

**ASSESSMENT AND POSSIBLE EXPANSION OF TAXES TRANSFERRED TO LOCAL
GOVERNMENT BUDGETS IN LATVIA**

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Abstract. The research aim is to assess taxes transferred to the budgets of local governments and to discuss possibilities for the expansion of tax revenues to be transferred to local government budgets. The research leads to the conclusion that the part of personal income tax deductions in local government budgets should be gradually increased up to 100% determining the personal income tax as local government tax thereafter. This could enhance the possibility to increase the financial independency and to strengthen the income base of local governments. The issue on the distribution of personal income tax by a place of work and not by a place of residence shall be solved in the future, thus, prescribing that the personal income tax is transferred to the budget of that local government in which territory the workplace is located. The immovable property tax should be determined as local government tax and the tax autonomy of local governments should be expanded through the possibilities to define taxable items and rates, and to plan the immovable property tax revenues. Since the promotion of economic performance in its administrative territory is one of the autonomous functions of local governments, it could be reasonable to link the local government budget with some of taxes (for example, corporate income tax), which are closely related with the economic performance. The expansion and diversification of taxes transferable to local government budgets would increase the level of financial autonomy, stability, and legal capacity of every local government.

Key words: local government budget, personal income tax, immovable property tax.

JEL code: H71; H72

Introduction

Tax attribution to a particular budget is a significant state activity which ensures transparency and purposefulness of the taxation policy. The tax distribution policy between the budgets in Latvia might be characterised as typically centralised, since the majority of taxes are transferred to the state budget. Only a small part forms the revenue source of local governments. Deductions from personal income tax, immovable property tax, lottery and gambling tax, and natural resources tax are transferred to the budgets of local governments.

The amount of financial resources being at disposal of local governments is one of the most debatable financial issues of local governments. The general opinion held by the local authorities is that the financial resources of local governments are insufficient for the implementation of functions delegated to local governments and prescribed by the legal and regulatory enactments.

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The research topicality and choice grounds on the wish to describe the taxes to be transferred to local government budgets and to analyse the possibilities to increase and diversify tax revenues transferred to local government budgets.

The research is based on the **hypothesis** that the increase and diversification of taxes transferred to local government budgets would maximise the level of financial autonomy, stability, and legal capacity for every local government.

The following research **aim** is defined to verify the hypothesis: to assess taxes transferred to the budgets of local governments and to discuss possibilities for the expansion of tax revenues to be transferred to local government budgets.

The following **tasks** are advanced to achieve the research aim:

- 1) to characterise the revenues and structure of personal income tax, immovable property tax, lottery and gambling tax, and natural resources tax;
- 2) to analyse the possibilities for the expansion of tax revenues to be transferred to local government budgets.

The monographic descriptive method, the methods of economic analysis and statistical data analysis are used for the research purposes. The research is based on the application of data on tax revenues of local governments from the Ministry of Finance of the Republic of Latvia and the State Regional Development Agency as well as the report on the increase and diversification of financial resources of local governments by the Ministry of Regional Development and Local Government Affairs (2010).

