LATVIJAS NODOKĻU SISTĒMAS IZVĒRTĒJUMS

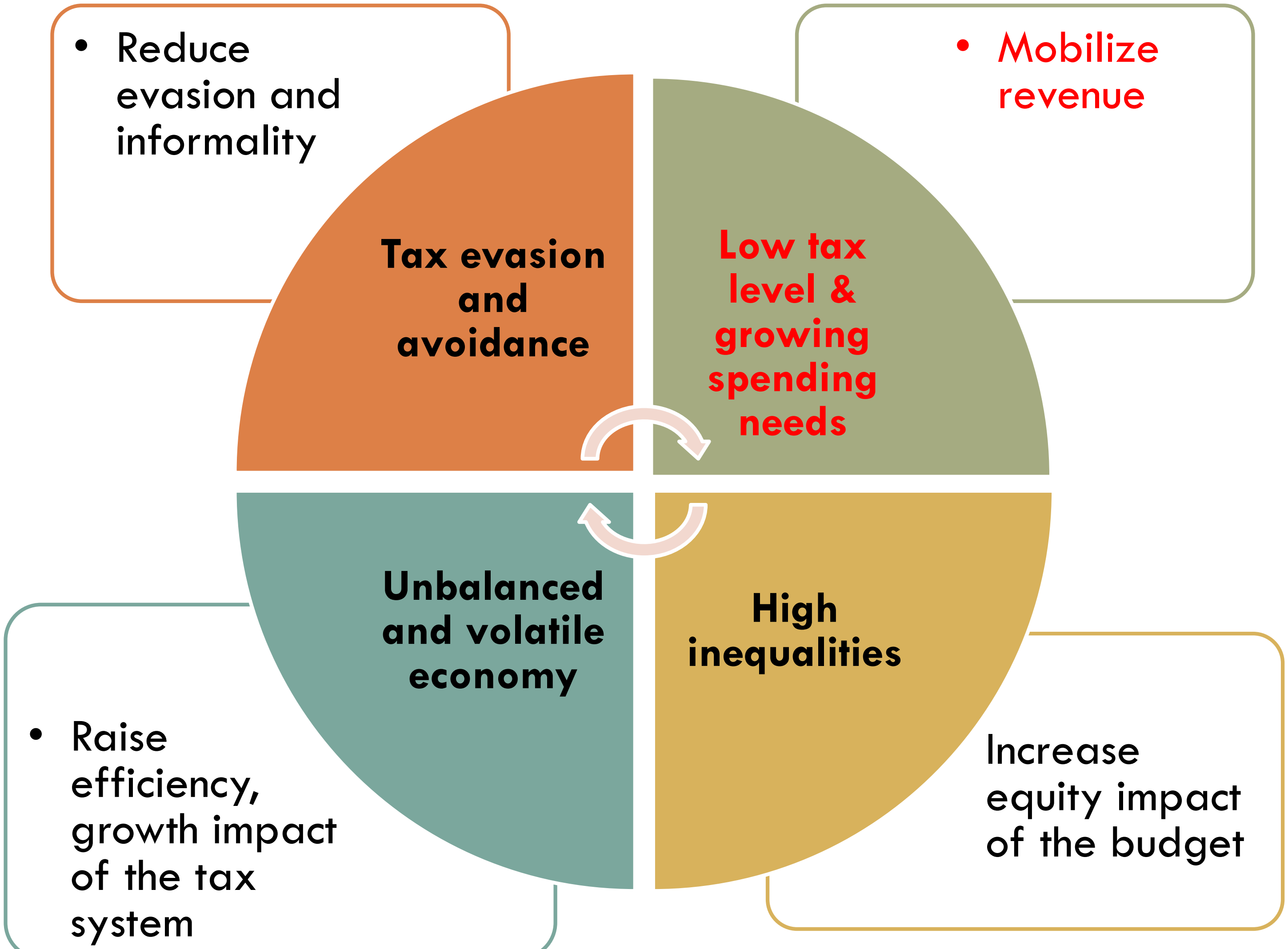
PASAULES BANKAS NOSLĒGUMA PREZENTĀCIJA UN DISKUSIJA

WORLD BANK GROUP

Latvia: Tax Policy Review

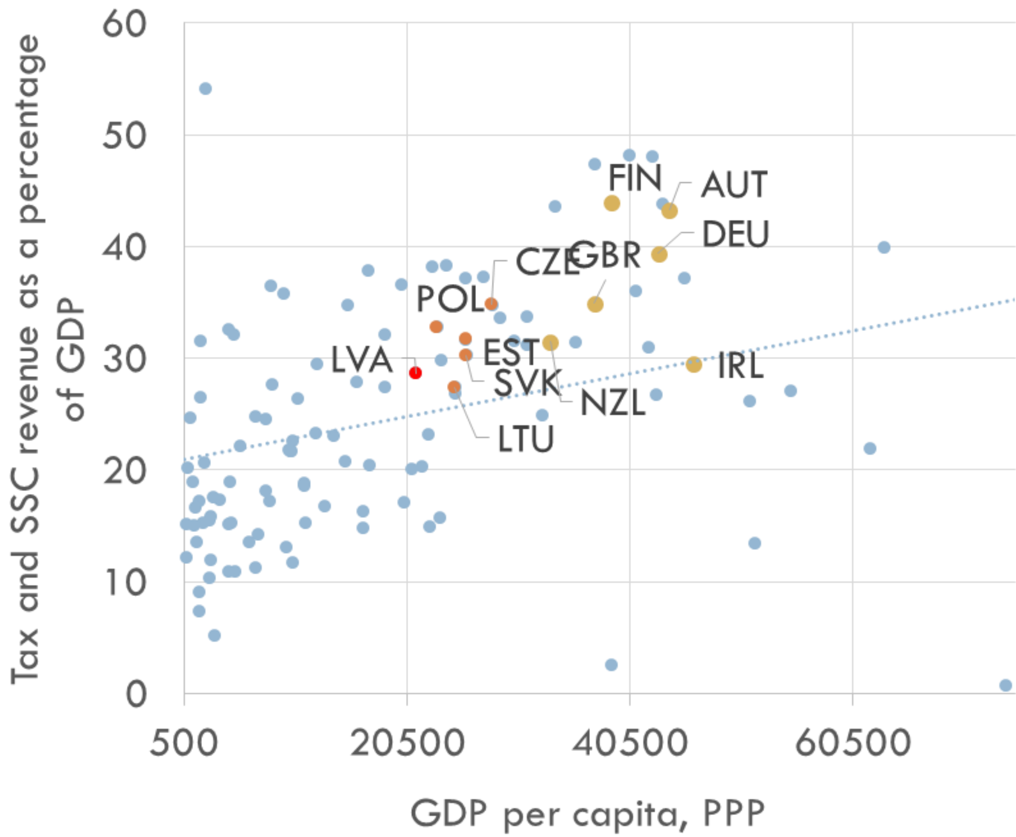
Riga, April 13, 2017

Tax strategy to address existing vulnerabilities



Tax revenue as a share of output in Latvia is low compared to developed countries

Level of taxation vs. GDP per capita (PPP), 2014



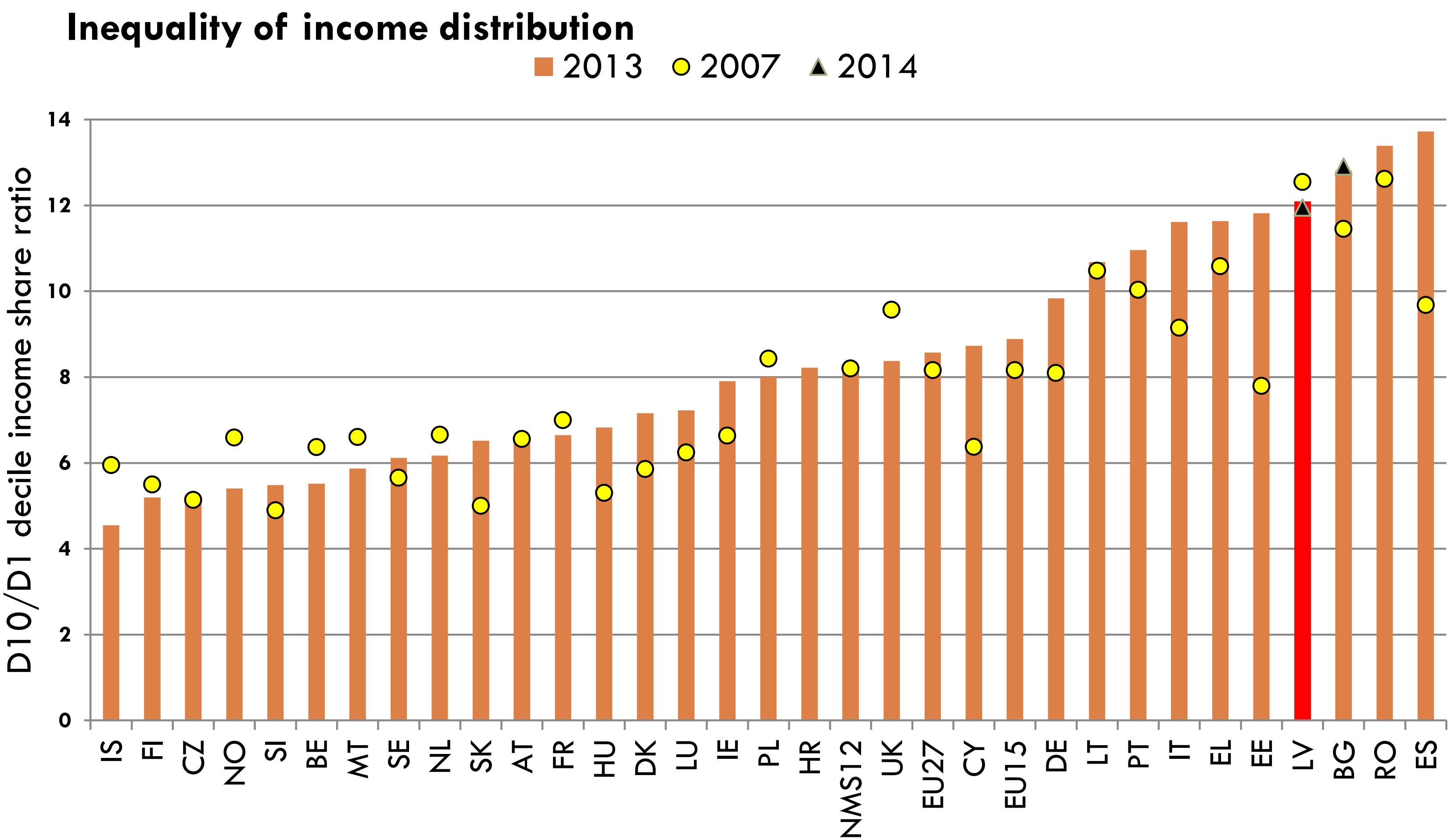
Toward EU or beyond

Latvia has low tax and social security contribution revenue as a % of GDP compared to OECD

But, share is above global average, given level of development

Source: World Bank staff calculations based on OECD data.

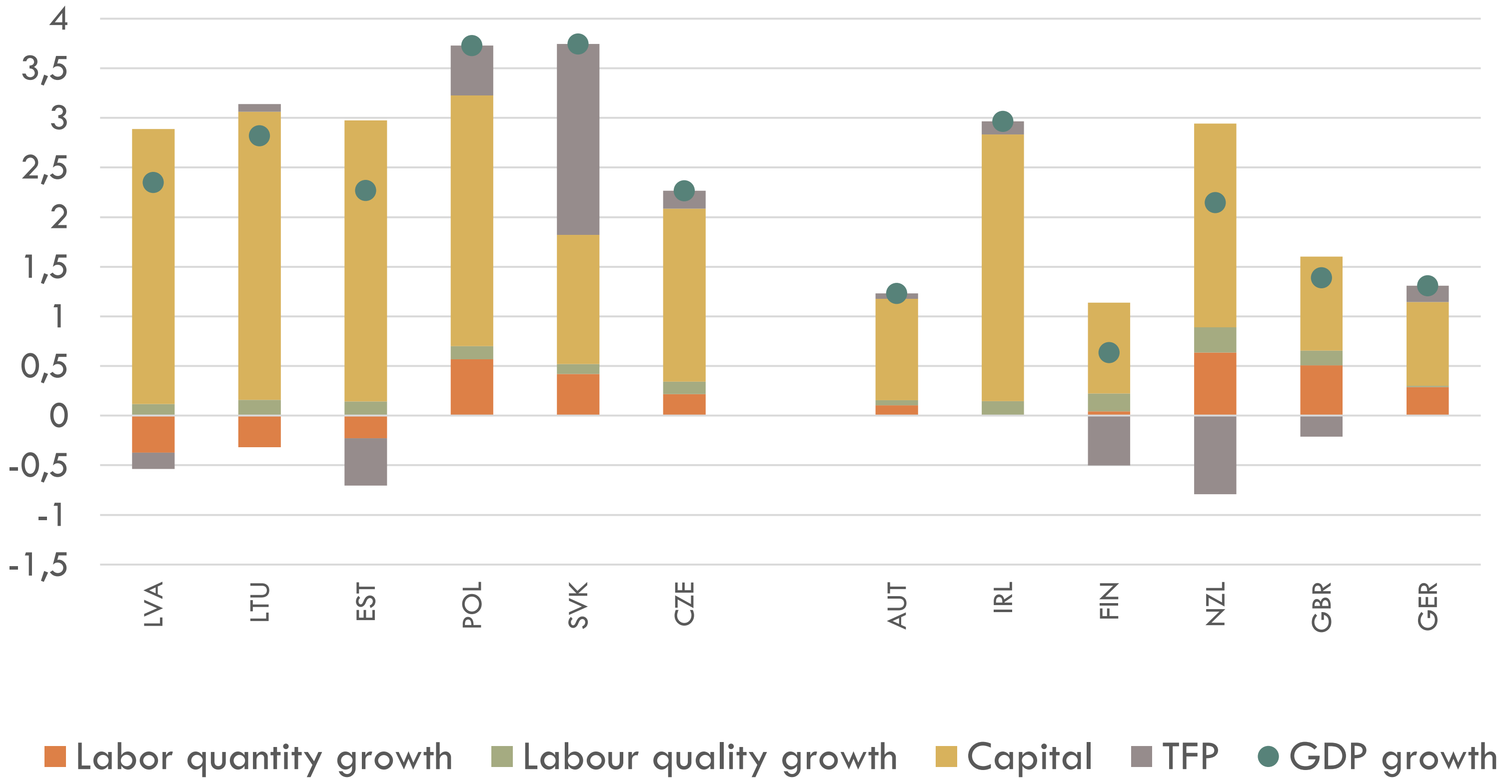
Gap between rich and poor is wider than in most EU countries, including popular destinations of Latvian emigrants



Source: Eurostat, based on EU-SILC 2008, 2014 and 2015.

