ANALYSIS OF TRENDS IN THE TAX BURDEN IN LATVIA

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Abstract. Latvia's "Tax Policy Strategy 2011-2014" was elaborated, taking into account the need to ensure the stability and predictability of its tax policy and to increase the competitiveness of Latvia's national economy as well as Latvia's intension to introduce the euro in 2014. The research aim is to analyse changes in the trends in tax burden in Latvia in 2009-2012 within the common context of the EU tax environment by employing comparative analysis. To achieve the aim, the following research tasks were set: to characterise the changes in the trends in tax burden in Latvia in 2009-2012 and to perform an international comparative analysis; to identify factors promoting and hindering business and social development basing on the analysis of trends in the tax burden performed in the present research. To make statistical data on the EU States comparable, the European system of national and regional accounts 1995 (ESA 95) and the tax classification based on ESA95 were used.

The majority of tax revenues in Latvia are composed of labour taxes, although, over the recent years, the proportion of these taxes in the total tax revenue has been reduced from 52% in 2009 to 50.8% in 2011. Labour taxes in Latvia, to a greater extent, reduce the real income level, particularly for population groups with the lowest income.

The country's fiscal policy for 2013-2015 is determined by several factors: a course towards a balanced government budget over the economic cycle, observance of the fiscal policy terms set by the Stability and Growth Pact (SGP), and economic growth measures to be implemented in the post-crisis period. The most significant measures affecting tax revenues in the period 2013-2015 will be: a reduction in the personal income tax rate from the present rate of 24% (in 2013) to 22% in 2014 and to 20% in 2015 and a reduction in the tax burden to 26.3% of GDP in 2015. The enhancements in the tax policy have to be oriented towards the improvement of Latvia's demographic situation, systematic and purposeful attraction of foreign investments, and faster transferring of the tax burden from labour to consumption.

Key words: tax burden, fiscal policy, Latvia, labour taxes, EU-27.
JEL code: E62, H24, H72, J38, K34, O16

Introduction

The objective of any nation is to justify and set a tax burden that makes as small negative effect on economic activity in the country, as possible. Therefore, a topical problem is the structure and rates of taxes, which may, to a great extent, affect business activity, consumption, and other important macroeconomic indicators. The indicator of total tax burden and a structural analysis of tax groups are one of the most essential issues of examination and analysis, which is regularly tackled both by the European Commission's planning departments and by national strategic planning commissions, the task of which is to create favourable conditions for economic development and to prevent crises and their effects.

Since 2001, Eurostat's national account team has set four key indicators that are widely used for international comparisons. Since 2009, the European Commission has performed international comparisons in accordance with a single methodology elaborated by it, and a full text of the methodology was included in the European Commission's report *„Taxation Trends in the European Union*" (2009). Theoretical studies and situation analysis aimed at enhancing the tax system from various aspects have been conducted by several authors in Latvia: Juruss M. (1999); Ketners K., Titova S. (2009); Joppe A. (2010); Jarve K. (2010); Tkacovs O. (2008); Sproge I. (2010); Vitola I., Leibus I., Joma D., Jakusonoka I. (2012); Stucere S. , Mazure G. (2012); Vitola I., Joma D. (2012). Tax burden analysis becomes increasingly urgent, therefore, the **research aim** is to analyse changes in the trends in tax burden in Latvia in 2009-2012 within the common context of the EU tax environment by employing comparative analysis.

To achieve the aim, the following **research tasks** were set:

— to characterise the changes in the trends in Latvia's tax burden in 2009-2012 and to perform an international comparative analysis;
— to identify the factors promoting and hindering business and social development basing on the analysis of trends in the tax burden performed in the present research.

Materials and methods

In the present research, the following research **methods** were employed: the logical and constructive methods, induction, statistical data processing methods as well as statistical grouping methods and the graphic method.

