



31 May 2013

Position Paper on Tax and Macroeconomic Policy

1. Executive Summary

In 2012 Latvia was successful in keeping up a high rate of growth, reducing unemployment and maintaining low inflation. The austerity measures undertaken showed their effect. FICIL acknowledges that the main challenge for the future is to work to make such growth sustainable in the longer perspective.

Latvia has been successful in meeting the Euro convergence (Maastricht) criteria, even to the extent that it is likely to be compared to itself, when it comes to inflationary development. This has made the planned introduction of the euro on 1 January 2014 a likely reality. Being a member of the Eurozone puts additional stress on fiscal discipline. This can be safeguarded by the newly adopted Law on Fiscal Discipline.

Close monitoring of Latvia's external competitiveness needs to continue. Like the Latvia Competitiveness Report for 2011, which was published in 2012, we think that policy should concentrate on three priority areas: (1) The size of the informal economy; (2) The quality of the education system; and (3) Improvement of transport infrastructure and in addition to that (4) Efficiency of the healthcare and welfare systems; (5) Governance of publicly owned enterprises.

Successfully addressing these issues should, in the medium term perspective, have considerable spill-over effects on other key areas such as income inequality (intrapersonal as well as regional), innovation, productivity in manufacturing, manufacturing's share of GDP and capital market development. Strong efforts should be made to improve efficiency of the Latvian healthcare system – a strong tenet of quality of life in the Latvian labour force and for the general public.

Stressing the need for quality economic analysis and monitoring of national competitiveness, FICIL continues to encourage establishment of an independent Competitiveness Institution.

2. Recommendations

In order for Latvia to keep on track for continued rapid and sustainable growth, we see it necessary to address the following issues:

- (i) *The size of the informal economy.* It would seem that the informal economy in Latvia is substantially larger in relative terms than in comparable countries. The informal economy not only badly affects tax collection and Latvia's budget situation but also and more importantly in some ways has a distorting effect on competition, through affecting resource allocation as well as discouraging direct foreign investment. It is therefore of the utmost importance that strong measures are taken to reduce its influence on the economy. Neither is it acceptable for legislative provisions to be advanced that discriminate against any group of companies and are to the detriment of companies operating legally in the sector.
- (ii) *The quality of the educational system.* As outlined by FICIL in its position papers of 2009 and 2010, it is of great importance for a sustainable economic growth that strong efforts are made to improve the quality of higher education as well as introducing a dual vocational training system.
- (iii) *Improvement of the transport infrastructure.* With Latvia's geographical location, efforts to improve the transport infrastructure would quickly have positive effects on Latvia's economy.
- (iv) *Efficiency of the healthcare and welfare systems:* those areas should gain a lot from stronger co-ordination and putting the emphasis on motivating the seeking of employment. Strong efforts should be made to improve efficiency of the Latvian healthcare system – a strong tenet of quality of life in the Latvian labour force and for the general public.
- (v) *Reform of corporate governance of publicly owned enterprises* is essential for the development of capital markets in Latvia (position paper of 2011) and competitiveness (Position paper of 2012). Decisive action is required to conclude the reform.

More detailed tax considerations developed by FICIL's Tax Group have been set out in the appendix to this paper.

3. Rationale for recommendations

Latvia can take pride in having the highest growth rate 5.6 % during 2012, of all EU members. This has been achieved not only by a continued positive development of the export sector but also by domestic demand. Through the austerity measures and certain structural reforms performed during the recent crisis, public finances have been put in order, with debt to gross domestic product forecast to be 45 % this year and a budget deficit of just 1.4 %.

However, Latvia is the poorest member state in EU after Romania and Bulgaria with GDP still below potential. Unemployment has fallen but remains high at 12.8%, a large share of which is cyclical. A high number of people, mainly of working age have left the country, which, *inter alia*, raises risks of a future lack of a skilled work force.

This position paper puts forward five areas, where decisive and urgent action is deemed necessary:

3.1. The size of the informal economy

We believe that only a truly radical approach will shift the Latvian economy from its current unsustainable equilibrium. A key agency in this is the State Revenue Service (VID) and a reform of the tax administration in Latvia is unlikely to succeed from within. Accordingly, our proposal here would be to look for best practices and seek major technical assistance reaching out to other EU countries. The task would be to reshape and simplify the tax administration and tax system and to introduce a credible system of incentives and sanctions that would result in a shift of behaviour by both firms and individuals. These measures should be combined with a review of Latvian tax legislation aiming at simplification.

Smuggling of excise goods is one of the biggest problems in the informal economy. It significantly reduces tax revenue and damages sectors of manufacturing and legal trade of excise goods. The resolution of these problems requires radical solutions to stop the flow of excise goods of illegal origin. Any policy that creates barriers to the legitimate trade of excise goods, thereby contributing to an increase in smuggling, is not permissible.

Underlining public health as an important variable of the sustainability of the Latvian economy (see below 3.4), we nevertheless believe that goals of reducing smoking and the use of alcohol are best carried out by targeted and proportionate steps aimed at educating the public rather than discriminatory bans on particular groups of traders. Where legislative change is considered to create certain incentives to society, intended and unintended consequence alike must be considered.

