly in horeca sector. Thus, the industry proposes to the Latvian government to set in place gradual reduction schedule for the existing excise tax on soft drinks.

FICIL proposal for excise tax on oil products

Companies - licensees of excise and/or customs warehouses operating with oil products have a problem concerning rates of allowable losses and methods for assessment, calculation of the losses, exempt from excise tax and other customs duties (VAT, import duty).

Regulations of Cabinet of Ministers for the circulation of excisable goods (regulations No.662) include part XII and XIII which prescribe different rates of allowable losses for the same kind of fuel. Rules on application and calculation of the rates in the regulations are unclear, therefore they could be interpreted differently. In practice the rates and procedures of calculation of the allowable losses in excise and customs warehouses are applied differently, causing risk of additional excise tax liability to companies involved in transportation and trade of oil products. It is also necessary to clarify application of rates and procedures for calculation of allowable losses for customs warehouses. This legislative provision should be clarified to remove uncertainty for business maintaining excise and/ or customs warehouses operating with oil products.

FICIL proposal with respect to tax administration

FICIL would propose the following activities in the field of tax administration:

1. To allocate adequate resources to the State Revenue Service to strengthen its power to combat tax fraud in line with the European Parliament's resolution of 19 April 2012 aimed at intensifying the combat against tax fraud and tax evasion.

2. To shift tax audits' focus from examining reported numbers to assessment of their reasonability and identifying understated tax revenues. In FICIL's view, it is a practical and powerful way of reducing the amount of shadow economy in Latvia.
3. To educate tax auditors and judges on practical application of assessment method (aprēķina metode) and 'substance over form' concept to collecting taxes by involving reputable industry experts for transferring knowledge and experience to tax inspectors.
4. To incorporate qualitative key performance indicators in SRS remuneration and motivation system to enhance the quality of tax audits and properly remunerate and retain quality people, e.g. bonuses are paid and tax inspectors are entitled to promotion and pay rise only to the extent that tax audit assessments are not appealed or if not more than a certain percentage (below officially reported 30%) of tax audit assessments are appealed, etc.
5. To ensure that SRS publishes regular, up-to-date, top quality explanatory material (metodiskais materiāls/ skaidrojumi) that addresses current business practices and situations and incorporates ECJ rulings, and knowledge and experience obtained by the SRS Controls department during tax audits as well as rulings and explanations issued by the SRS to taxpayers.
6. To consider employing foreign professionals with knowledge and practical experience in designing and implementing methodology and practices for combating tax fraud in top positions in the SRS (e.g. from developed EU member states with long-term history of successful tax fraud combat, e.g. UK, Germany, Sweden, etc.). It would ensure transfer of relevant experience and accelerate generation of fiscal revenues.
7. To inspect companies employing self-employed persons for compliance with employment criteria set by the Personal Income Tax Act to reduce competition distortions and increase tax revenues.
8. A possibility for a company to apply for advance rulings on behalf of its employees.
9. To educate judges in the tax field to increase the quality of tax appeal process and reduce costs incurred on litigation for the state and private sector.
10. To ensure that the provisions included in the tax legislation are in line with other legislation acts in force in Latvia. For example, the terms included in the Insolvency Law were introduced with Law on Corporate Income Tax with delay while the provisions included in the Law on Value Added Tax are not updated till today.

Other proposals for corporate income tax

1. To allow depreciating for tax purposes the intangible assets acquired in business combinations/ acquisitions and recognised in the balance sheet separately from goodwill as a result of purchase price allocation exercise (e.g. exclusive rights of distributorship, customer contracts, licences to customer databases, etc.) to ensure that business transactions that take place in modern business environment are recognised and addressed in tax law to increase Latvia's attractiveness to foreign investors .
2. To abolish withholding tax on any proceeds from sale of real estate located in Latvia and sale of shares in companies holding real estate in Latvia to remove unequal treatment that currently exists between non-resident tax payers selling assets to other non-residents (not taxable) and to Latvian residents (taxable).

Other proposals for excise tax

1. To review the proposed system for excise tax refund on fuel for farmers.

Other proposal for personal income tax

1. To expand the list of allowable deductions (set at 10% of gross taxable income) by including interest paid on loans for the acquisition/ construction of real estate which is declared by an

individual as his/ her primary residence, subject to limits and with proper anti-avoidance rules. It would facilitate increase in population's disposable income and facilitate consumption and growth of country's economy.