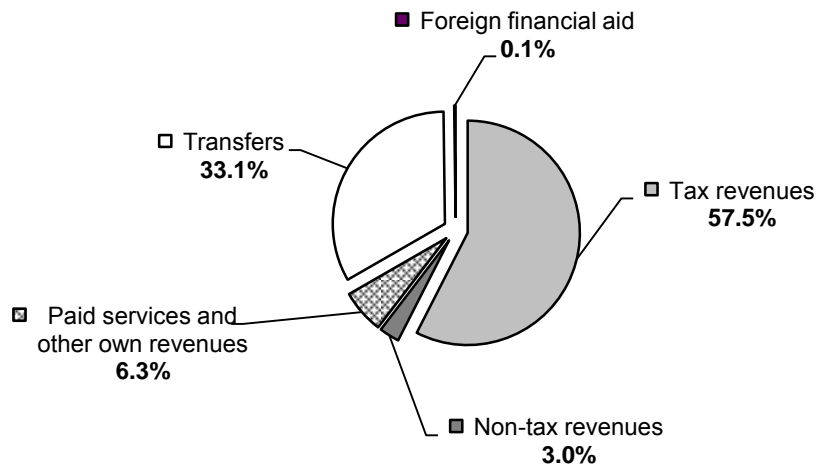
Research results and discussion

The budget volume of local governments is related with the sphere of competence delegated to local governments or functions, tasks and duties entrusted to them.

The reports of local government budgets on the basic groups of revenues consistent with the budget revenue classification comprise tax revenues, non-tax revenues, received payments, paid services and other own revenues, foreign financial aid, and transfers.

Figure 1 reflects the structure of local government basic budgets by the basic groups of reporting.

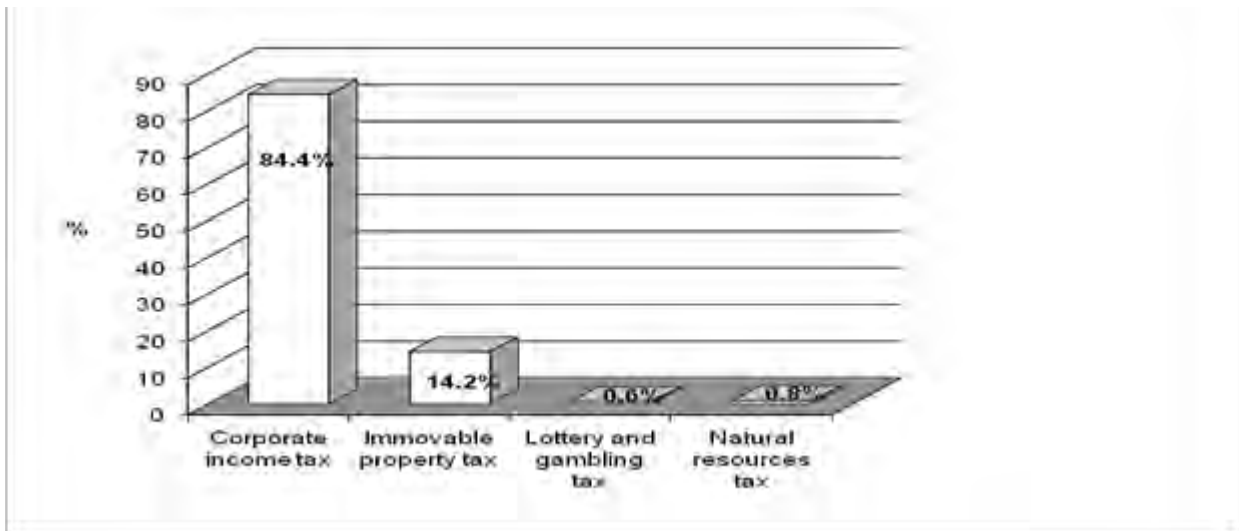
In 2012, the revenues of local government basic budgets amounted to LVL 1426.6 million. The largest volume of revenues was comprised by tax revenues - 57.5%, followed by transfers - 33.1%. Paid services and other own revenues amounted to 6.3%, non-tax revenues - 3.0%, and foreign financial aid - only 0.1% (Skaidrojums par pasvaldību..., 2013).



Source: authors' construction based on *Skaidrojums par pasvaldibu...*, 2013

Fig.1. Revenue structure of local government basic budgets in 2012

In 2012, total tax revenues of local governments amounted to LVL 825.9 million (*Kopsavilkums par pasvaldibu...*, 2012).