Materials published by Eurostat, the Central Statistical Bureau of the Republic of Latvia (RoL), the Ministry of Finance of the RoL, and the Treasury of the RoL for the period 2004-2012 were analysed and theoretical and methodological studies on fiscal policy management were used in the present research. To make statistical data on the EU states comparable, the European system of national and regional accounts 1995 (ESA 95), which

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Table 1

Tax changes in the EU-27 to prevent the crisis in 2009

Tax group	Member States	
	Decrease	Increase
Labour taxes		
Personal income taxes	OE, DK, FI, FR, DE, HU, **LV**, LT, LU, MT, NL, PL, PT, SI, SK, SE	EL, IE, UK
Social contributions made by employers	CZ, FI, HU, NL, SE	IE, RO, UK
Social contributions made by employees	CZ, NL, SE, SK	LT, RO, UK
Capital increase	RO	IE
Reform is postponed		CZ, EE
Enterprise income taxes		
Rate of social contributions	EL, LU, PT, SE	IT, LT
Government benefits	OE, BG, ES, IT, NL, DE, FR, LT, PL, PT, SI, SK	
Consumption taxes		
Value added tax		
Standard rates	UK	HU, IE, **LV**, LT
Reduced rates	BE, CY, CZ, FI, FR, MT, RO	HU, EE, IE, **LV**, LT
Capital income taxes		
Property and inheritance taxes	EL, ES, IT, LU, PT	
Environmental taxes	DE, NL, RO	FI, IT, **LV**, LT, SI, UK

Source: European Commission (2009) Taxation Trends in the European Union …

was introduced in accordance with Council Regulation (EC) No.2223/96 on 25 June 1996, was employed. The tax classification was designed based on the ESA95 methodology.

Research results and discussion

Any nation makes its fiscal policy based on the extent of government functions and the number and scope of services provided to the public. However, affected by the economic crisis, GDP in several EU states sharply decreased: 5.8% in the EU-27 in 2009, 3.5% in the eurozone (EU-17), whereas in Latvia – 19% (Eurostat, 2013).

Measures of the EU Member States to combat the economic crisis were different, depending on their government budget balance and the social situation in the country. Usually, the measures consisted of tax reductions, but the states with an insufficiently balanced budget or those whose GDP sharply fell, including Latvia, Lithuania, and Estonia, were forced to increase taxes. Information on the measures in the EU-27, summarised by the European Commission, is presented in Table 1.

According to the European Commission's data on the measures taken in the EU Member States to decrease the effects of the crisis, mainly fiscal consolidation measures were taken to change expenditures, while in several Member States tax burdens were increased as well (European Commission, 2010).