Issues with limited progress

There has been little progress in a number of issues proposed by FICIL and discussed between FICIL Tax Group and the Ministry of Finance in late 2011, namely:

1. Introduction of preferred taxpayer status (“white lists”) concept for companies with long-term record of tax compliance. Namely, the respective provision has been introduced in the Law on Taxes and Fees; however no further guidance is available. Currently, the Cabinet Regulations providing the further clarifications have been discussed in the Meeting of State Secretaries. However, we believe that these regulations should have been already in force in order taxpayers would be entitled to prepare themselves for the proposed requirements. Besides there is no information on whether the group of the companies can obtain the respective status.
2. Implementation of advance pricing agreements to be concluded between taxpayers and tax authorities based on planned structure and pricing mechanism of a transaction, not yet formally agreed and/ or documented between the parties. The benefit of APA availability is increased predictability of business environment for multi-national groups operating in Latvia or considering investing in the country.
3. Development of tax and commercial regulation for employee share option plans.
4. Development of tax law in respect of non-profit organisations - definitions and practical examples and explanations of what activities of non-profit organisations would be viewed as non-taxable social benefit and/ or charitable activities and what activities would be regarded as taxable commercial activities. Also a clear definition and interpretation for distinguishing terms “donation” and “sponsorship” is needed, in particular, in what circumstances displaying of donor company's logo by the donee would be regarded as a mere gratitude and when be viewed as taxable commercial activity.
5. Prevention of duty-unpaid cigarette and alcohol supplies from CIS countries (e.g. by ensuring rotation of customs officials, etc.).

Appendix 1-1

FICIL proposal for CIT incentive for R&D costs

According to progress report on Latvia's national reform programme in the context of "Europe 2020" strategy implementation, R&D activity in Latvia has a number of significant challenges, e.g. low number of people employed in science and research sectors, low potential for commercialization of research results, poor cooperation between research and manufacturing sectors, large number of small and medium businesses that lack capacity to invest in R&D etc.

We propose to introduce tax incentive for CIT purposes with respect to R&D costs incurred by a company. Currently, according to the Latvian Corporate Income Tax Act, R&D costs related to the business activities of a company are deducted from income in the year when incurred or, if patent is registered as a result, then R&D costs are multiplied by 1.5 before writing them off for CIT purposes over 5-year period. In contrast, respective law in Lithuania provides more beneficial provisions for deduction of R&D costs incurred by a company for the purposes of CIT. Namely, according to Lithuanian CIT law, accelerated depreciation may be used for assets used in R&D activities on more favourable conditions:

- a) The plant and machinery (2 to 15 years, in comparison to ordinary depreciation 5 to 15),
- b) Computers and software (2 years, in comparison to ordinary depreciation 3 years),
- c) Other assets (2 years, in comparison to other depreciation 4 years).

Additionally, Lithuanian Corporate Income Tax Act allows deducting 300% of R&D costs (except for depreciation and amortisation costs) from the income in the corresponding tax year, if certain conditions are met. Qualifying R&D costs exclude the amount of financial support received from EU funds, the national budget and other state, municipal or financial aid funds, i.e. tax relief is applied only on R&D costs financed from own or borrowed resources.

That is, Lithuania offers more beneficial tax regime for companies performing R&D activities and is more attractive for foreign investors.

However, Lithuanian model is not the only possible option. Many countries in the world have implemented different tax incentives for R&D expenditure to encourage additional research investments by businesses (e.g. tax credits, "super" deductions or cash grants). Recently (in 2001-2008), the so called „patent box" regime has been implemented in a number of EU countries (Belgium, France, Hungary, Luxembourg, Netherlands, Spain, UK – from 2013) that provides a reduced CIT rate for certain income arising from the exploitation of intellectual property through tax deduction (generally, 50% and more) or exemption of qualified intellectual property income.

Different options for encouraging R&D activity in Latvia are possible and, if implemented, could make Latvia more attractive for foreign investment.

Appendix 1-2

Maximum amount of the social security contributions

Before 01.01.2009 the maximum amount of the social security contributions to be paid to the Latvian State budget was revised every year, passing on the Regulation issued by the Cabinet on minimum and maximum amount of the object of the social security contributions.

The maximum amount of the social security contributions to be paid was pegged to the average monthly earnings of the year in the country. The maximum amount of the social security contributions was calculated by multiplying average earnings of the year, ratio 9 and the amount of the month (12).

The formula is following:

$I_{max}(t+1) = V(t-1) \times 9,0 \times 12$, where

$I_{max}(t+1)$ stands for maximum object of the social security contributions for the next year,

$V(t-1)$ stands for average monthly earnings of the last year.

Appendix 1-3

FICIL proposal for roll-over relief for business owners-individuals

- Qualifying shares – shares in a company that carries on business that involves significant capital investments, e.g. real estate used for letting, real estate and machinery used for manufacturing of goods or provision of services, and that have been in the individual's direct ownership for at least 24 months;
- Qualifying business assets – buildings and machinery (equipment) used for production of goods or provision of services that were in business use for at least 24 months;
- Unincorporated private business: private proprietor – individuālais uzņēmums, sole trader – individuālais komersants, registered businessperson – VID reģistrēts saimnieciskās darbības veicējs.
- Examples of non-qualifying assets: loans granted to the private company or unincorporated private business, light passenger vehicles (unless the nature of business involves use of such cars, e.g. taxis).