Source: authors' construction based on *Skaidrojums par pasvaldibu...*, 2013

Fig.2. Structure of tax revenues in 2012, %

The data of Figure 2 outline that the personal income tax revenues formed proportionally the largest part of tax revenues in 2012. Personal income tax is the main source of tax revenues (and at the same time it is also the main source of total revenues) for local governments, as it constitutes 84.4% of tax revenues and 48.9% of basic budget revenues. Immovable property tax accounts for 14.2% of tax revenues and 8.2% of basic budget revenues. The amount of lottery and gambling tax (0.6%) and natural resources tax (0.8%) revenues in the budgets of local governments is relatively small (*Skaidrojums par pasvaldibu...*, 2013).

Characteristics of personal income tax

The amounts of personal income tax are transferred to the local government budget of a taxpayer's place of residence and the state budget consistent with the breakdown prescribed by the annual law on the state budget.

According to the data of Table 1, the part of deductions from the personal income tax revenues for local governments has annually changed since 2005, when it reached the highest indicator of 83% in 2009. However, the share has been reduced to 80% from 2012.

Table 1

**The breakdown of personal income tax revenues by budgets for the period of 2005-2014,
% of total revenues**

Year	State budget	Local government budget
2005	27%	73%
2006	25%	75%
2007	21%	79%
2008	20%	80%
2009	17%	83%
2010	20%	80%
2011	18%	82%
2012	20%	80%
2013	20%	80%
2014	20%	80%

Source: *Nodoklu ienemumu sadalijums ...*, 2012; *Informativais zinojums "Par..."*, 2009

The number of persons employed at the national economy sectors, wages/salaries, the non-taxable minimum and the amount of tax reliefs as well as the minimum wage are the main factors impacting the revenues from personal income tax.

Table 2

Personal income tax revenues for the period of 2007-2012

Indicators	2007	2008	2009	2010	2011	2012
Personal income tax, total, mln LVL	888.0	1035.4	729.4	778.8	792.2	868.1
of which in the state budget	186.9	231.8	124.5	155.6	142.8	170.9
of which in the local government budget	701.1	830.6	604.9	623.3	649.4	697.2

Source: *Pasvaldibu finansu raksturojums...*, 2012; *Nodoklu ienemumu analize...*, 2013; *Skaidrojums par pasvaldibu...*, 2013

The data of Table 2 reveal that the revenues from personal income tax in local government budgets were LVL 604.9 million at the beginning of the economic downturn (decline in wages and employment rates) in 2009, while in 2008, the corresponding amount was LVL 830.6 million. This means that the personal income tax revenues in 2009 were respectively 27.2% smaller compared with 2008; the particular decline was also due to the reduction of the personal income tax rate from 25% to 23%. Even the reduction of non-taxable minimum from LVL 90 to LVL 35 per month (from 1 July 2009) could not compensate the essential decline in the personal income tax revenues. Regardless the adjustments made in the personal income tax administration in 2010 (reduction of the non-taxable minimum and increase of the tax rate from 23% to 26%) and 2011 (reduction of the tax rate from 26% to 25%), the increase of personal income tax revenues in local government budgets was relatively small. In 2011, the revenues

from personal income tax amounted to LVL 649.4 million which is LVL 181.2 million or 21.8% less compared with 2008 (Nodoklu politikas aktualitates, 2013).

In 2012, the personal income tax revenues in local government budgets were LVL 697.2 million or 7.4% more compared with 2011. Faster recovery of the labour market – the increase of employment, and wages and salaries - as well as the undertaken measures for the abatement of shadow economy explain the growth in personal income tax revenues.

Personal income tax revenues greatly differ by local governments. In 2012, the absolute volume of tax revenues in the territory of 119 local governments ranged between LVL 196 thousand (Baltinava county) and LVL 263.81 million (Riga). Though, the personal income tax revenues per capita ranged between LVL 121 (Riebini county) and LVL 526 (Marupe county) (Regionu attistiba Latvija ..., 2013).