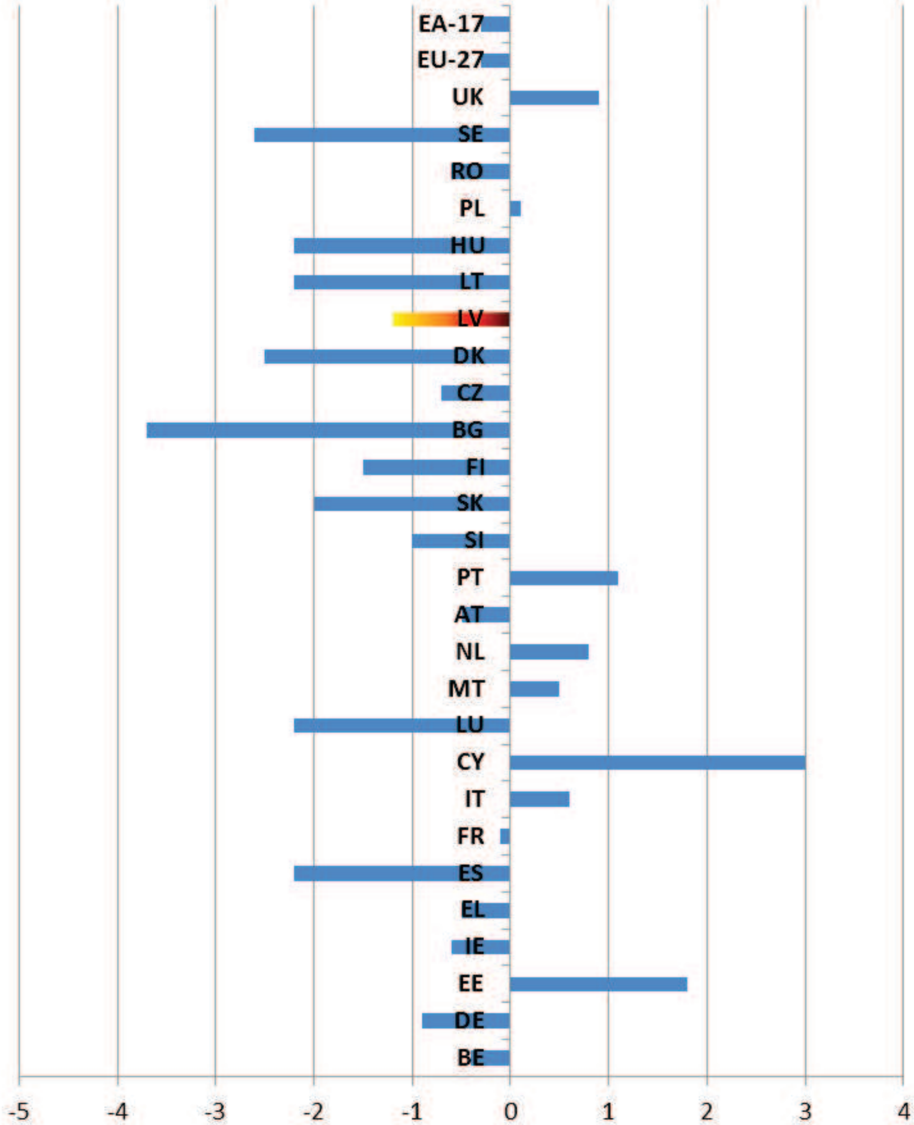
As regards the measures aimed at balancing the government budget and reducing the effects of the crisis on businesses, the majority of these measures targeted reductions in labour taxes, especially, reductions in personal income tax rates or increases in the tax base.

Many Member States, as the main measure, reduced their enterprise income tax, i.e. reduced the tax rate or the tax base (Table 1).

In the period 2008-2011, a series of measures were taken for balancing Latvia's national government budget: state administration costs were significantly reduced, salaries in the public sector were cut by 10-30%, expenditures on government procurement were decreased, and other unpopular measures were taken. As a result, domestic consumption and the population's purchasing power considerably declined. To offset the decrease in budget revenues, several tax rates were raised. On 1 January 2009, the standard VAT rate was raised by 3 percentage points (from 18% to 21%), but in 2011, the standard VAT rate was raised to 22%; at the same time, the reduced VAT rate was raised by 2 percentage points (from 10% to 12%).

These rates negatively affected the competitiveness of Latvia's goods in the local market and decreased the population's purchasing power even more. On 1 July 2011, the excise tax on natural gas was also raised. The rights of local government on setting immovable property tax rates were extended, as this tax was 100% collected by local governments.

The measures aimed at raising the tax burden caused a decrease in business activity. The analysis of tax revenues as a percentage of GDP in 2011 compared