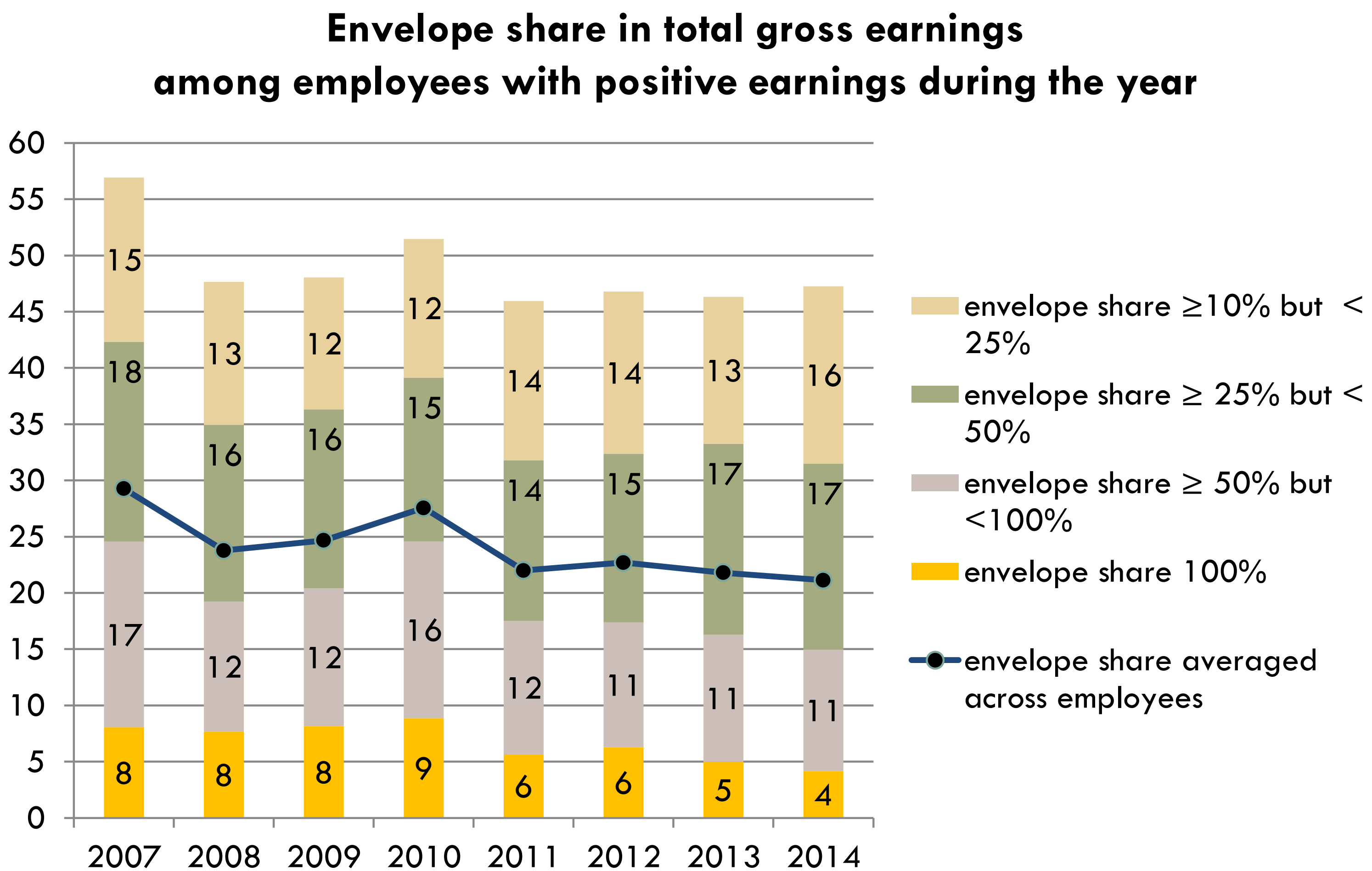
Capital accumulation drove GDP growth in recent years while total factor productivity withered

Contribution to GDP growth, percentage points, average over 2005-2015



Source: Groningen Growth and Development Centre, Total Economy Database.

The incidence of partial informality (envelope wages) is high and stable



Note: Estimates are conservative and should be seen as lower bounds. Self-employed are not included.

Source: Calculations based on EU-SILC 2008-2015 and Latvia's State Revenue Service data.

Latvia has scope to mobilize more tax revenues and improve fairness of the tax system without imposing unnecessary costs on the economy

- Holistic view of system, not tax by tax
  - Changes to taxation involves equity and growth trade offs
  - Changes to taxation trigger behavioral responses

- Priorities for tax reform
  1. **Phasing out micro-enterprise regime.** MET raises concerns of misuse for tax avoidance, inadequate social protection for employees and creates unfair tax competition
  2. **Reduction in the high participation tax for low-income workers** through more progressive taxation of labor
  3. **Tax administration reform** oriented on increased compliance
  4. Broadening tax base via **limitation of tax expenditures** that can bring more revenues from CIT and VAT
  5. **Redesigning tax rates** to target more effectively externalities or internalities associated with consumption (excise)

Increasing revenues by three percentage points of GDP involves substantial changes to the tax system

Measures	Revenue impact (% GDP)
1. **Personal income tax (wages)**	**0.09-0.3**
1.1. Non-linear tax schedule, lower tax for low-income workers	
3-rates PIT (19%/23%/33%)	0.31
3-rates PIT (19%/23%/29%)	0.1
3-rates PIT (19%/23%/29%) + EITC	0
1.2. 19% PIT rate for self-employed	-0.01
2. Uniform tax rate (15%) on capital income	0.11
3. Corporate income tax	**0.06-0.68**
3.1. Changes to tax depreciation	
Remove accelerated depreciation of fixed assets	0.22
Remove enhanced depreciation for new tech. equipment	0.29
3.2. Limit on the offset of losses carried forward	
Limit loss relies to 80 percent of profit before taxation	0.06
Limit loss relies up to 5 years	0.17
4. Microenterprise tax regime	**0.21**
5. VAT	**0.13**
5.1 Eliminating reduced VAT rates	
Standard rate for accommodation services in tourism	0.04
Standard rate for district heat supply and firewood	0.08
5.2 Reduce VAT threshold	0.01
6. Excise tax	**0.37-1.0**
Alcoholic beverages	0.3
Cigarettes	0.2
Fuel	0.5
7. Property tax	**0.1**
8. Tax compliance	**0.56**
reduction of VAT gap (by 20%)	0.24
reduction of underreporting of wages (by 20%)	0.32
TOTAL(MIN-MAX)	**1.4-3.1**

Revenue target: 32% for tax to GDP

How to find 3% additional revenues over the medium-term?

Betting on compliance alone is unlikely to yield all the needed revenues in the medium term

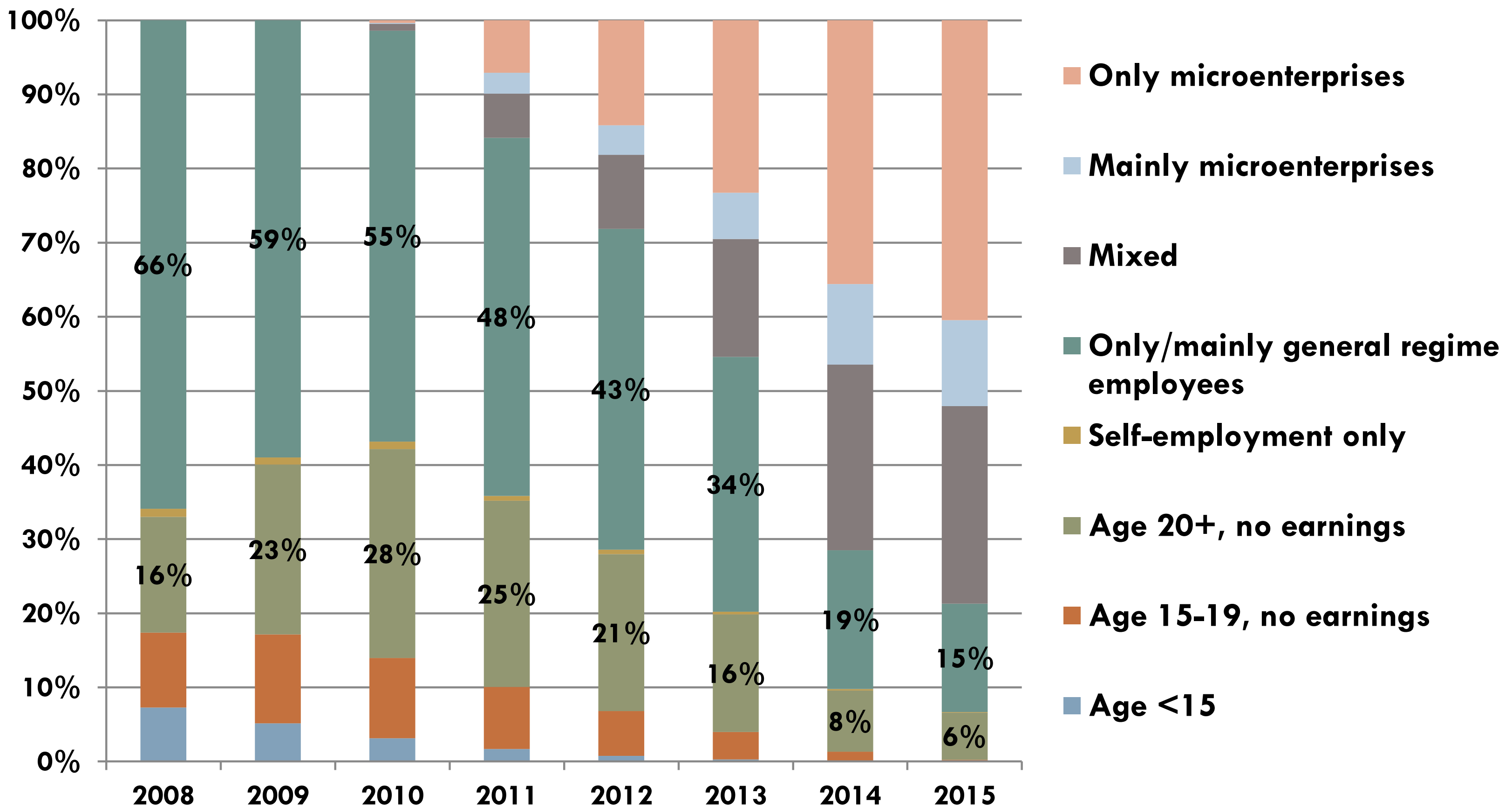
Estimates of the impact of different tax measures…

Microenterprise tax: Main issues

- Provides opportunity for tax avoidance/tax arbitrage and violates the principle of neutrality whereby individual/firms earning similar wages/profits treated equally by the tax system
- Concern on neutrality in tax treatment by size (and organizational form) creating unfair tax competition
- Shift economic activity away from larger companies to smaller businesses, may inhibit innovation/expansion
- Negative impact on social security system due to inadequate social protection for employees (reduction in contributions)
- Labor productivity is lower for MET regime
- Does not provide targeted support to Latvia-based start-ups
- Costly regime with unclear objectives (estimated tax revenue foregone - 60 million EUR annually in 2014-2015)

Much of the inflow into the microenterprise regime came from the general regime, but also from non-employment

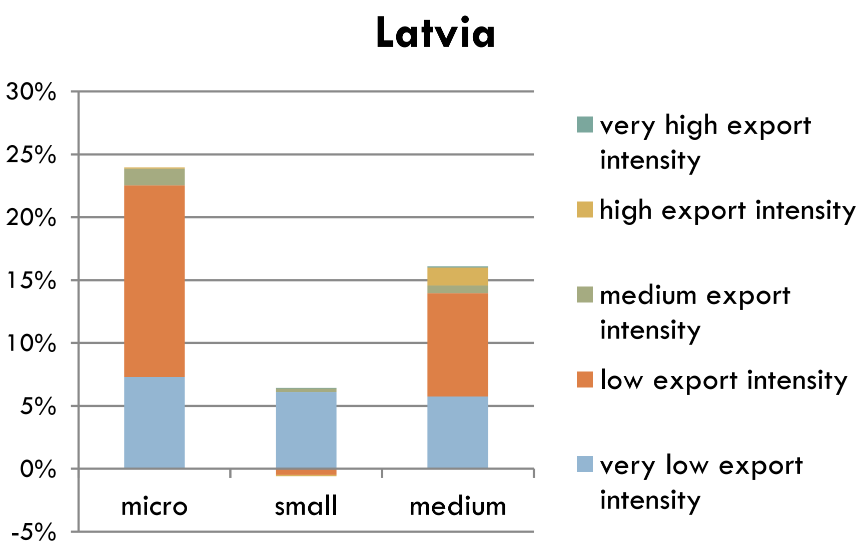
Individuals who worked in microenterprises in 2014-2015, by work history over 2008-2015

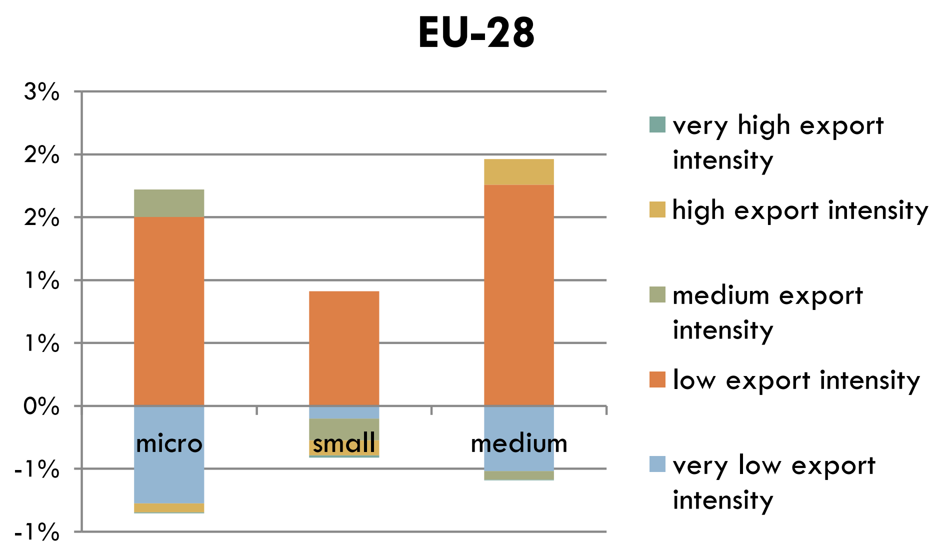


Source: Calculations based on State Revenue Service data.