Since the deductions from the personal income tax are transferred to the local government of a **taxpayer's place of residence, and a situation observed within the years of economic growth that a significant number of population decided to change their place of residence for living outside Riga and working in Riga** led to the result that the local governments of Pieriga where the economic activity was lower than in Riga produced the largest personal income tax revenues per capita simultaneously being the richest local governments (Skaidrojums par pasvaldibu..., 2013).

Revenues from personal income tax are considered in the financial equalisation calculations of local governments. Even after the equalisation, the tax revenues per capita of Pieriga local governments whose economy is based on the working places in Riga exceed the personal tax revenues per capita of Riga.

Frequent changes of the personal income tax revenue rate and uncertainty in the determination of the amount of tax deduction part to be transferred to local government budgets complicate the budget planning and development process of local governments which determine and substantiate the necessary amount of resources for the performance of their autonomous functions, tasks and voluntary initiatives. Therefore, the part of deductions from the personal income tax revenues in local government budgets should be gradually increased up to 100% and afterwards the personal income tax should be determined as local government tax to increase the financial autonomy of local governments and to strengthen their base of revenues.

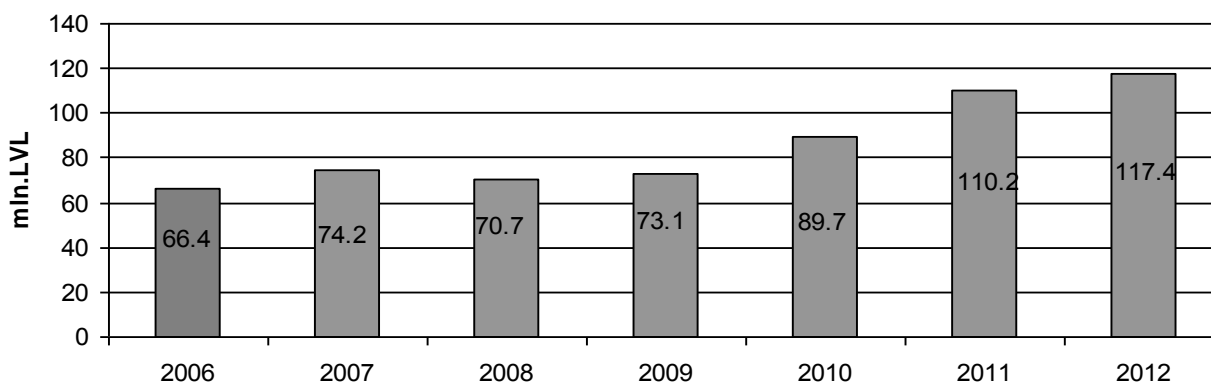
In future, the solution of an issue on the distribution of personal income tax by the place of work and not the place of residence is very significant, thus, determining that the personal income tax is transferred to the **budget of local government which locates the taxpayer's place of work**. The implementation of this recommendation and increase of the part of deductions from the personal income tax (without other changes) in favour of local governments may lead to the increase of contradiction on the promotion of economic activity and the discrepancies in the financial capacity of local governments. The increase of the part of deductions from the personal income tax in favour of local governments would not ensure the reduction of unfavourable differences which is the aim of regional policy. It would require also the change of tax equalisation mechanism.

Characteristics of immovable property tax

Immovable property tax is the only tax in Latvia, the revenues of which for 100% are transferred to the budget of the particular local government which administers the tax.

In Latvia, immovable property tax as instrument of the state fiscal policy underwent stagnation period up to the moment of crisis in the national economy (Vanags, 2011). In 2008, the general economic recession led to a considerable lack of financial resources and the financial crisis in Latvia.

In order to attract financial resources, the immovable property tax system was adjusted to the existing economic and political situation, and it underwent reforms.