***Source:* author's construction based on European Commission (2011) Taxation ...**

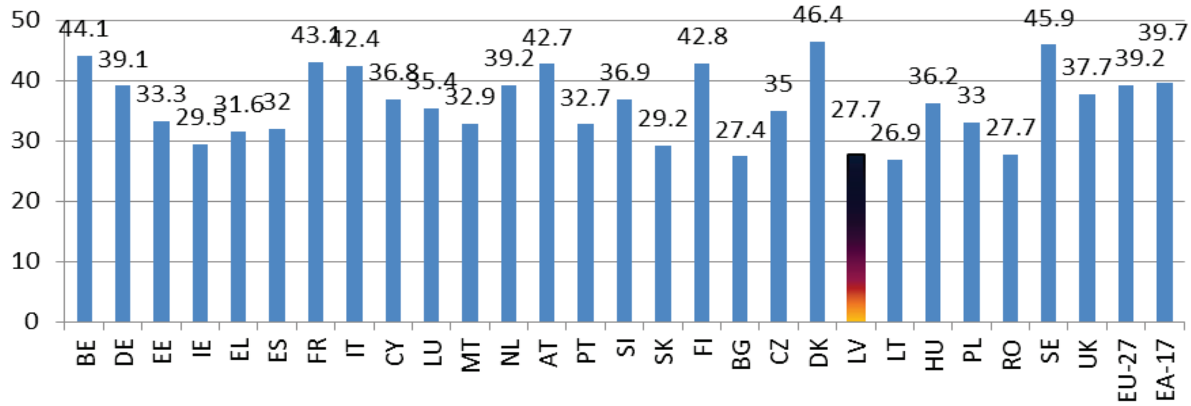
Fig.1. **Changes in tax revenues as a percentage of GDP in 2011 compared with the average of ten years (2000-2009)**

with the average of ten years (2000-2009) showed that in Latvia, like in the EU-27 and in East European countries EA-17, the tax burden was slightly lower – by approximately 1% in Latvia, 0.4% in the EU-27 and EA-17 (Figure 1). The average tax burden in the EU-27 accounted for 39.2% of GDP, while in Latvia it was 27.7% of GDP (Figure 2).

Although Latvia's total tax revenue as a percentage of GDP was one of the lowest in the EU, yet, its effect on the business environment was negative, as the proportion of labour taxes in the total tax revenue was too high (50.8% in 2011), and, given the large social contributions to be paid by employers, it significantly hindered Latvia's economic development and caused an increase in the grey economy. Being aware of the seriousness of the problem, Latvia's government took a series of measures aimed at reducing the grey economy. The "Plan of Measures to Combat the Grey Economy and Promote Fair Competition 2010-2013" is being implemented in Latvia. The Plan includes 66 various measures, based on the priorities set in the Euro Plus Pact for combating grey economies. The most important emphasis is placed on establishing a more effective tax system:

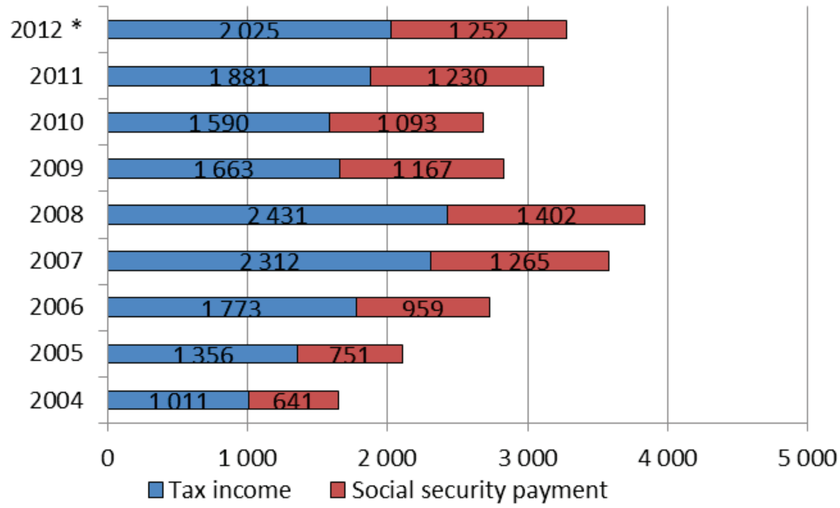
- tax burden has to be transferred to areas where the risk of tax evasion is lower (from labour taxes to property and consumption);
- reduction of the number of tax relief and exemptions;
- changes in the procedure of paying taxes (for instance, reverse VAT for scrap metals, the procedure of paying the personal income tax on prizes);
- cancellation of several unreasonable requirements (for instance, a reduction of the tax rate on interactive games).