Employment growth of micro firms in Latvia is driven by low and very low export-oriented industries

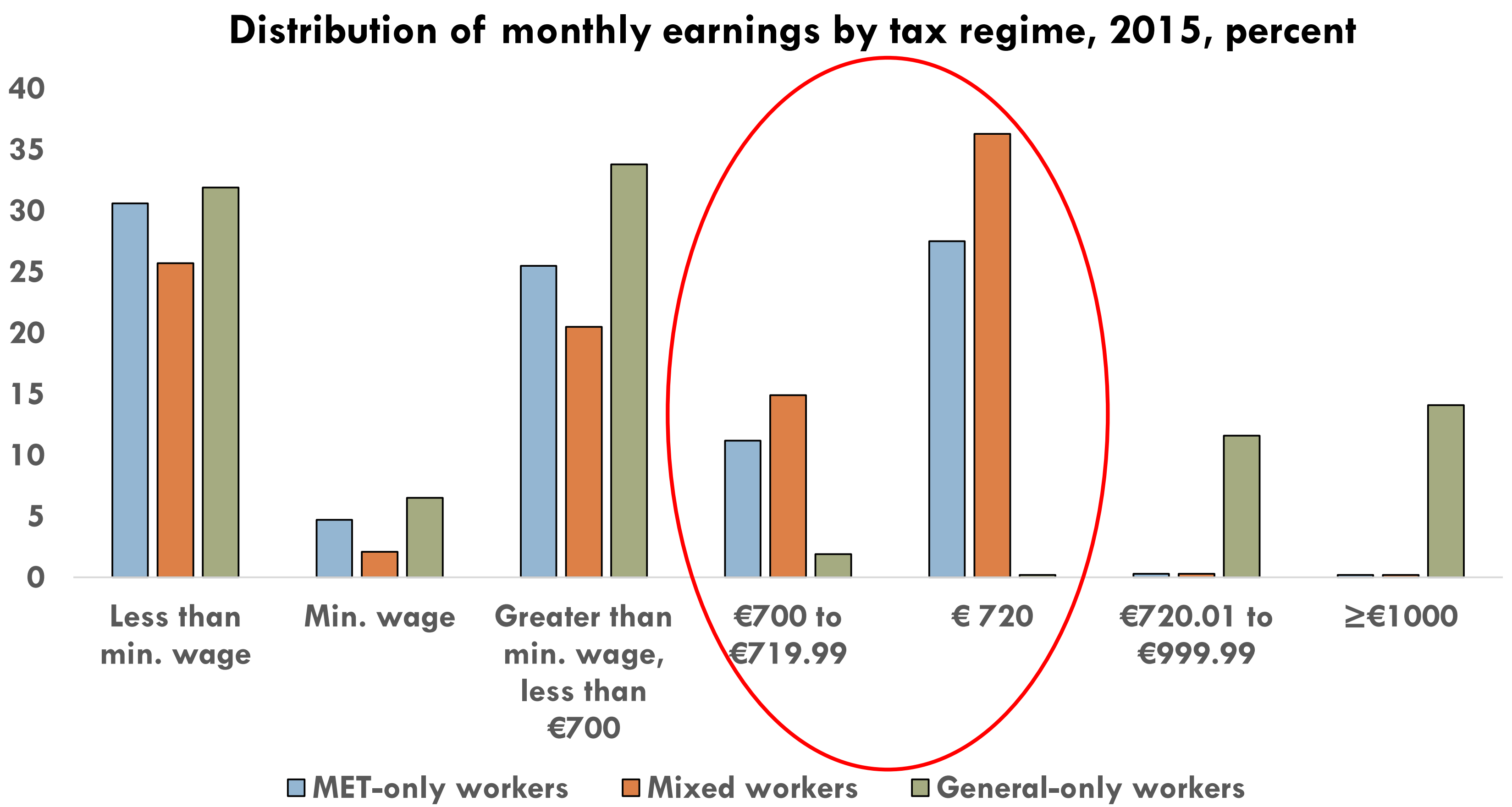
Employment change and contribution of sectors with different export intensity by SMEs size classes, 2010/2015





Source: SME performance review 2016.
Note: micro: 0-9 employees, small: 10-49 emp., medium: 50-249 emp.; a sector's export intensity is assessed on the basis of the ratio of sector exports to total final demand sales

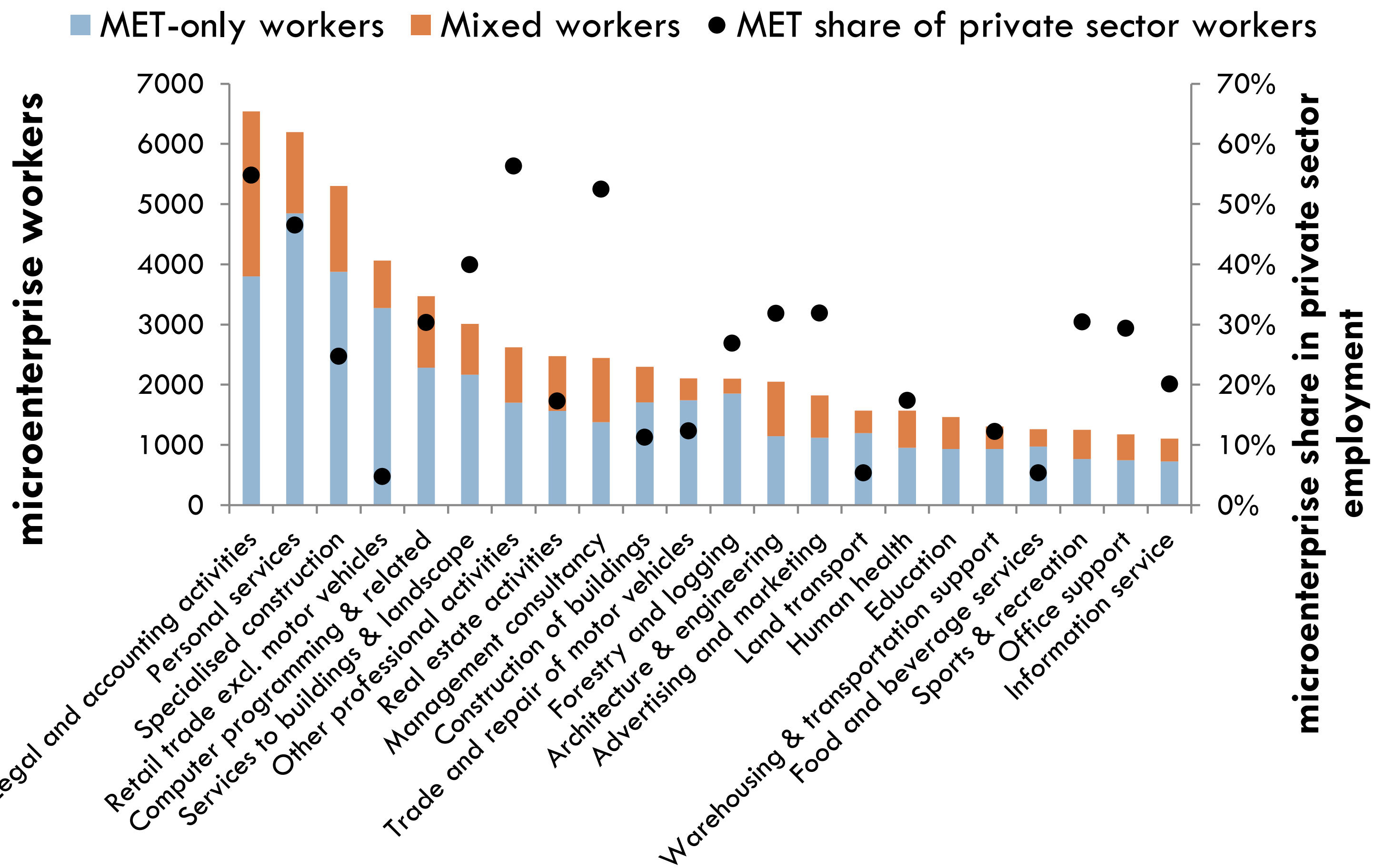
Evidence for wage bunching around MET maximum (suggesting some wage manipulation in MET, given that high share of MET workers are highly qualified)



Notes: Minimum wage refers to minimum monthly wage (€320 in 2014 and €360 in 2015).
Source: Calculations based on State Revenue Service data (monthly records).

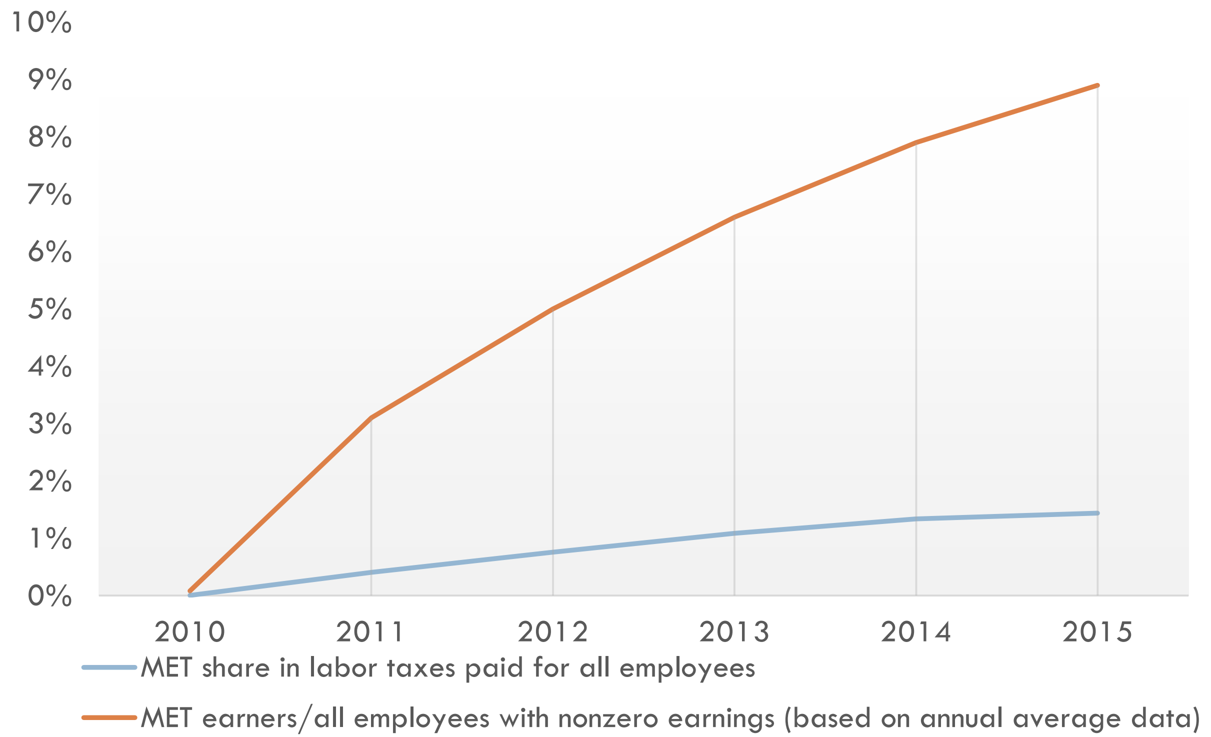
Sectoral variation of the MET share in employment suggests that firms use MET to reduce the tax burden

MET workers and MET share in private sector employment, 2015



Increase in share of tax revenue from MET is well below increase in the share of MET taxpayers

Changes in the share of MET tax revenue/earners in labor taxes/taxpayers in Latvia, 2010-15