Source: authors' construction based on Pasvaldību finansu raksturojums..., 2012; Nodokļu ienemumu analīze..., 2013; Skaidrojums par pasvaldību..., 2013

Fig.3. **Immovable property tax revenues for the period of 2006-2012**

The data of Figure 3 outline that the immovable property tax revenues in absolute figures produce an annual growing tendency. The decrease of the immovable property tax revenues in absolute figures was observed only in 2008. The change of immovable property tax rate for land from 1.5% to 1% of the cadastral value and the introduction of limitation for the tax increase in the amount of 25% explain the decrease in immovable property tax revenues. A significant growth in the share of immovable property tax in total tax revenues of Latvia is observed starting from 2010. In Latvia, the set of items taxable by the immovable property tax was broadened from 2010 – immovable property tax was levied upon residential buildings and engineering structures, and it also meant the introduction of a minimum payment of immovable property tax (LVL 5) as well as the immovable property tax rate for land was increased by 0.5% and an additional rate of 1.5% was introduced for unfarmed agricultural land. Reforms in the system of immovable property tax continued also in the following years. Immovable property tax rate for residential buildings was doubled to 0.2-0.6% of the immovable property cadastral value from 2011. An essential novelty in the administration process of immovable property tax has been introduced in Latvia from 2012. Under Section 46 of the law "On Local Governments", local governments had the rights to issue Binding Regulations which prescribed the rights to apply the increase of tax rate limitation in 2012 for land or retain the amount of tax for land at the rate of 2011 as well as to state whether the immovable property tax was imposed on auxiliary buildings and environment degrading constructions (Stucere, Mazure, 2012).

Starting from 2013, local governments are eligible to issue Binding Regulations for setting and administration of immovable property tax and to determine immovable property tax rates within the government set range from 0.2% to 3% consistent with the targets and needs of each local government. A limit of 1.5% is set for the tax rate fluctuations (from 0.2% to 3%) up to which local governments may voluntarily determine tax rates. The rate exceeding 1.5% may be levied only upon immovable property

which is not managed consistent with the procedure prescribed by the regulatory enactments, for example, hovels located in the territory of a local government and degrading the environment and endangering the population safety as well as unutilised agricultural area (Likums par..., 2012).

A range of the implemented changes in the immovable property tax system numerically outlines a 40% increase in immovable property tax revenues in 2012 compared with 2008. However, immovable property tax revenues in 2012 compose only 0.9% of GDP (Taxes in Europe, 2013). Therefore, an issue on the expansion of items taxable by the immovable property tax and the increase of tax rates should be solved in the future.

Generally, the immovable property tax is, to a great extent, a local government tax already now, since the immovable property tax is transferred to local government budgets (part of deductions - 100%). Local governments administer immovable property tax, they have the rights to set tax reliefs (this option is not characteristic of a state tax) and starting from 2013 local governments are eligible to determine tax rates within the limits set by the central government. Therefore, the immovable property tax should be determined as local government tax and the tax autonomy of local governments should be expanded through the possibilities to define taxable items and rates, and to plan the immovable property tax revenues.

Characteristics of lottery and gambling tax

The lottery and gambling tax is paid by companies which have received a special permit to organise and maintain lotteries and gambling consistent with the law "On Lottery and Gambling Duties and Tax". Revenues from the lottery and gambling tax in the amount of 75% are transferred to the state basic budget and 25% of the revenues are transferred to the budget of a local government which territory locates the place for organisation gambling. Revenues from the state scale lottery tax are transferred to the state basic budget, while the revenues from the local scale lottery tax are transferred to the budget of a local government which territory locates the place for organisation the lottery.

Table 3

Lottery and gambling tax revenues for the period of 2007-2012

Indicators	2007	2008	2009	2010	2011	2012
Lottery and gambling tax, total, mln LVL	29.7	29.9	25.1	15.3	16.1	19.4
of which in the state budget	22.4	22.8	20.1	11.6	12.2	14.8
of which in the local government budget	7.3	7.1	5.0	3.7	3.8	4.6

Source: Pasvaldibu finansu raksturojums..., 2012; Nodoklu ienemumu analize..., 2013; Skaidrojums par pasvaldibu..., 2013

The amount of revenues from the lottery and gambling tax is relatively small, and it accounts for 0.6% (in 2012) of all tax revenues. In addition, this tax is more characteristic to urban local governments, and there is a set of local governments producing no revenues from the lottery and gambling tax.