The Plan also includes support for businessmen who faced problems during the crisis: for instance, the



Source: European Commission (2011) Taxation Trends in the European Union …

Fig.2. **Tax revenues as a percentage of GDP in the EU Member States in 2011**



Source: author's construction based on Treasury, 2012; * forecast;

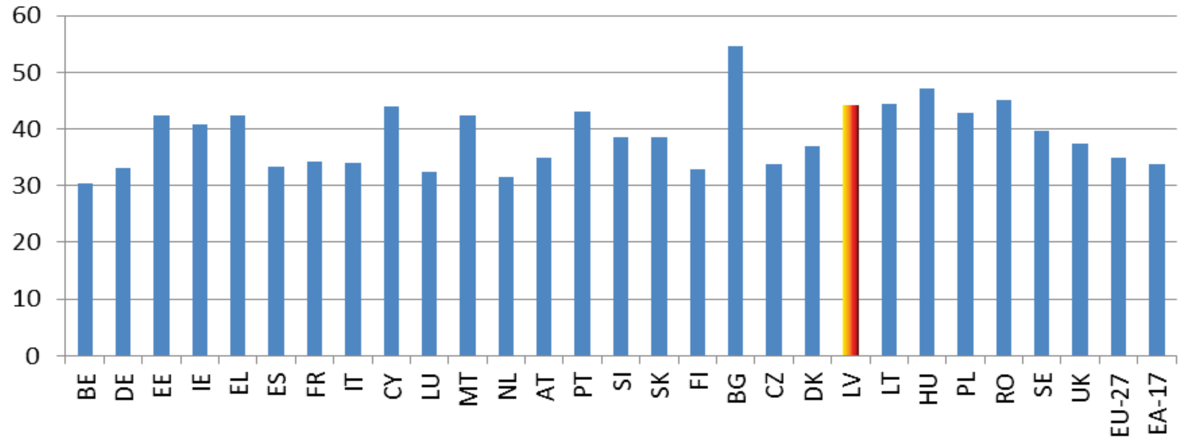
Fig.3. **Changes in tax revenues in Latvia in 2004-2012, mln LVL**

measure "Tax Amnesty" is an extraordinary activity to write off fines and delay penalties to those businessmen that have paid the principal amount of tax debt until a certain day; the measure "Income Legalisation" enables persons who evaded taxes to cover the loss caused to the government in relation to tax evasion, but at the same time such persons are released from legal responsibility as well as funds acquired in unregistered economic activity were legalised, thus facilitating the transition to the legal economy; the measure "Initial Declaration" is the initial declaration of one's material status, which states that any property is considered as acquired illegally, if it is acquired after submitting the initial declaration and if it is not possible to prove its origin.

In addition to the mentioned plan for combating the grey economy and providing fair competition, the "Plan of Measures to Reduce Unregistered Employment 2010-2013", the "Action Plan to Combat Illegal Trade and Smuggling", and the "Tax Collection Strategy of the State Revenue Service 2010-2013" were elaborated and implemented. In the period after the tax amnesty, the intensity of audits was increased and the tax collection process was intensified as well as the procedure of liquidation of enterprises was simplified. To implement these measures effectively, at the same time, the capacity of control institutions had to be increased by granting them additional rights, providing them access to additional information, optimising their functions and operational tasks as well as allocating additional resources to these institutions. Already in 2011, in the result of implementing the complex of these measures, additional revenue of LVL 60 million was collected. In 2011, the proportion of grey economy in Latvia was 30.2%, which was 7.9 percentage points less than in 2010 when the proportion of grey economy in the national economy reached 38.1% (Putnins T., Sauka A., 2012).

Changes in tax revenues in Latvia in the period 2004-2012 are presented in Figure 3.