Source: WB's calculations based on the SRS of the Republic of Latvia

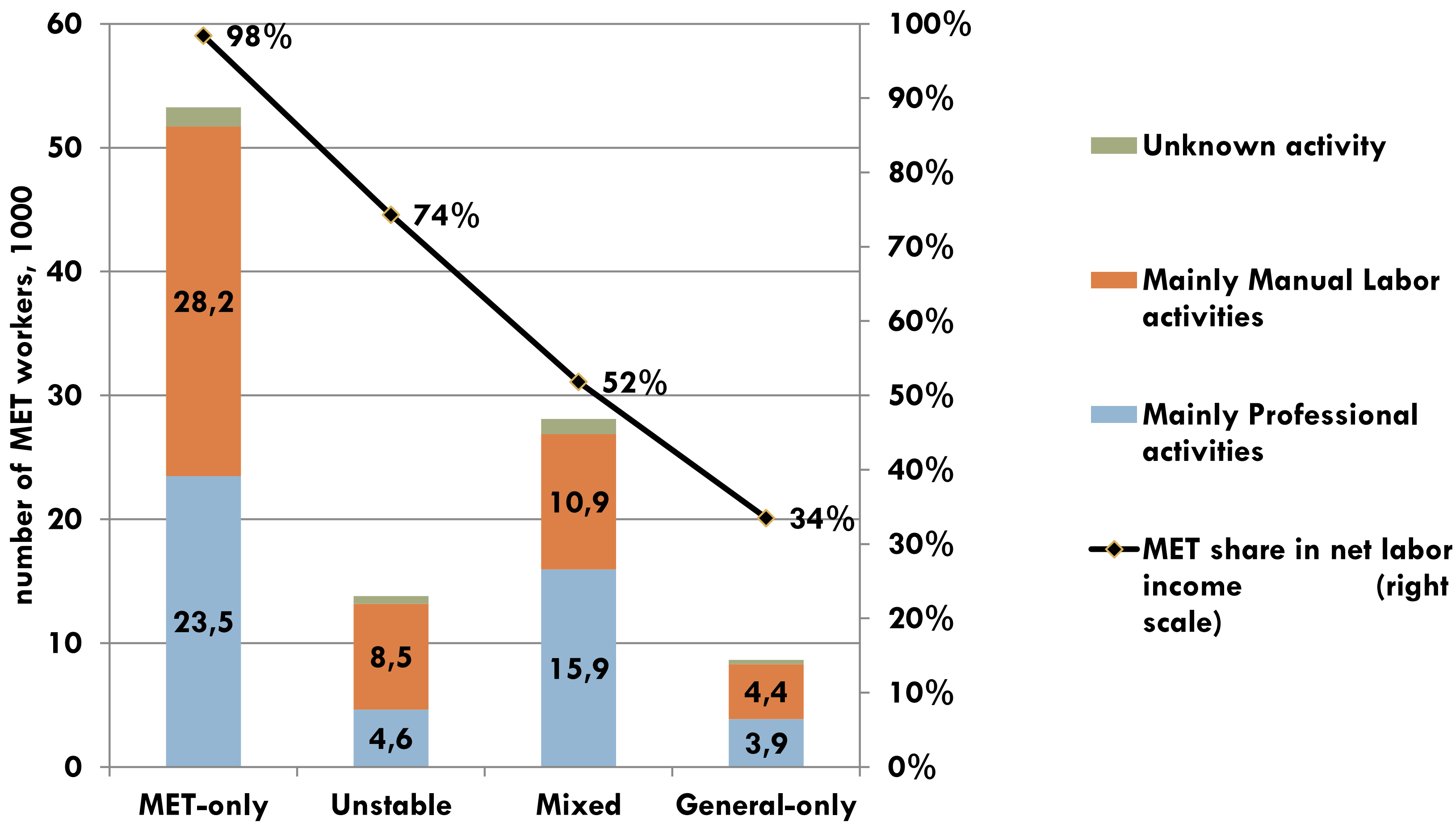
Workers highly vulnerable to MET phase out (MET-only and Unstable) do low-paid manual work

Profiling of individuals with positive microenterprise earnings in 2014 or 2015 by tax regime over 2014-2015

Tax regime	Description	MET share in net labor income, 2015	Number of MET workers, 2015	Number of months worked in 2015
MET-only	Below average wages and productivity, gained pay under MET regime	98.4	53247	9.1
Unstable (switching btwn regimes)	Low productivity and remain low paid/vulnerable under MET regime	74.3	13799	6.8
Mixed	Works more than average worker, main winner of the regime in terms of earnings	51.8	28107	11.3
Mainly general tax regime	Above average workload and earnings.	33.5	8634	11.1

Source: Calculated based on Latvia's State Revenue Service data.

Majority of workers in two high-risk groups (MET-only and Unstable) are concentrated in low-paid, manual jobs



Microenterprise tax: Moving Forward

- Gradual phase out of the MET regime
  - Limit time period of the relief (e.g. 2-3 year period) after which microenterprises would migrate to general tax regime
  - Gradual phase in of PIT/CIT for microenterprises (e.g. 25% income tax in year 1, 50% in year 2, 75% in year 3 and 100% in year 4)
  - Increase rate (e.g. EVA regime in Hungary from 15% of annual sales in 2003 to 37% in 2013)
  - Restricted MET scheme for lifestyle business – e.g. sole traders/ proprietors with low turnover, e.g. up to €20,000 (Tax Card regime in Poland)

combined with:

- Introduction of a targeted tax relief for „innovative"/start-up businesses
  - tax credit for employment and/or investment costs in the first few years of trading, with provision for carry forward of unused relief;
  - reduced PIT for skilled employees engaged in R&D
  - Australia: 'innovation company' with use of a principles-based test

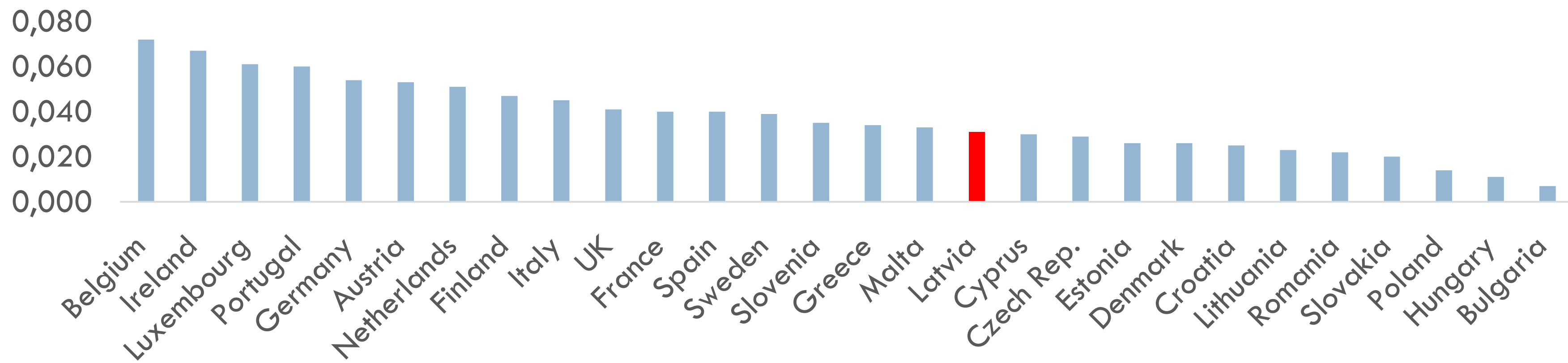
Personal income tax: Main issues

Unfair (contributes to vertical and horizontal inequalities) and reduces economic efficiency

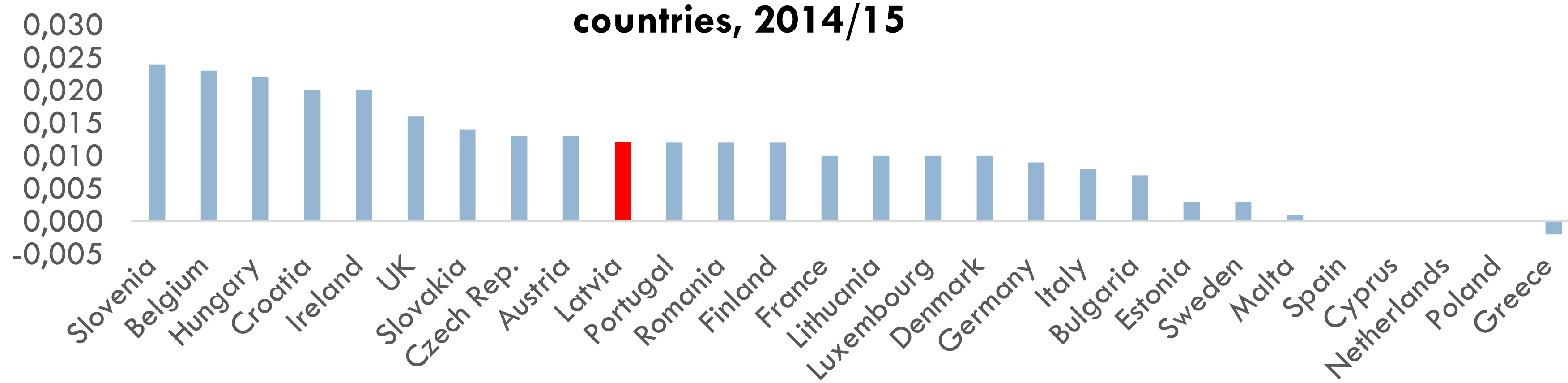
- The failure to tax different kinds of income consistently
  - There is a bias in the tax system in favor of investment in property
- High tax burden for low income workers
  - Low-income workers in Latvia can face a very high effective marginal tax rate (EMTR). EMTRs in Latvia do not satisfy the criteria for an optimal tax system.
  - Additional earnings generate no increase in net income until they exceed 40% of the average wage
  - High participation tax rate for low-income workers (33.5 percent for all incomes above the minimum income)
- Causes informality and tax compliance problems: high estimated incidence of wage underreporting

Direct taxes play a small role in reducing inequality, social security tax has close to the average EU impact

Increase in disposable income inequality without direct taxes, EU countries, 2014/15



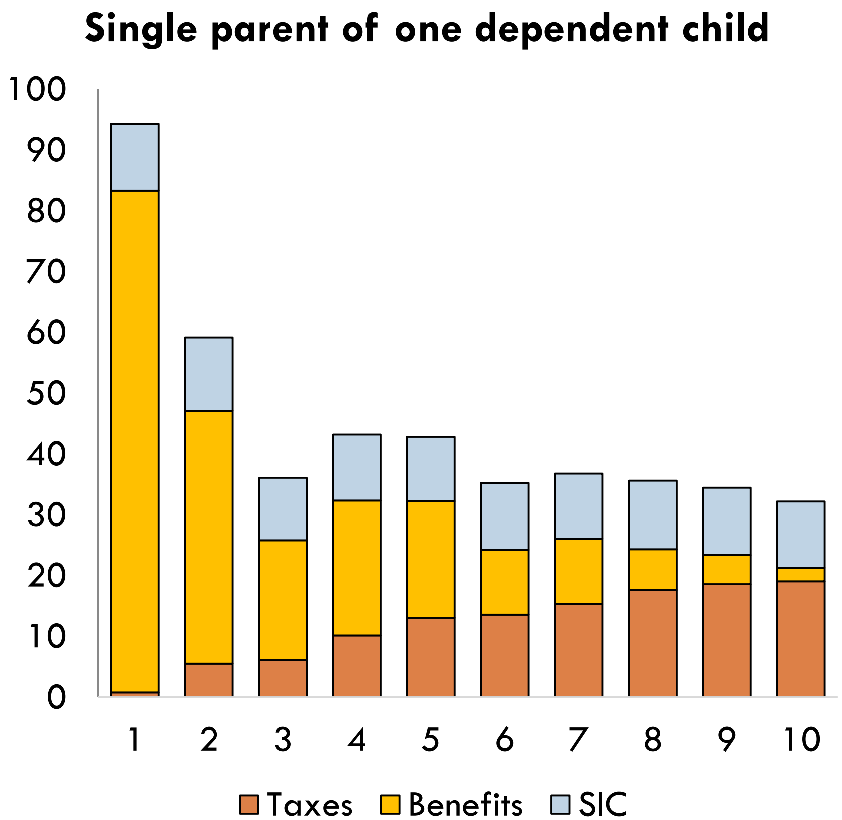
Increase in disposable income inequality without social security contributions, EU countries, 2014/15

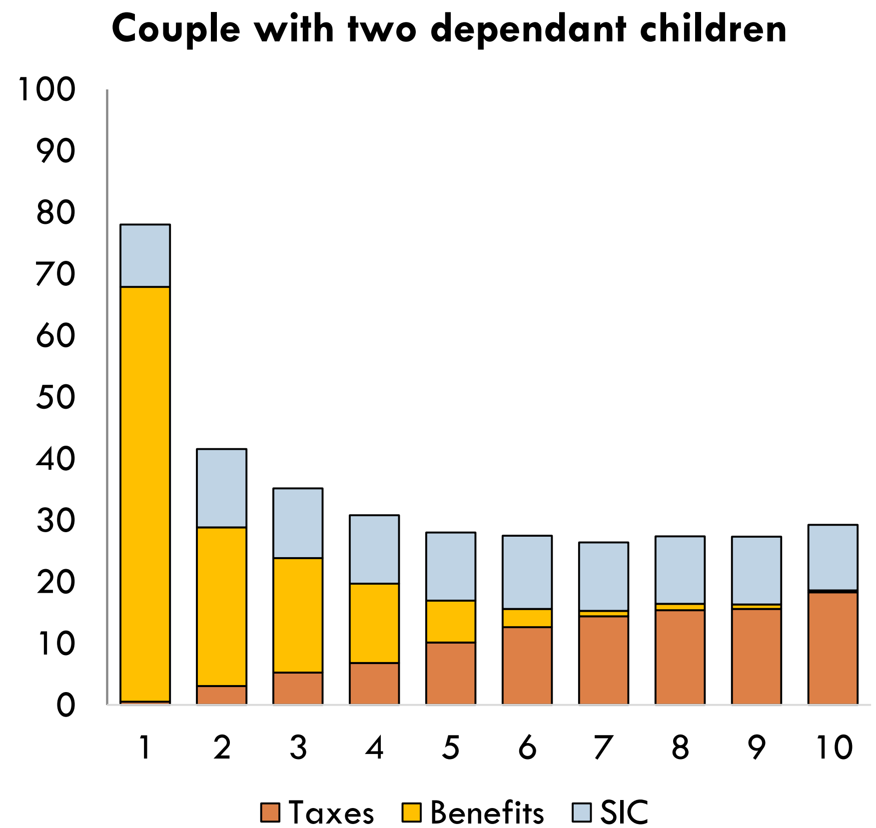


Source: Extracted from Table 4 in Chrysa Leventi and Sanja Vujackov (2016) *Baseline results from the EU28 EUROMOD (2011-2015)* EUROMOD Working Paper Series EM3/16- May 18, 2016.