A large informal sector results in substantial misallocations of the economy's scarce resources – directing them to labour intensive, low productivity businesses in particular in the service sector, and in addition to that, potentially increases income inequality as employees are less protected socially and in terms of welfare support of those in most need. A policy that successfully reduces the share of the informal economy will accordingly reallocate resources to activities with higher productivity and/or higher capital intensity and which are more likely to be innovative and active in the manufacturing sector. Successful action on reducing the informal economy will directly increase Latvian prosperity and thereby contribute to reducing inequalities and will very likely also improve manufacturing performance by removing or at least reducing distortions to investment in capital intensive sectors.

3.2. Quality of the educational sector

Many of the internationally accepted standard measures of the quality of education denote to a weak performance of the higher education system in Latvia. These include the low number of scientific citations, the low level of innovation and the low level of innovation-based entrepreneurship. Furthermore, as Latvia moves up the economic development ladder, the shortcomings of the higher education system may constitute increasing bottlenecks thereby slowing down Latvia's development towards an innovation driven economy. Since educational reform affects the economy with considerable time lags, it is important that these issues be addressed urgently.

In higher education the key to improving quality is to open the Latvian higher education system to competition at all levels. And here, competition means international competition.

Latvian universities are currently protected from international competition by language restrictions. Thus we believe that discriminating rules on the appointment of foreign professors should be removed. This would open the way for Latvian institutions to compete in the world market in order to attract the best professors and researchers. Needless to say salaries would have to be commensurate. This would also open the way for teaching in EU languages and thus enable Latvian institutions to compete more effectively for overseas students. Programmes in English could become an export article not the least towards the East and also Central Asia. In the longer perspective this could lead to future business relations.

The core element of vocational educational reform should be development of a genuine apprenticeship system. FICIL has suggested following the German/Austrian model. Direct involvement of employers in training is the most effective way of ensuring that training matches their needs, the lack of which is frequently regarded as a key labour market bottleneck in Latvia. There appears to be reluctance on the part of Latvian employers to pay for education and training on the grounds that they believe they would lose trained workers to competing firms. Thus there is a prisoner's dilemma problem – an industry or sector may collectively benefit from a better-trained and better-matched workforce but individual employers have insufficient incentive to provide such training. A possible solution that is used in some EU countries is a training levy of a specific percentage of the wage bill, which could be used to subsidise training activities. Here too we propose that international expertise is sought to design and implement a modern apprenticeship system for Latvia.

3.3. Improvement of the transport infrastructure

Latvia has managed to take advantage of its geographical location. At the same time Latvia lags in the quality of its roads which has implications for international links but more importantly for mobility of both goods and people within Latvia.

Both inter-urban and intra-urban transport provision in Latvia leaves much to be desired. Overall transport infrastructure affects the productivity of all sectors of the economy and hence infrastructure investment is seen to have a high return in terms of increased competitiveness. According to the Competitiveness Report, in a Latvian context research suggests that in the 2007-2013 programming period investment in the transport priority has the biggest impact on GDP. Transport infrastructure also has a long implementation lag and so on both impact and time lag grounds qualifies as a priority. Moreover, the availability of Cohesion Policy funding means that prioritised infrastructure investments can actually be implemented.

3.4. Efficiency of the healthcare system

Key priorities for the Latvian health care system are to improve timely access to quality health services along with initiatives to improve health system performance and ensure its long-term sustainability.

This can be achieved through further efforts to increase efficiency inside the system combined with purposeful and targeted public and private investments in the system.

Several pre-requisites have been identified:

- Long-term transparent strategy and investment plan should clarify services actually covered (and not covered) by public funding (actual basket), clearly define further public investment areas as well as reveal opportunities for private investment, e.g. insurance;
- Efficacy indicators for health system performance should be elaborated and introduced;
- Medium and long-term human resource strategy should be introduced *as soon as possible*, to rationalize the use of current resources and secure sustainability of the system;
- Structural reforms for investment in primary care and prevention, in order to reduce short and long term sick leaves and primary disability cases should be continued.

Strengthen cooperation and co-ordination of efforts between Ministry of Health and Ministry of Welfare to address the challenges related to the increasing proportion of an ageing population and to ensure better planning of investments in social sector. The health of an ageing population (workforce) is a prerequisite for the success of the reforms (e.g. rise in retirement age) aimed to ensure sustainability of the social security system.

3.5. Governance of publicly owned enterprises

In 2012 Government adopted policies outlining the intended development in the realm of commercial activities undertaken by public institutions and standards of governance thereof. An inter-sectoral Working Group was established by the Prime minister to assess the present situation *vis-à-vis* the standards proposed and suggest change where appropriate (e.g. in legal status of an institution).

FICIL urges the Government to continue along the path already embarked on. Consider conclusions made by the Working Group and where conceptual differences in opinion persist, such as those about the need of reform or ways to implement it, take a decision as the final expression of the political will.