According to Table 3, the largest lottery and gambling tax revenues were observed in 2007 and 2008. Revenues from the lottery and gambling tax significantly decreased between 2009 and 2011. In 2010, the lottery and gambling tax revenues reached the lowest figure of LVL 3.7 million which is by 97% less compared with 2007. The impact of the general economic situation on the sector of lotteries and

gambling and the effectiveness of requirements for the certification of slot machines explain the decline in these revenues.

In 2012, the lottery and gambling tax revenues increased by LVL 0.8 million or 21% compared with 2011. This increase coincides with the general recovery of the state economic activity.

It would be necessary to increase the lottery and gambling tax rates to maximise the budgetary revenues of local governments. These changes would be favourable to the society, since they reduce dependency risk on gambling and limit the development of gambling in the country.

Characteristics of natural resources tax

Payments of the natural resources tax are directly related with the economic activities of Latvian companies and the environmental load caused by them. Therefore, the natural resources tax revenues increase with the increase of the general economic activity and decrease with the slowing down of the activities of companies and local governments undertaking environmental protection measures. Revenues from the natural resources tax are transferred to the state basic budget and the special budget of local governments (Nodokļu politikas aktualitātes, 2013).

Tax payments for the extraction or use of natural resources or environmental pollution within the amounts specified by the limits are transferred in the amount of 60% to the special environmental protection budget of such local government in the territory of which the relevant activity is performed. Tax payments for: the utilisation of useful characteristics of the subterranean depths by pumping natural gas or greenhouse gases into geological structures are paid into the special environmental protection budget of such local government in the territory of which the relevant activity is performed (if the activity takes place in the territory of several local governments – proportionally to the territory utilised); the use of radioactive substances to the amount of 100% are paid into the special environmental protection budget of such local government in the territory of which the radioactive waste disposal site is located (Dabas resursu nodokļa..., 2013).

Revenues from the natural resources tax are relatively small in local government budgets, they account for less than 1% of all tax revenues.

Table 4

Natural resources tax revenues for the period of 2007-2012

Indicators	2007	2008	2009	2010	2011	2012
Natural resources tax, total, mln LVL	10.4	11.1	10.8	8.7	10.4	13.6
of which in the state budget	7.6	8.0	8.4	5.4	5.6	6.9
of which in the local government budget	2.8	3.1	2.4	3.4	4.7	6.7

Source: *Pasvaldību finansu raksturojums...*, 2012; *Nodokļu ienemumu analīze...*, 2013; *Skaidrojums par pasvaldību...*, 2013

The data of Table 4 reveal that the revenues from the natural resources tax had a tendency to increase every year. Decline in the particular tax revenues was observed only in 2009 when the tax revenues amounted to LVL 2.4 million or 29% less compared with 2008. The decrease in the natural resources tax revenues might be explained by the decline of the economic activity and measures of local governments undertaken in the sphere of environmental protection.

The highest peak of the particular tax revenues, i.e. LVL 6.7 million, was reached in 2012 which was by LVL 2.0 million or 42% more compared with 2011. The increase in the natural resources tax revenues is related with the growth of the general economic activity.

It is recommended to increase the share of the natural resources tax revenues paid to local government budgets on the extraction (use) of natural resources or environmental pollution. This would enhance more efficient activities of local governments for the limitation of environmental pollution in their territories and ensure financial assistance in undertaking environmental protection measures.

Possibilities for the expansion of taxes transferred to local government budgets

Since the promotion of economic activities in the territory of particular local government is one of the autonomy functions of local governments, it would be reasonable to link the local government budget of any of taxes which are directly related with the economic activity and to determine a certain part of tax revenues as deductions for local governments. In Latvia, this could be the corporate income tax.