Participation income tax rate for workers remains high especially for the low-income households

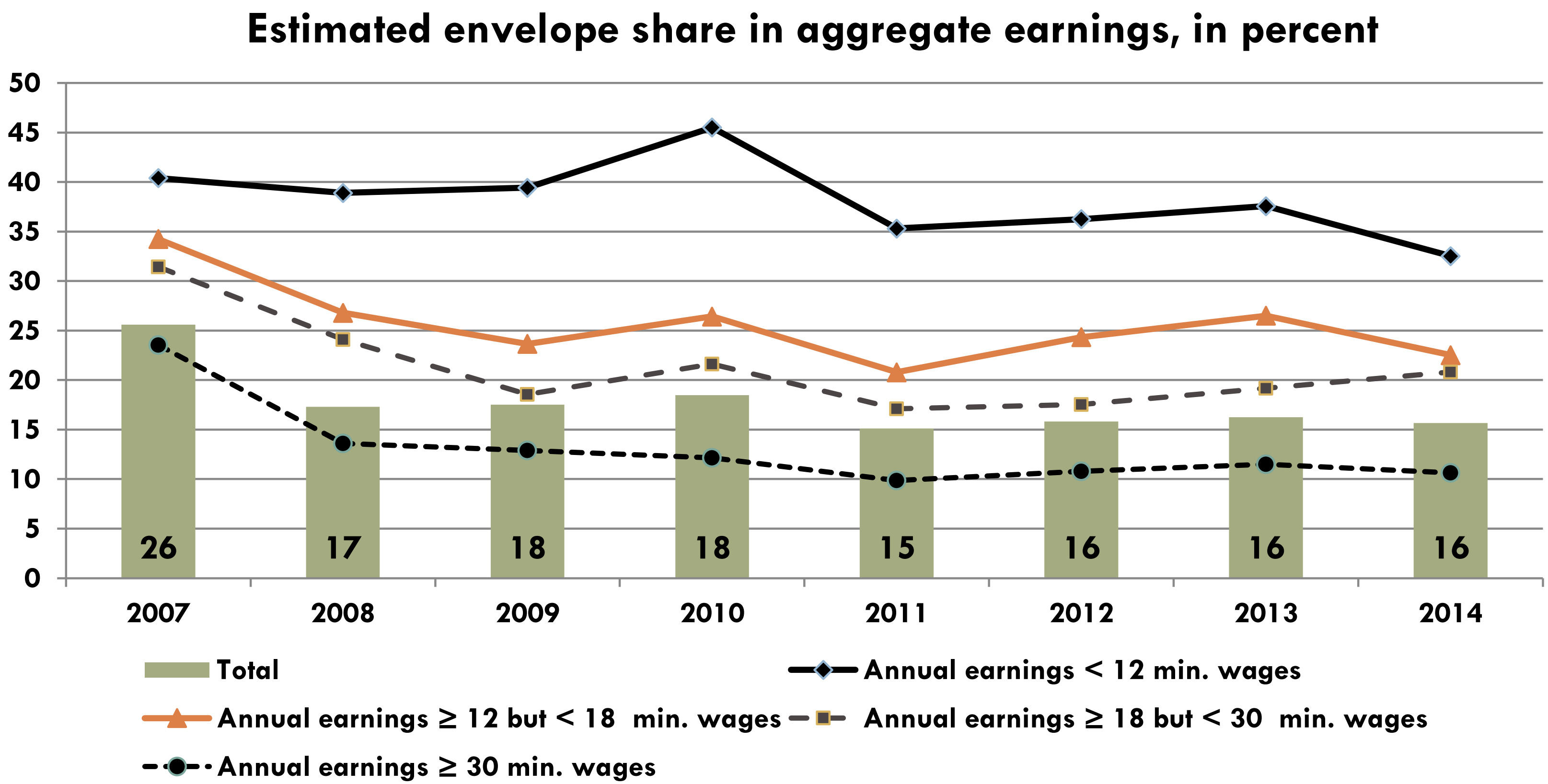
Contributions of taxes, benefits, and social security contributions to participation tax rate, by decile of equalized disposable income and selected household types, 2015





Source: EUROMOD simulations and further calculations using EUROMOD-adjusted EU-SILC data

Envelope share in the wage bill is higher for low-income workers



Note: Base: all employees with some earnings during the year, including those without envelope wages. No self-employed. The estimates are conservative and can be seen as lower bounds.
Source: Calculation based on EU-SILC 2008-2015 and Latvia's State Revenue Service data.

Tax treatment of capital income is not uniform

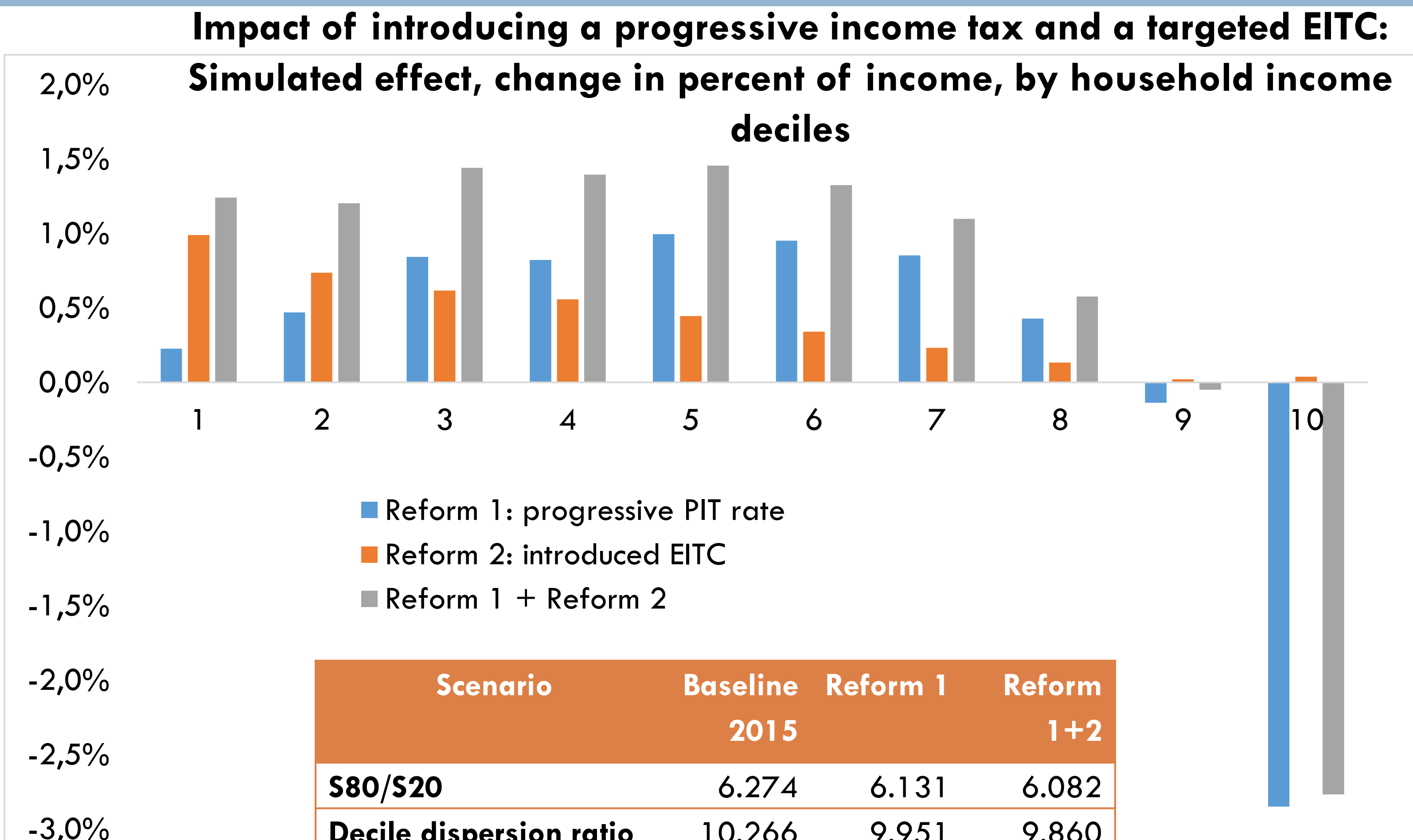
- Aggregate burden of capital taxes in Latvia is low
- Taxing capital income at very low or zero rates is not socially desirable
- Tax treatment of capital income is not uniform
- Non-uniform tax treatment of capital income is inefficient, generates inequities and provokes tax arbitrage

Personal capital income	Rate	Corporations	Rate
Interest	10%	Interest (effective)	0% (10%)
Dividend	10%	Dividend (effective)	15% (23.5%)
Capital gains on assets	15%	Capital gains (effective)	15% (27.8%)
Housing		microenterprises	
Imputed rental income	-	Interest (effective)	9% (9%)
Realized rental income	10%	Dividend (effective)	9% (18.1%)
Deduction mortgage rent	-	Wealth taxes	
Capital gains housing	0%, 15%	Property	0.2-3%
Occupational pensions (2nd pillar)		Stamp duty immovable property	2%
Pension benefits	23%	Inheritance	-
Deduction contributions employer/employee	0%/23%		
Pension accrual	10%		
Private pension saving (3rd pillar)			
Pension benefits	0%/23%		
Deduction contributions employer/employee	0%/23%		
Pension accrual	10%		

Personal income tax: Directions for reform

- Introduce a non-linear tax schedule to reduce the tax burden on low-income workers
  - Consider multiple rate system and raising the top rate: 19%/23%/29% (or 33% as the top rate)
  - Introduce an earned-income tax credit (EITC), tapering it out as incomes grow
  - Set withdrawal rates for minimum-income guarantees and housing at less than 100 percent when taxpayer gets a job and moves above threshold
- Raise the share of capital taxes in total tax revenue to increase efficiency and equity of mix between taxes on labor/consumption and capital income
- Introduce uniform tax treatment of all capital income (interest, dividends, capital gains, pensions, firm-ownership and housing)
- Ensure that changes to PIT are revenue generating or revenue neutral

PIT reform (a 3-rate PIT: 19%/ 23% (from €360)/ 29% (from €1300) substantially reduces the gap between the rich and the poor



Scenario	Baseline 2015	Reform 1	Reform 1+2
S80/S20	6.274	6.131	6.082
Decile dispersion ratio	10.266	9.951	9.860
Gini	0.361	0.355	0.354

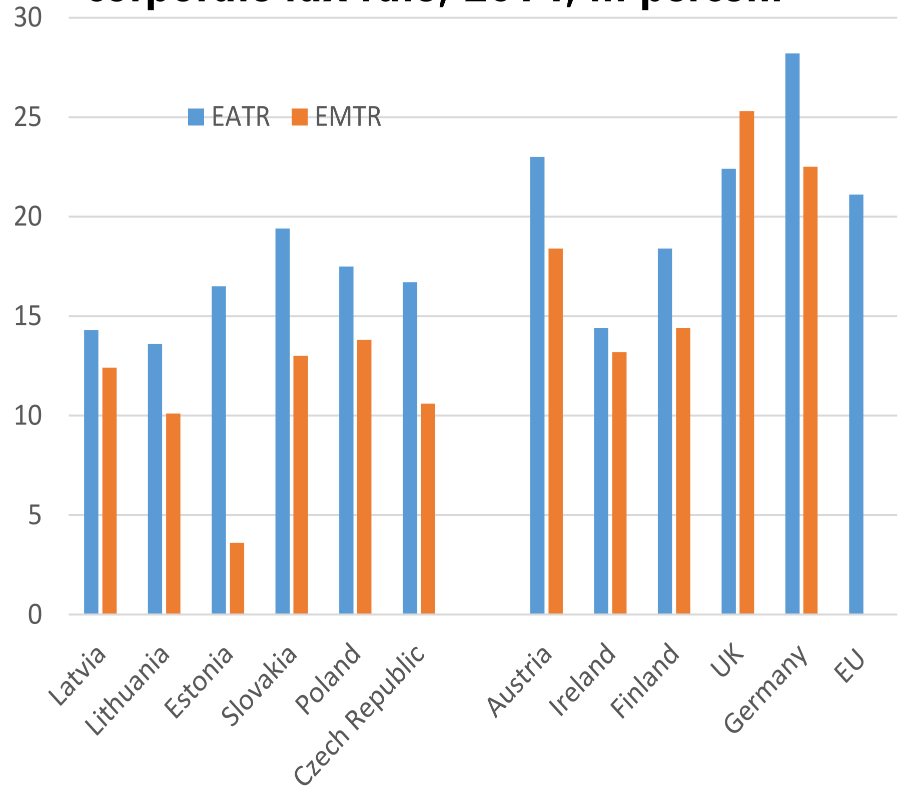
Source: EU-SILC microdata and staff calculations.