The most significant risks for the stability of Latvia's economy and the collection of tax revenues are associated with events in the eurozone, changes in prices of commodities in the world market, and economic growth in



***Source:* European Commission (2011) Taxation Trends in the European Union in 2011**

Fig.4. **Proportion of direct taxes in the total revenue in the EU, %**

other largest world economies. To determine the positive or negative effect of taxes on business development, it is necessary to make a comparative analysis of trends in the collection of direct taxes, paying special attention to trends in the collection of enterprise income tax (EIT).

In Latvia, the flat EIT rate of 15% is relatively low, compared with other EU Member States, while in the EU, EIT rates range from 12.5% to 33.9%. According to I.Vitola (Vitola I., Leibus I., Joma D., Jakusonoka I., 2012), the major EIT payers in Latvia are small and medium enterprises, and the conditions of applying the EIT are the same for both large and small income enterprises, which is not socially fair. In many EU Member States, the progressiveness of enterprise income tax is based on support introduced for small and medium companies (in Belgium, France, Great Britain, Luxembourg, Lithuania etc.).

In such EU Member States as Italy, France, and others, different EIT rates are applied depending on a region in which a company operates. In the case of Latvia, on 1 September 2010 the micro-enterprise tax was introduced, the rate of which was 9% of annual turnover. It was an effective fiscal instrument to support small businesses during the crisis, especially in countries with high labour costs. This tax comprises all the taxes to be paid to the government on the condition that the turnover is less than LVL 70000 (EUR 99600), the number of employees is less than five, and the income of employees does not exceed LVL 500 (EUR 711) a month.

The author agrees with an opinion expressed by I.Leibus (Vitola I., Leibus I., Joma D., Jakusonoka I., 2012) – in order to ensure that the criteria set for micro-enterprises in Latvia do not limit the possibilities for increasing the turnover of a micro-enterprise, the number of its employees, and its income, it is necessary to elaborate one-year transitional provisions that would enable micro-enterprises to expand their business without raising their tax burden.

The proportion of direct tax revenues in the total revenue in the EU-27 is shown in Figure 5. In Latvia, labour taxes contribute to the largest proportion of tax revenues, although a reduction of the proportion of these taxes in the total revenue was implemented over the recent years – from 52% in 2009 to 50.8% in 2011. Labour taxes in Latvia, to a greater extent, reduce the real income level particularly for population groups with the lowest income, as incomes exempt from the PIT are very low. For example, persons living and working in Belgium and earning EUR 7000 (after paying social contributions) pay no income tax, whereas in Latvia a PIT of EUR 1680 has to be paid (Troch R., 2013).