Corporate income tax as direct tax is more related with the territory; though, this relation is not unequivocal. The inquiry of information on taxpayers regarding the attribution of tax to the territory of economic activity may cause certain difficulties and additional burden to those companies which have several places of activity (main office, structural subdivisions) and mobile activity. In addition, a direct linking of this tax to the territory of a particular local government would increase regional disparities in the country, as, for example, 55% of all individual merchants and commercial societies of Latvia operate in Riga (Regionu attistiba Latvija..., 2012).

At the same time, it would be essential for the entire municipal sector to consider the changes of economic activity indicators in their revenues. Therefore, the payment of a certain part (for example, 1-5%) of the corporate income tax into the financial equalisation fund of local governments could be an optimal solution. Hence, the economic activity in the local government, for example, the number of registered companies and structural subdivisions, is considered for the money redistribution purpose.

An independent budget and rights to determine local taxes and duties is one of the features characterising the essence of local governments. Also, the European Charter on Local Self-government envisages that at least part of financial resources of local authorities shall be gained from the local taxes and charges which rates the local government is eligible to determine within the limits prescribed by the law. Local government taxes ensure the possibility to adjust the level of expenditure to the local needs and choice. The responsibility of local authorities on the spending of financial resources is larger if they determine tax amount paid by the population or legal entities. The expansion and diversification of taxes transferred to local government budgets would increase the level of financial autonomy, stability and legal capacity of every local government.

Conclusions, proposals, recommendations

1. To increase the financial independency and to strengthen the income base of local governments, the part of personal income tax deductions in local government budgets should be gradually increased up to 100% determining it as local government tax thereafter.

2. The increase of the part of deductions from the personal income tax in favour of local governments would not ensure the reduction of unfavourable differences which is the aim of regional policy. It would require also the change of tax equalisation mechanism.
3. The issue on the distribution of personal income tax by a place of work and not by a place of residence shall be solved in the future, thus, prescribing that the personal income tax is transferred to the budget of that local government which territory locates the workplace.
4. Generally, the immovable property tax is, to a great extent, a local government tax already now, since the immovable property tax is transferred to local government budgets (part of deductions - 100%). Local governments administer immovable property tax and they have the rights to set tax reliefs (this option is not characteristic of a state tax) as well as starting from 2013 local governments are eligible to determine tax rates within the limits set by the central government. Therefore, the immovable property tax should be determined as local government tax and the tax autonomy of local governments should be expanded through the possibilities to define taxable items and rates, and to plan the immovable property tax revenues.
5. It would be necessary to increase the lottery and gambling tax rates to reduce dependency risk on gambling, limit the development of gambling in the country and enlarge budgetary revenues from taxes.
6. It is recommended to increase the share of the natural resources tax revenues paid to local government budgets on the extraction (use) of natural resources or environmental pollution. This would enhance more efficient activities of local governments for the limitation of environmental pollution in their territories and ensure financial assistance in undertaking environmental protection measures.
7. Since the promotion of economic activities in the territory of particular local government is one of the autonomy functions of local governments, it would be reasonable to link the local government budget of any of taxes which are directly related with the economic activity and to determine a certain part of tax revenues as deductions for local governments. The corporate income tax could be one of such taxes, part of which could be deducted and paid into the budgets of local governments simultaneously prescribing that the corporate income tax revenues are included into the financial equalisation calculations of local governments.
8. An independent budget and rights to determine local taxes and duties is one of the features characterising the essence of local governments. Therefore, local government taxes should be introduced in Latvia. Local government taxes ensure the possibility to adjust the level of expenditure to the local needs and choice. The responsibility of local authorities on the spending of financial resources is larger if they determine tax amount paid by the population or legal entities.
9. The expansion and diversification of taxes transferred to local government budgets would increase the level of financial autonomy, stability, and legal capacity of every local government.

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