Corporate income regime: Main issues

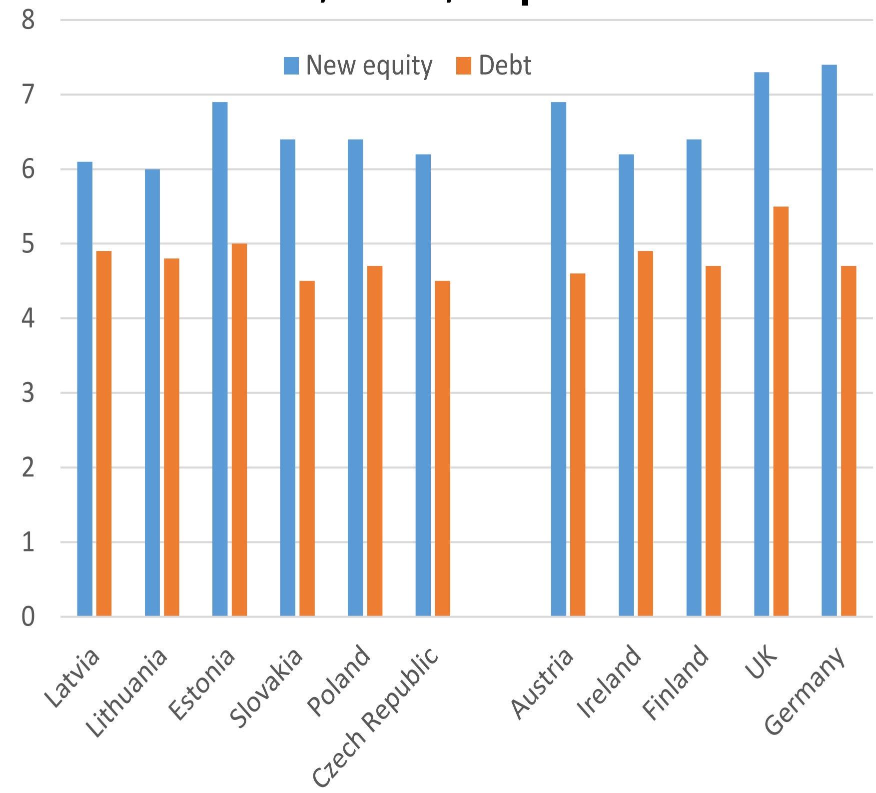
- CIT system imposes relatively low marginal investment distortions
- Corporate income tax (CIT) revenue low compared to EU and OECD averages—reflects low tax rate, narrow and eroded tax base
- Loss of 1.5% of GDP in revenues from tax expenditures (80% for promotion of investment), due to: tax incentives for investment (carry forward losses, accelerated depreciation of fixed assets, enhanced depreciation for new technological equipment for production, tax relief for R&D expenditure) and other tax credits and deductions such as tax rebates for farming or allowances for charitable donations
- Complexity of Latvia's taxation of business income creates distortions and inequalities (the main avoidance vehicle is the microenterprise tax)
- Tax treatment of owners of closely-held corporations and workers requires a solid split between labor and capital incomes
- Asymmetric tax treatment of debt and equity offers an incentive for corporations to use debt rather than equity financing, limiting incentive for equity investment

Latvia's CIT system imposes low investment distortions

Effective marginal and average corporate tax rate, 2014, in percent



Cost of capital by financing method, 2014, in percent

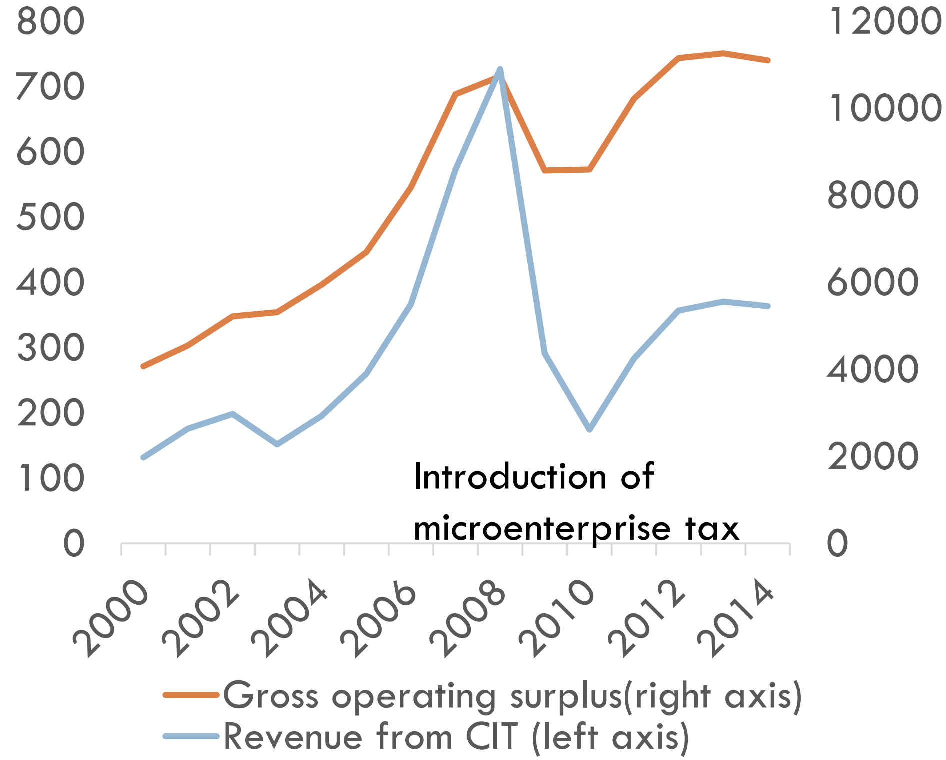


Sources: OECD, KPMG, Latvia Latvia's Ministry of Finance.

CIT revenues recovered less after crisis than the growth in corporate profits would have suggested

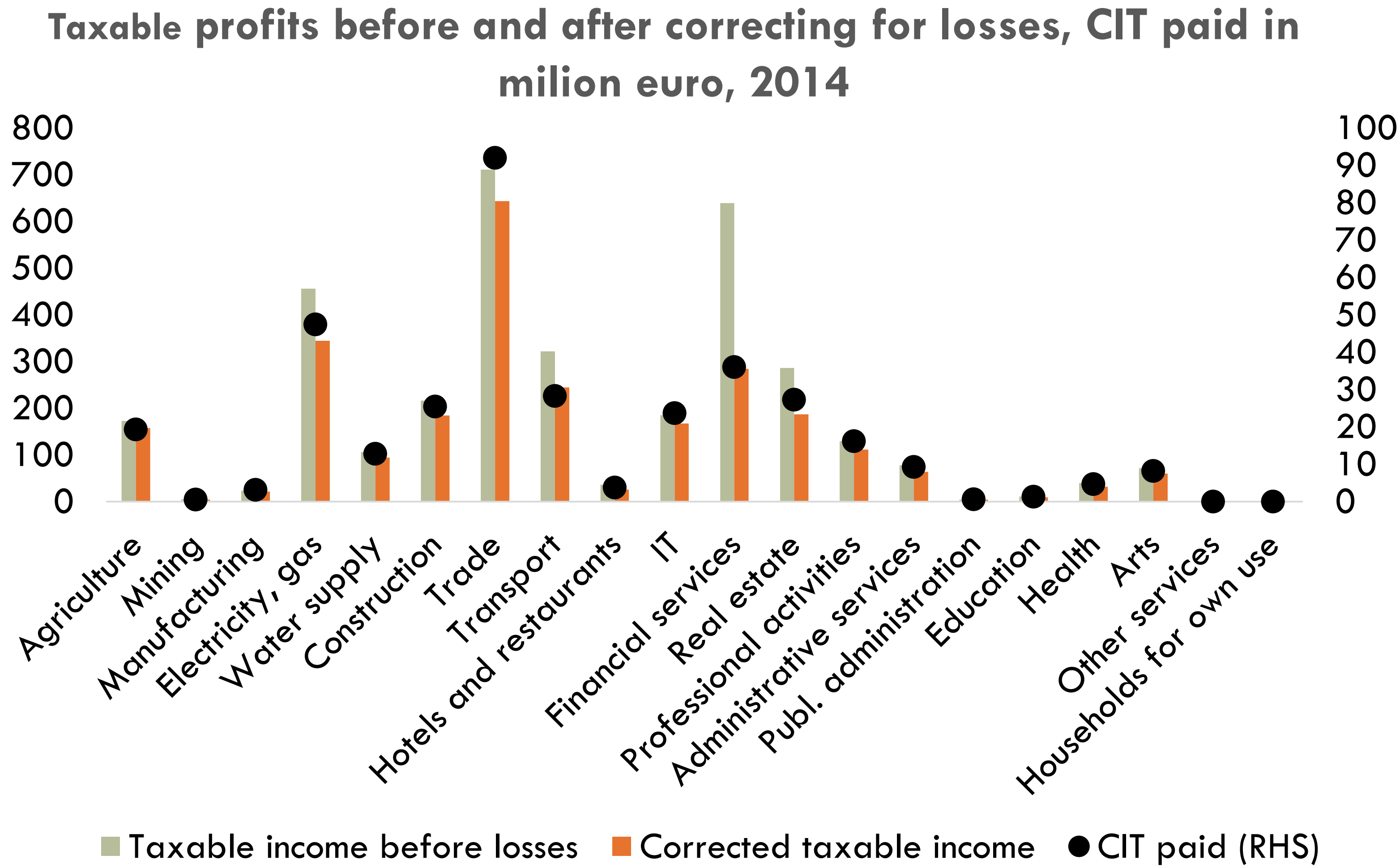
Latvia: PIT and the potential tax base, 2000-14, € million

Latvia: CIT and the potential tax base, 2000-14, € million



Source: Eurostat national accounts data, and Latvia's Ministry of Finance.

There has been some base erosion lowering effective rate, e.g. due to write-offs for loss relief



Source: Latvia's State Revenue Service.

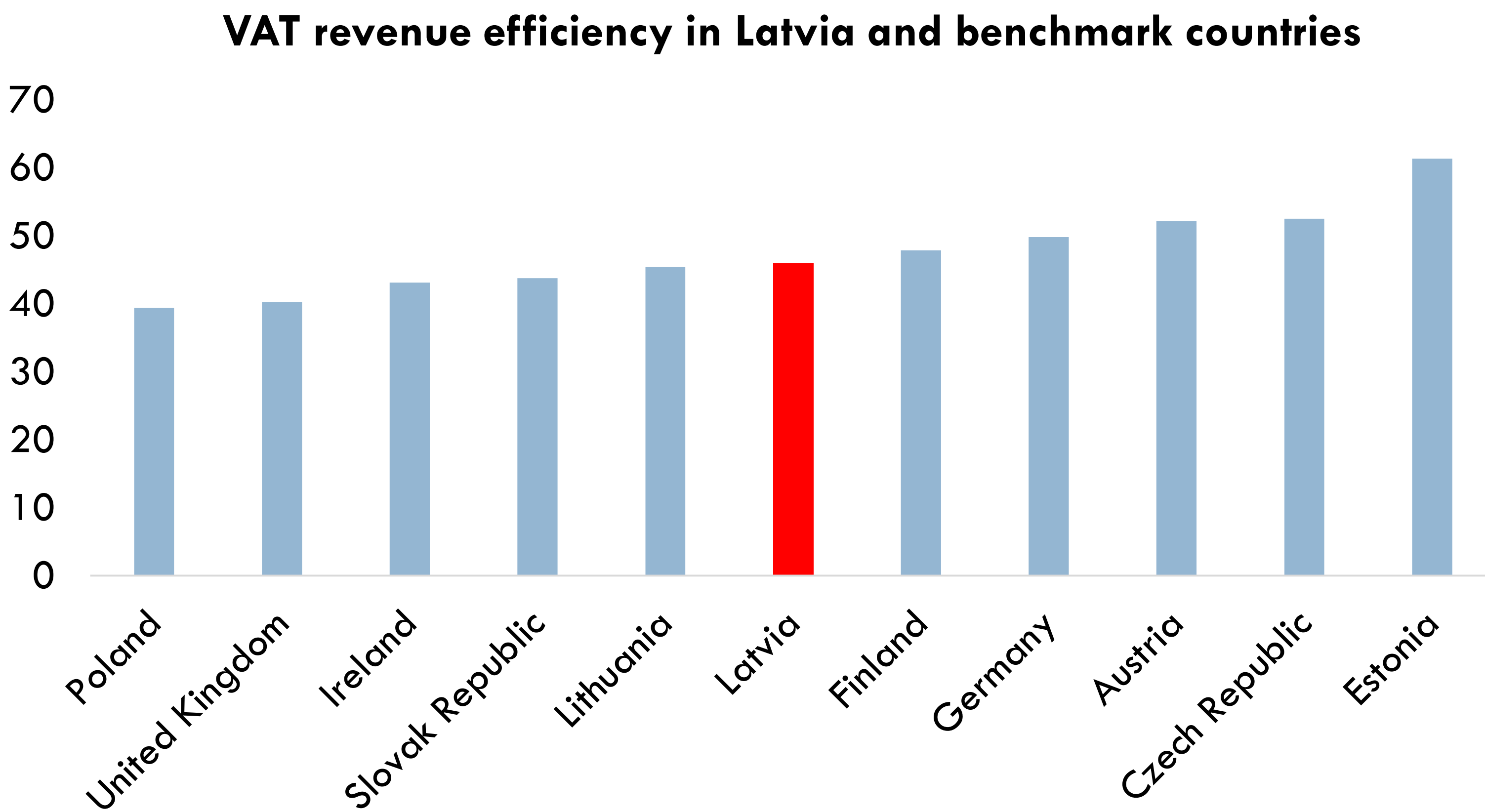
Directions for CIT reform

- Broaden tax base, re-focus tax allowances, including:
  - Look at whether to restrict accelerated depreciation and tax rebates for acquisition of new production technology equipment and ensure the enhanced deduction for R&D is effective and focused on innovative enterprises
  - Restrict loss relief (amount of losses/ time for which losses could be carried forward)
- Take steps to counter base erosion and profit shifting (BEPS), including effective implementation of EU Council Directive on CIT avoidance
- Consider introducing provisions to counter the accumulation and retention of earnings within closely-held companies to stop avoidance of PIT on shareholder income
- Consider introducing a partial deduction for the costs of both debt and equity, which is a combined ACE/CBIT that could eliminate distortions on the financing decisions of firms in revenue-neutral way
- Reform microenterprise tax

Value-added tax: Main issues

- Value-added tax (VAT) is fairly broad-based with standard rate that is close to EU average
- Differentiated VAT rates should be used for two reasons: reducing labor-market distortions or income redistribution
  - Direct provision of income support is more effective for income redistribution
- Reduced rates and exemptions in VAT are costly in terms of public revenue
- A significant amount of VAT revenue is lost due to tax evasion and avoidance