Annex 1: Detailed Tax Policy Considerations

FICIL would like to thank the Ministry of Finance for the constructive dialogue held at the beginning of 2013 on tax considerations developed by the FICIL Tax Group and for implementing a number of significant amendments in Latvian tax law that have been discussed previously (amending new VAT law, introducing the legislative background for stock option plans) as well as for continuing work on a number of other significant developments (new VAT law, etc.).

Year 2012 was very successful for the economy of Latvia and economic growth was substantially better than it was forecasted at the beginning of last year. Thus at the moment Latvia's economic performance outperforms other EU countries which are still experiencing economic downturn or comparatively slower growth. Using the achievement can further enhance Latvia's attractiveness to potential investors. However, in order to support investors to choose Latvia for their investments, one of the questions of major importance is a stable

and attractive tax system as well as good cooperation between government and companies working in Latvia.

Going forward, the government should:

- (1) Focus its efforts on efficient communication and cooperation with taxpayers, combating the informal economy and tax smuggling as well as maintaining an 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.
- (2) Set out more concrete plans for the tax changes over a longer time perspective, i.e. not just over one year which as determined by the current budget. Since as of 2013 Latvia has a medium term budget planning perspective (ie 3 year perspective), it would also be necessary that tax changes are highlighted at least over the same time perspective. Something similar was done for the personal income tax, the decrease of which was clearly put in law covering a 3 year perspective.
- (3) Firm commitment to reduce the tax burden on labour and shift it towards residential real estate.

FICIL would like to emphasise the areas where we see that further development is needed in order to achieve a good environment for foreign investors.

1. Transparency and predictability in cooperation with the tax administration

Although during past years significant improvements have been made in the work of the tax administration, it is still more focusing on penalizing rather than cooperating with tax payers in Latvia. Recent developments with respect to the introduction of an in-depth cooperation program with large taxpayers has shown good examples of ways for cooperation between the tax administration and taxpayers. However, further work has to be done in order to ensure that cooperation between taxpayers and the tax administration is transparent and predictable. According to FICIL's view, the following areas should be addressed:

- to ensure consequent and preventive work with taxpayers – participation by the VID in an in-depth cooperation programme, introducing tax risk management systems in companies and ensuring correct and straightforward provision of opinions on questions raised by the taxpayers in non-standard situations;
- to shift the resources of the VID 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, rather than performing regular tax audits of the largest and faithful taxpayers, including the revision of risk analyses principles that are used to determine companies subject for tax audits;
- to incorporate qualitative key performance indicators in the VID 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;
- to consider employing in top positions in the VID foreign professionals (e.g. from developed EU member states with long-term history of successful tax fraud combat,

such as UK, Germany, Sweden, etc.) who have knowledge and practical experience in designing and implementing methodology and practices for combating tax fraud. It would facilitate the transfer of relevant experience and accelerate generation of fiscal revenues;

- to ensure that the VID 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 State Revenue Service Controls Department during tax audits.
- any attempts and administrative efforts to address "the informal economy", need to be done on the basis of a whole identified industry. For example, taking certain subsectors within manufacturing and then working through all of its companies. When audits are performed on only a selection of companies within a sector, this is likely to result in reducing competition for those others in the same sector which are still evading taxes.

2. Personal income tax system abuse – fair competition principle

According to the current experience of FICIL members, especially in the insurance sector, there are several companies that abuse the principles introduced in Law on Personal Income Tax with respect to the taxation of private individuals that are self-employed. Thus, in order to achieve fair competition between market participants, the VID should perform reviews of companies that engage self-employed people.

The tax burden on wage income should not be higher than that in our major competitor countries. The overall trend of reducing the tax burden on wage income should be continued and should also include reasonable and significant increase in tax free allowances to near the levels in the other two Baltic countries, which are our closest competitors.

3. New VAT Law amendments – observing principles of transparency, continuity and predictability

A new VAT Law was introduced in Latvia as of 1 January 2013. Currently, there are several issues in the VAT Law that have violated the principles of transparency, continuity and predictability, such as the period when input VAT deduction rights may be exercised. FICIL is following and supporting the current work of Ministry of Finance in the field of amending the new VAT law and supporting the proposals provided by the Latvian Tax Consultants Association.

4. CIT reliefs on R&D and large investment projects – ensuring continuity

The Law on Corporate Income Tax currently contains several CIT reliefs, including relief on large investment projects. In addition a relief on research and development costs is being considered. FICIL believes that the system of CIT reliefs should be stable and predictable in order that companies working in Latvia are able to develop by planning further large investment or research and development projects that are supported by the Government as one of the key aspects for further economic growth. This would ensure the continuity of business work in Latvia and long term planning possibilities.

Thus, FICIL supports and encourages the Ministry of Finance to come up with the suggestions for more predictable and stable CIT relief incentives in the field of R&D and large investment projects, in order that companies are able to prepare themselves and to ensure that the relief is used by more taxpayers in Latvia in the most effective way.