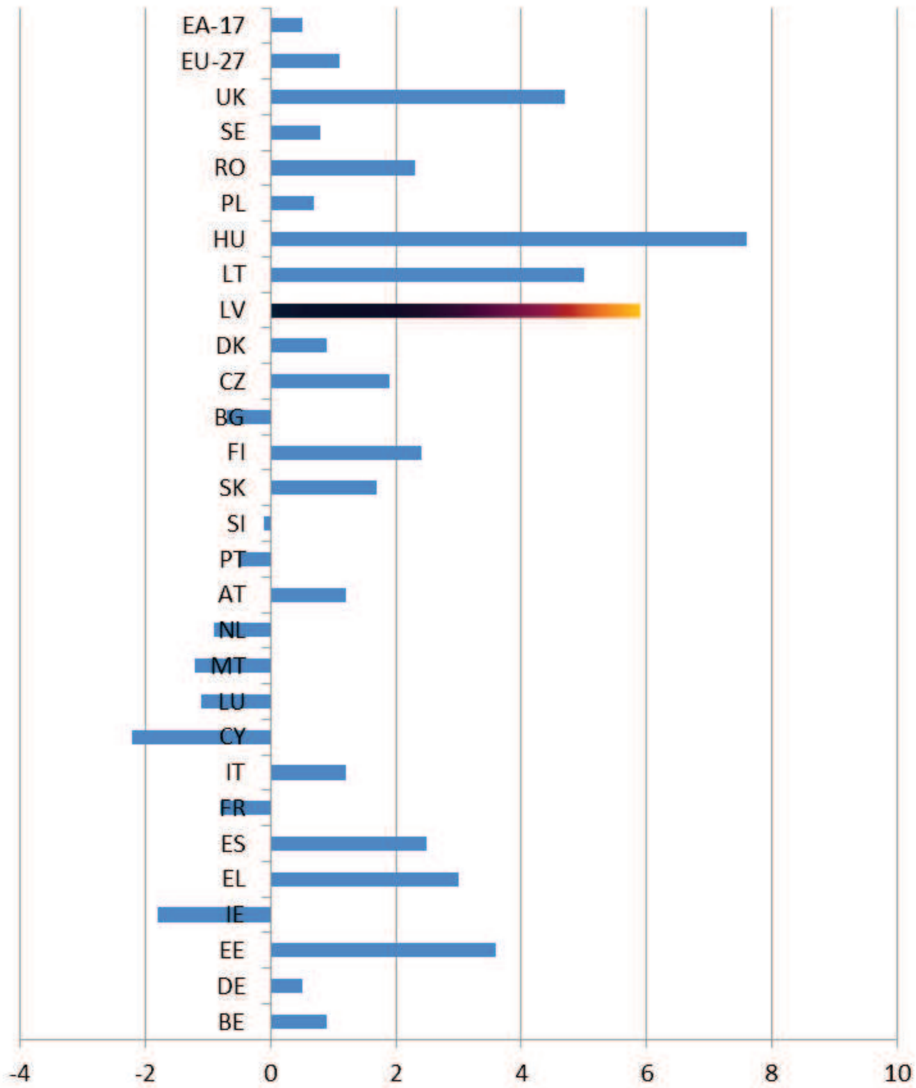
Along with the reduction of labour taxes, the overall tax system environment, its simplicity, predictability, and administration are not less important issues. According to the annual World Bank and Price Waterhouse Cooper study "Paying Taxes", three indicators are used to evaluate the ease of paying taxes: number of payments, time to be spent on complying with all tax laws and regulations, and costs – the total tax rate. In 2012, among all the countries included in the study, Latvia was ranked, based on these indicators, 11^{th}, 128^{th}, and 86^{th}, respectively.

In 2013 in Latvia, a company has to make 7 payments to pay all the taxes, 8 in Estonia, and 11 in Lithuania; the calculation and paying of taxes take 264 hours a year in Latvia, 85 in Estonia, and 175 in Lithuania; the total tax rate in Latvia is 36.6%, 67.3% in Estonia, and 43.7% in Lithuania (Paying taxes, 2013).

As regards the ease of paying taxes in 2012, in the PwC rating, Latvia was ranked 62^{nd}, Estonia 47^{th}, and Lithuania 57^{th} (Paying Taxes, 2012), whereas in 2013, Latvia's rating has considerably improved and Latvia was ranked 52^{nd}, Estonia 50^{th}, and Lithuania 60^{th} (Paying taxes, 2013).

In the period 2008-2012 in Latvia, in total, there were taken fiscal consolidation measures with a fiscal effect of 17% of GDP, of which 6.8% of GDP were composed of measures on the revenue side, while measures on the expenditure side accounted for 10.2% of GDP. In the period 2008-2012, on average per year, Latvia took fiscal consolidation measures accounting for 3.4% of GDP (Convergence Programme 2012-2015).