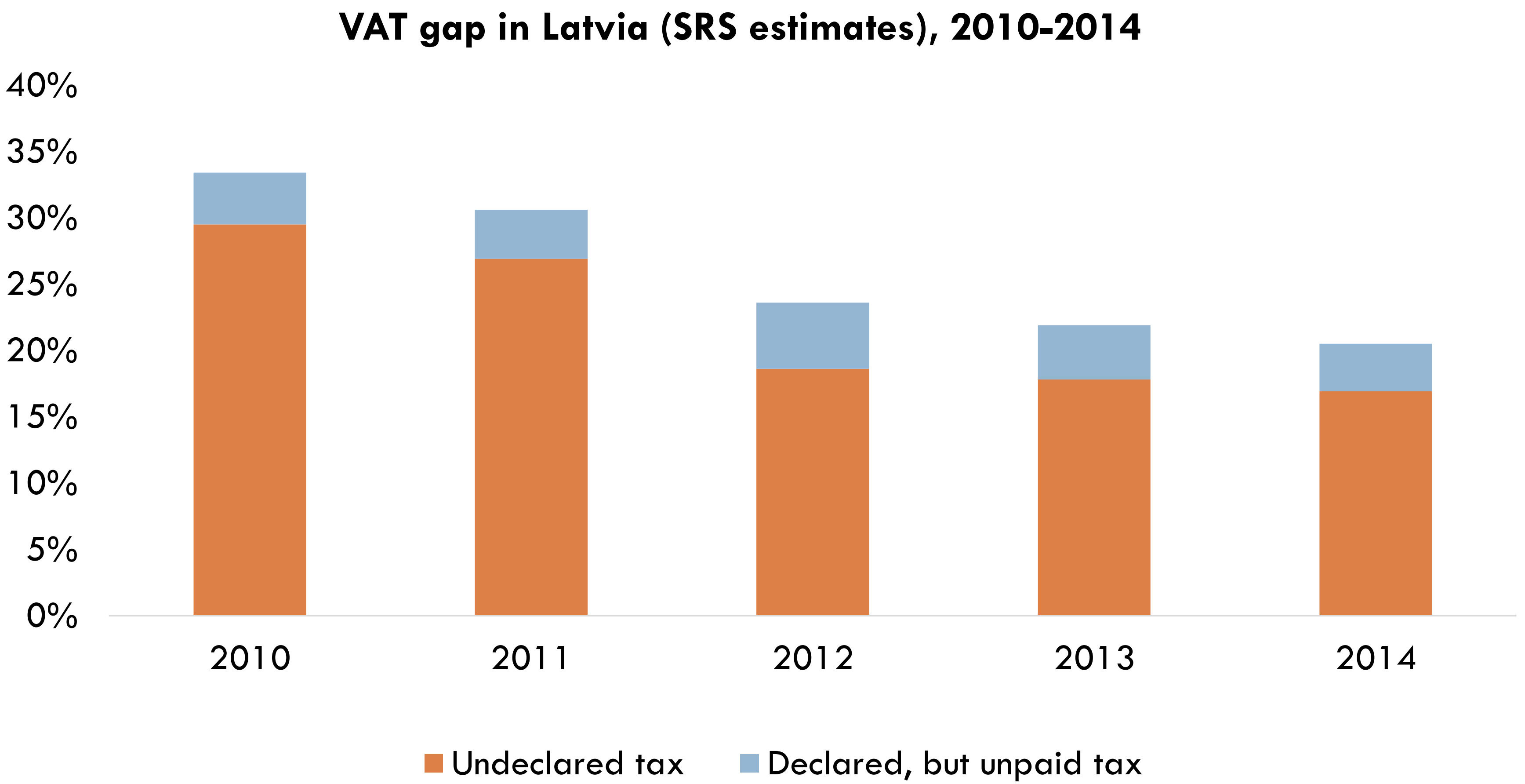
VAT revenue efficiency close to EU average but still far below efficiency of Estonia or Czech Republic



Note: Policy efficiency measures the extent to which the statutory VAT tax imposed equals that which would be collected by a standard VAT rate from the "ideal" broad tax base with perfect compliance. VAT efficiency is defined as the ratio of VAT revenue to the potential tax take (derived from applying the standard rate to the consumption base).

Source: Eurostat.

Significant amount of VAT revenue lost due to tax evasion and avoidance



Source: Latvia's State Revenue Service data.

Reduced VAT rate regime costs 0.6% of GDP; some provisions may be “socially desirable” (e.g. on health supplies)

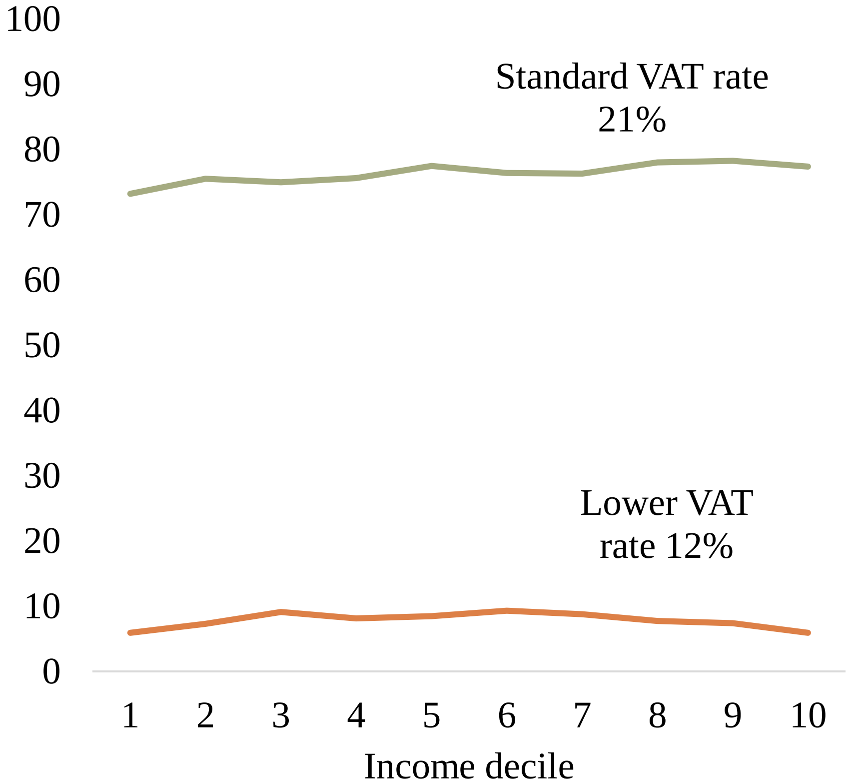
Revenue loss due to reduced VAT regime, 2014

Cost of reduced VAT rate	thsd. EUR	% of GDP
Total cost	152,638	0.65
of which:		
Pharmaceuticals	103,168	0.44
Medical devices	2,744	0.01
Specialized food for infants	719	0.00
Regular inland passenger transport and carriage of passenger luggage	10,422	0.04
Text books and original literature	3,164	0.01
Newspapers, magazines, bulletins and other periodicals*	3,745	0.02
Tourist accommodation services	9,642	0.04
Residential heat supply	18,985	0.08
Supply of firewood to residents	51	0.00

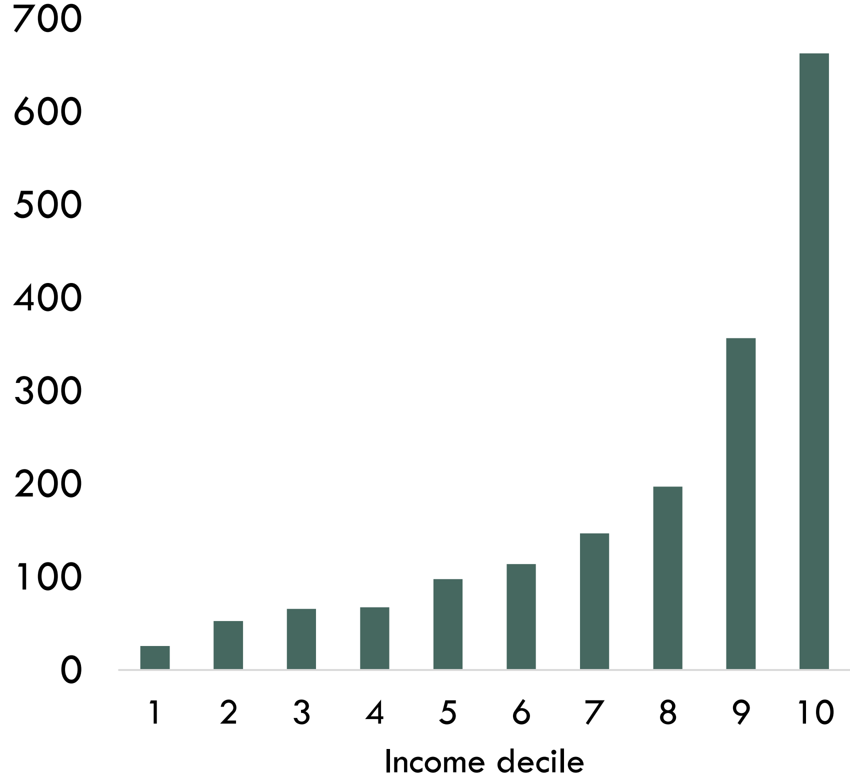
Source: Latvian Ministry of Finance.

Lower VAT rate not targeted to low-income groups, more effective to give targeted income support

Share of household consumption (cash) by VAT rate category, 2014

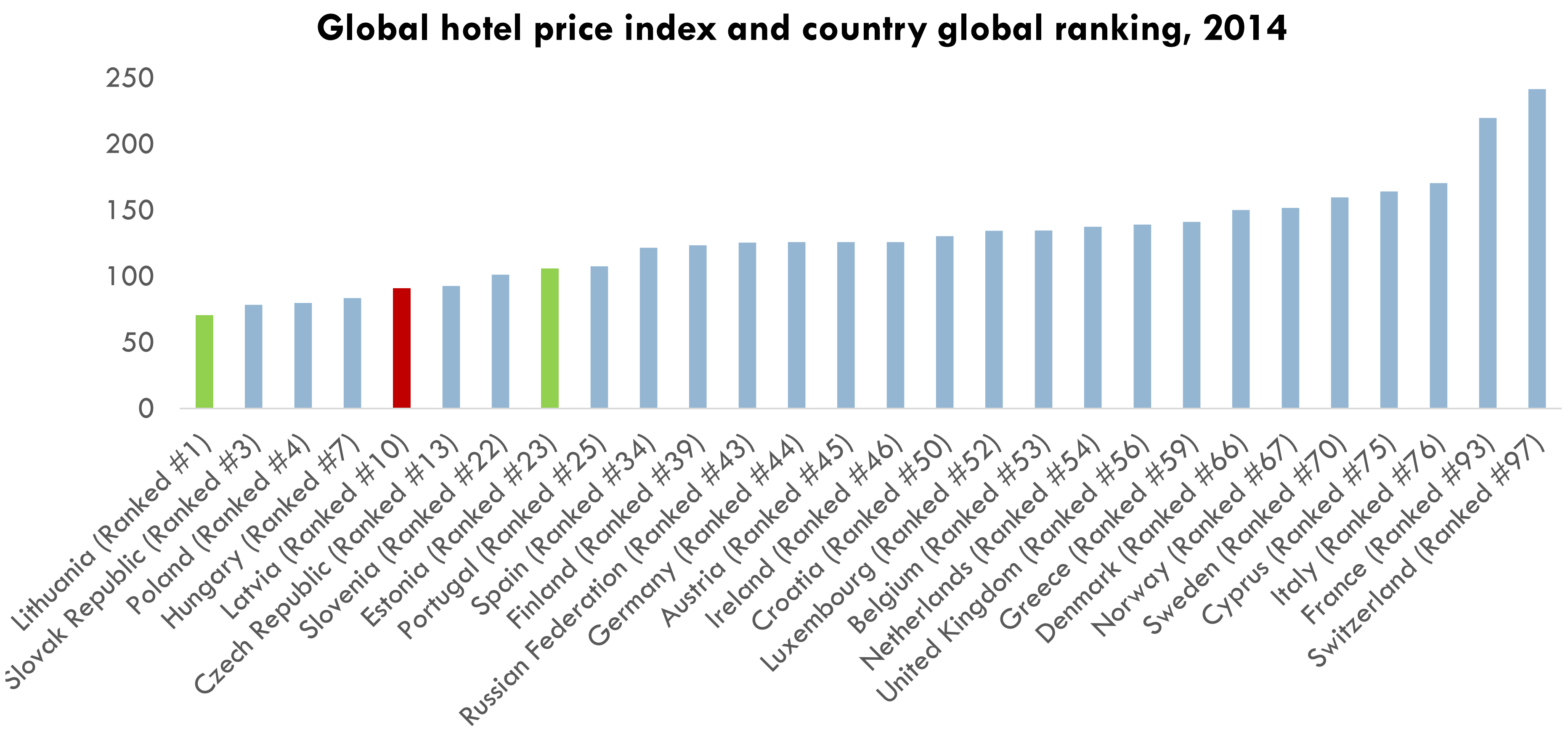


Hotel/Restaurant consumption per capita by income decile, in euros, 2014



Source: World Bank calculations based on Household Budget Survey, 2014.

Example: Lower VAT rate on hotel accommodation benefits visitors and richer local population, but does not necessarily drive competitiveness



Source: The Travel & Tourism Competitiveness Index Dataset © 2015 World Economic Forum.

VAT reform options

- Actions to target improved tax compliance are a priority
  - Investigate causes of VAT gap and then target tax administration measures to major areas of noncompliance
- Possibility to phase out certain exemptions to have one unified rate
  - Reduce cost of revenue losses due to reduced rates
  - Given their cost, carefully review efficiency and distributional impact of preferential VAT rate on goods and services, in particular on heating and hotel accommodation
  - Consider lowering VAT threshold
- Removing lower rate regimes likely to be politically sensitive—only Slovakia in the EU does not have a reduced-rate regime

Excise tax: Main issues

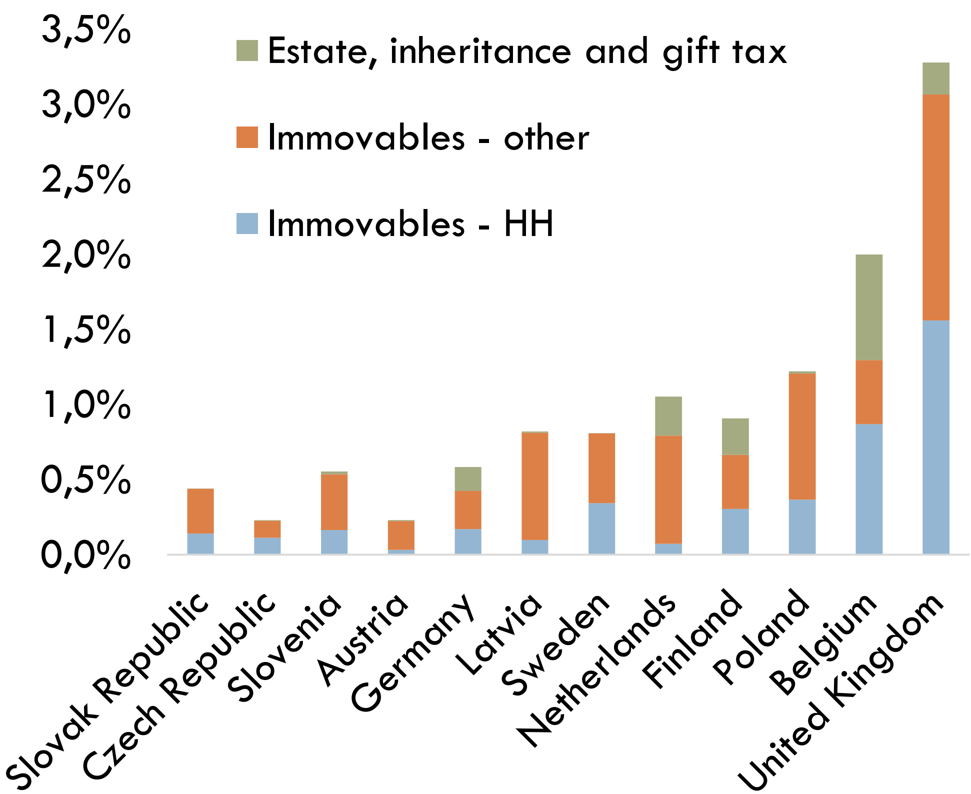
- Excise duties make a significant and stable contribution to Latvia government revenues
- Excise revenues are high but below Poland or Estonia
- In 2014 alcohol duties, though still below the EU average, were among the highest in the region
- Latvia has one of the lowest retail fuel prices in the EU, but when adjusted for PPP it has the fourth-highest duty on all types of fuel (see Annex N)
- Duties are high in in PPP-adjusted terms
- Differences in prices encourage smuggling, especially of cigarettes. Latvia is one of the countries with the highest consumption of smuggled cigarettes (more than 20% of total cigarette consumption are illegal) in the EU (KPMG 2013)
- The current structure of excise duties could be improved to better target potentially harmful consumption (the externalities and internalities associated with smoking, driving, and drinking)

Directions for excise reform

- Changing the application of excise duties to different products to correct socially costly behaviour
- There is a clear case for reform in how driving, smoking and alcohol are taxed
  - The government should consider basing the tax on fuel on CO_2 emissions (but combined with a support mechanism that would protect transport sector and Latvia's competitiveness)
  - Reform of alcohol taxation should target alcohol products systematically, because society consumes disproportionately more of the low-tax products (consider suspending planned increase in excise duty on strong alcohol and raising duties on beer and wine)
  - Changing the balance between the specific and ad valorem components of the tax on cigarettes could better target public health and rise revenues

Revenues from real estate taxes in Latvia are above Baltic neighbors, but below many richer EU countries

Property taxes as a percentage of GDP



- Latvia has an appropriate value-based property tax system
- It is advisable to bring cadastral values closer to market values, apply uniform assessment ratios to all properties, and reduce exemptions
- Over time property taxes could play a greater role in generating revenues, as occurs in some high-income countries

Source: OECD.

Further deepen tax compliance efforts (1)

- Reduce tax compliance gaps and increase voluntary compliance, through administrative measures but also tax policy, e.g.:
  - Introduction of withholding taxes for payments to subcontractors in high risk areas
  - Expanded access to financial data (e.g. debit and credit card use information)
  - Additional requirements for VAT registration of a company
- Continue with SRS efforts to measure the tax gap and use analysis to direct tax administration/policy
  - Decompose overall tax gap by taxpayer segment and by compliance attitude and behavior
  - Invest more in the data analysis function of SRS
  - Analysis of risk-based as well as random audit data for gap analysis purposes
  - Identify compliance attitudes through targeted survey

Further deepen tax compliance efforts (2)

- Ongoing monitoring of RASA Natural Persons Risk Analysis System efficiency is important (analyze trends in audit yields and review automated selection results)
  - Introduce additional cross-checking mechanism through (not more than 5%) random audits to compare with RASA audit results (helps also to identify new risks)
- Move to real-time control system of VAT chain and introduce early warning system of irregularities
  - Introduce e-invoicing system for B2B transactions

Additional slides

Estonia model of corporate income taxation: potential advantages

- It encourages investment and enterprise by allowing companies to retain their profits for reinvestment in the business
- The system is helpful to start-up companies with growth potential which may have problems accessing finance and attractive to FDI
- The Estonian system is simple and easy to administer (no special rules in regard to carry forward and offset of losses, no need for tax depreciation…)

How successful the Estonian CIT system has been in practice is open to debate

Empirical studies of Estonian tax system:

- The non-taxation of retained earnings does not necessarily mean that such earnings will be used productively - accumulated profits were held in large part as liquid assets and were not invested in productive assets (Hazak 2009)
- The Estonian companies accumulate relatively more liquid assets and rely less on debt financing after the reforms (Masso *et al*. (2013):
  - Share of liabilities in total assets has decreased by 7 percentage points
  - The share of cash and equivalent in assets (which has been used as liquidity indicator) has increased by 2-3 percentage points
  - The share of undistributed profits and reserves in total capital has grown by 11 percentage points

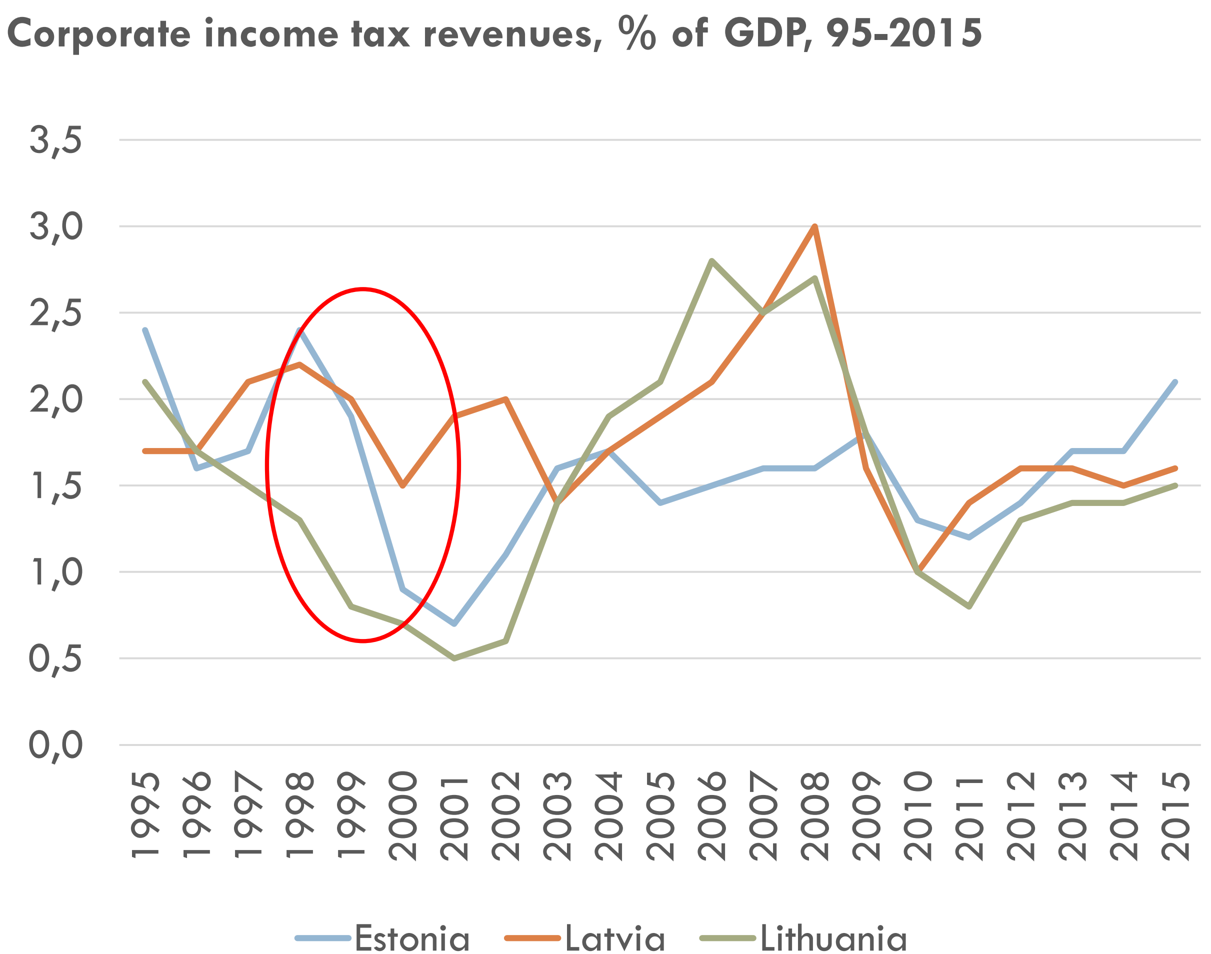
Other studies:

- There are no immediate effects of the regime on labour productivity and GDP growth (Staehr, 2014), though there is some positive impact at the firm level
- Prohorovs (2016) found positive impact on investment. During 4 years after introduction of the 2000 tax reform, the level of investment of Estonian enterprises increased by an average of 20 percentage points

Risks of the Estonian model of CIT

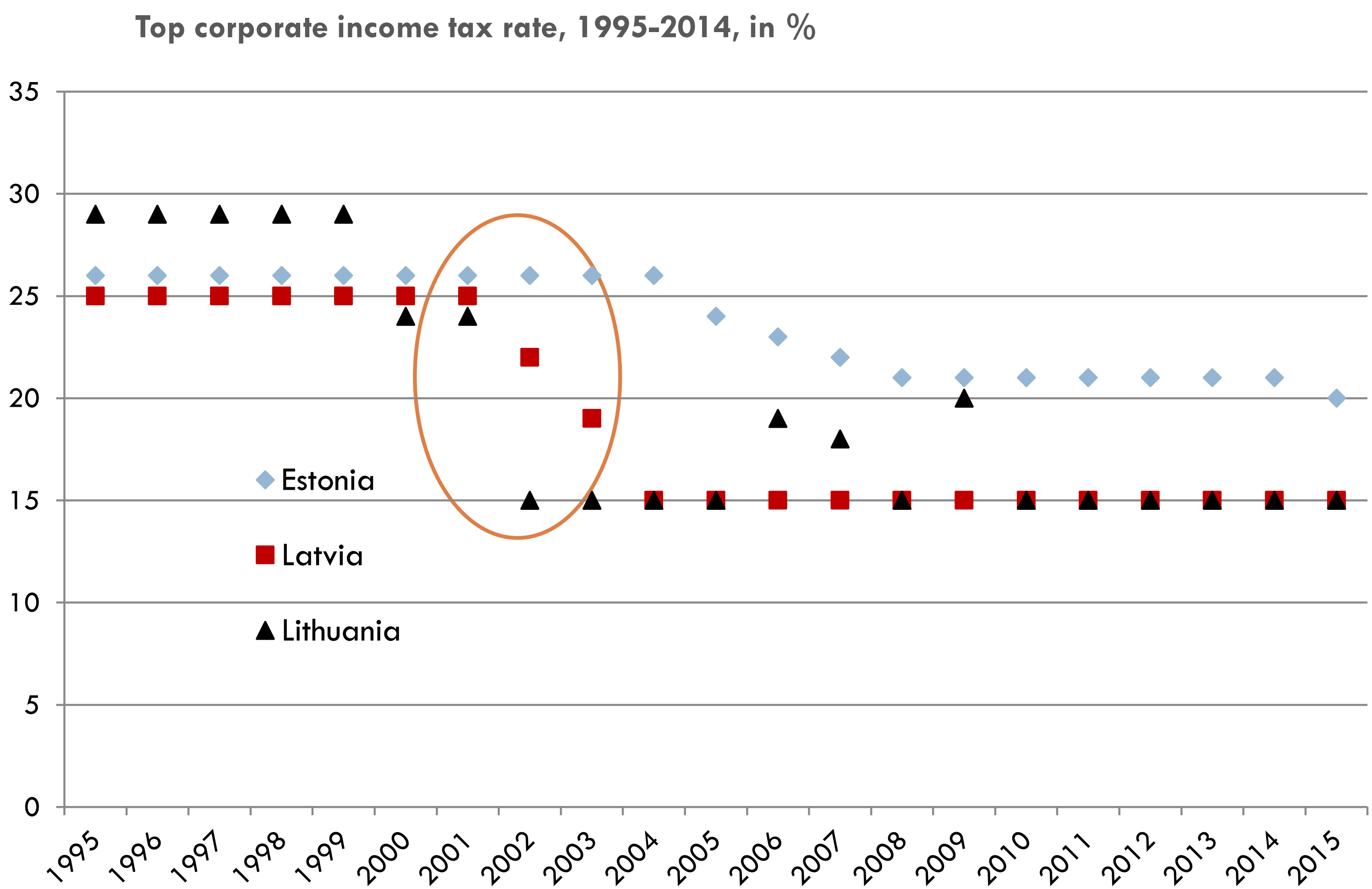
- Large revenue reduction plus revenue uncertainty
  - Distribution-based tax allows for deferral of taxation indefinitely =>that revenue yield becomes uncertain and unpredictable
  - Large revenue decrease was registered in Estonia (about 1% of GDP in early years)
- Tax avoidance vehicle:
  - provides an incentive for individuals to use a company structure to earn and accumulate non-business income and avoid personal income tax on such accumulated earnings
  - a distribution-based tax could, for example, encourage the use of ‘moneybox’ companies.
- No hard evidence that the regime results in productive investment or the most economically efficient use of earnings
  - Profits may end up being held in liquid assets or other passive investments

Collapse of CIT revenue in EE following the switch to dividend taxation. Revenue is now at the level of 1995



Source: Eurostat.

Collapse of CIT revenue in EE despite keeping a high statutory tax rate – 26%



Source: Eurostat.