On 7 September 2011, the Ministry of Finance together with cooperation partners of the government: the Latvian Confederation of Employers, the Latvian Chamber of Commerce and Industry, the Farmers' Parliament, and the Latvian Association of Commercial Banks signed the



Source: author's construction based on European Commission (2011) Taxation …

Fig.5. **Changes in the proportion of direct taxes in the total tax revenue, percentage points (2001/2008)**

Table 2

Tax revenues in the national budget (ESA code S.13) and the tax burden in 2012-2015, mln LVL

Type of taxes and ESA code		**2012**	**2013**	**2014**	**2015**	**2015/2012 +/-**
		Forecast				
1.Taxes on production and imports	D.2	1 731.5	1 810.3	1 888.8	1 967.9	+236.4
2. Current taxes on income and property	D.5	1 109.0	1 160.3	1 213.1	1 268.4	+159.4
3. Taxes on capital	D.91	1.7	1.7	1.8	1.8	+0.1
4. Social contributions	D.61	1 292.2	1 243.1	1 256.6	1 318.6	+26.4
of which real social contributions	*D.611*	1 272.2	1 223.1	1 236.6	1 298.6	+26.4
Total tax revenue		4134.4	4215.4	4360.3	4556.7	+422.3
Tax burden, % of GDP		**28.3**	**27.3**	**26.7**	**26.3**	**- 2.0**

Source: author's calculations based on the data of Latvia's Convergence Programme 2012-2015

Tax Policy Strategy 2011-2014. The tax strategy was elaborated, taking into account the need to ensure the stability and predictability of its tax policy and to increase the competitiveness of Latvia's national economy as well as Latvia's intension to introduce the euro in 2014.

Latvia's fiscal policy for 2013-2015 is determined by several factors: a course towards a balanced government budget over the economic cycle, observance of the fiscal policy terms set by the Stability and Growth Pact (SGP), and economic growth measures to be implemented in the post-crisis period. The most significant measures affecting tax revenues in the period 2013-2015 will be: the reduction in the personal income tax rate from the present rate of 24% (in 2013) to 22% in 2014 and to 20% in 2015. According to Latvia's Convergence Programme 2012-2015, it is envisaged to reduce the tax burden to 26.3% of GDP in 2015 (Table 2).

To prevent from returning to a pro-cyclical policy and fiscal indiscipline, which contributed to the economic crisis, as well as to maintain fiscal sustainability in a medium-term, i.e. to develop a balanced general government budget for a medium-term, Latvia started working on introduction of the provisions of the Fiscal Discipline Law (FDL) that clearly states the following: the principle of counter-cyclical fiscal policy, fiscal balance as an instrument of counter-cyclical fiscal policy, transitional conditions for public debt, including compliance with the terms of the SGP, and requirements for monitoring and informing to ensure that fiscal rules are observed.

The Fiscal Discipline Law stipulates the framework for a multi-year budget and sets an expenditure ceiling of 2+1 years – every year it shifts one year ahead. Latvia has all the possibilities for making a fiscal policy that results in persistent and gradual reductions in its budget deficit, leading to a balanced government budget. The economic growth indicators of 2012 allow Latvia to design an optimistic development scenario, in which the nominal budget deficit in the period 2013-2015 is set at 1.4%, 0.8%, and 0.3%, respectively, of GDP (Informativais…, 2012). The enhancements in the tax policy have to be oriented towards improving Latvia's demographic situation, systematically and purposefully attracting foreign investments, and faster transferring the tax burden from labour to consumption.

Conclusions, proposals, recommendations

1. Although Latvia's total tax revenue as a percentage of GDP is one of the lowest in the EU, yet, it has a negative effect on the business environment, as the proportion of labour taxes in the total tax revenue is too high (50.8% in 2011), and, given the large social contributions to be made by employers, it significantly hinders Latvia's economic development and causes an increase in the grey economy as well as to a much greater extent reduces the real income level, particularly for population groups with the lowest income.
2. To prevent from returning to a pro-cyclical policy and fiscal indiscipline, which contributed to the economic crisis, as well as to maintain fiscal sustainability in a medium-term, i.e. to develop a balanced general government budget for a medium-term, Latvia started working on introduction of the provisions of the Fiscal Discipline Law (FDL) as well as implemented a series of measures oriented towards reducing the grey economy.
3. The enhancements in the tax policy have to be oriented towards improving Latvia's demographic situation, systematically and purposefully attracting foreign investments, and faster transferring the tax burden from labour to consumption.

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