

THE EVALUATION OF MICROENTERPRISE TAX REGIME EFFICIENCY IN LATVIA

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Abstract. The primary goal of the article is to study the effect of the single tax introduction for the microenterprises in Latvia. The major aspects affected by the new regime introduction studied in the present article were net registration of microenterprises, the employment level in the country, the budget revenues. The tax benefits and exemptions available for microenterprises in Estonia, Latvia and Lithuania are considered in the article, too. The results of the research indicate that the largest number of tax exemptions for micro-entrepreneurship are available in Latvia. Besides, it was discovered that Latvian tax system is characterized by the lowest level of tax harmonization towards micro-entrepreneurship and the lowest level of the tax neutrality. Existing MET regime was not admitted to be efficient with regards to its impact on the researched aspects. The need for Latvian tax policy change with respect to the microenterprises is substantiated in article.

Keywords: tax regime for microenterprises; tax policy development for microenterprises; taxation of microenterprises in Latvia and Baltic states.

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Introduction

The tax policy exerts a major influence on the entrepreneurial activity (OECD, 2004; Huizinga, Laeven, 2008). Tax policy is able to motivate or demotivate entrepreneurial activity, investment activity and company development (Dickinson, P., 2013; Prohorovs et al., 2016). According to Carter (2013), the strategy in relation to the taxation of the micro, small and medium-sized enterprises is of the outmost importance in the overall tax architecture. Ang (1991) states that micro, small and mid-enterprises are too heterogeneous to consider them as one category of enterprises. Carter (2013) believes that the enterprises, which can be classified as micro-enterprises (ME), are not homogeneous as well (not only classical limited liability companies but also other types of small businesses, which comply with European classification (EC, 2008), are considered as ME in this article). ME undoubtedly form the largest group of enterprises according to the quantity. The share of ME in Europe is 92.2 % (Wymenga et al., 2012), while in Latvia 89 per cent of companies are ME (Prohorovs, Beizitere, 2015), which is 3.2 % lower than in Europe. Based on this, it can be assumed that under certain conditions, which would include also efficient tax system built-up towards ME, there is a potential in Latvia to

increase the quantity and the share of ME in the total number of the enterprises.

Almost every company begins its activity as ME. Besides, ME exert significant impact on the economy development, present and future state budget revenues and expenditures, social policy. Accordingly, the selection of the correct approach to the development of tax policy in relation to the ME plays a major role.

In 2010, a new tax regime for the microenterprises, having the turnover of less than 100 thousand euro and employing less than 5 employees, was introduced in Latvia. Microenterprises were charged with 9 % (12 %/ 15 % in 2017) single turnover tax. The companies are exempt from making social contributions and personal income tax payments for employees. However, as admitted by the government of Latvia, MET regime does not provide sufficient social security to the people employed by the microenterprise (Mikrouznemumu nodokļa likums, 2010). Therefore, the main goal of the present article is to research the impact and the efficiency of the microenterprise tax (MET) regime introduced in Latvia in 2010.

It is well-known that a new tax policy in relation to ME has to be developed in 2017 (Delfi bizness, 2016). To be able to correctly define the new tax rates, exemptions and tax benefits

within the tax policy for ME, it is crucial to determine approaches to the development of tax policy for ME and other forms of micro-entrepreneurship in Latvia taking into account the local specifics.

To achieve the stated goals authors of the present paper primarily employed the methods of comparative analysis and descriptive statistics.

Based on the obtained results the authors conclude that the problems associated with MET regime outweigh the benefits it provides and, therefore, its efficiency is minor.

Scientific contribution of the article is the analysis of fiscal policy efficiency in Latvia, Lithuania and Estonia in relation to micro enterprises, analysis of the MET regime efficiency in Latvia, as well as recommendations for improving tax policy in relation to micro and small enterprises in Latvia.

Literature review

Main factors influencing the development of tax policy for microenterprises

The way the tax system affects the small (and medium-sized) enterprises and tax legislation compliance issues by these companies since a long time are of central importance both for the economic policy authorities and the tax authorities (Carter, 2013). According to Makedonskiy (2005), an important task of the state is to create an economic environment favourable to all kinds of socially important entrepreneurship. He believes that when developing tax policy one should take into account the features, specifics and particular needs of groups of companies, which do not apply the general tax regime. Carter (2013) considers that to assess the successes and failures of the existing tax policy in relation to the small business, one needs to conduct a comprehensive analysis of the causes and possible consequences when developing the new tax policy applicable for the particular conditions. He believes that a thorough analysis of the taxpayers has to be done: for which groups and to what extent simplified regime is required.

Makedonskiy (2005) states that it is appropriate to use a fixed tax regime and relatively simple rules for the calculation and payment of tax for those type of companies (and individuals) that often avoid regular taxation. Carter (2013) considers that the abuse of the use of the simplified tax regimes is a serious problem, since the tax regime established for small (and medium-sized) businesses, affects the overall operation of the tax system, also in the context of tax neutrality and fairness. He notes that the tax system of micro, small and medium-sized enterprises also affects the level of the shadow economy and business growth opportunities. According to Makedonskiy (2005), the largest scale of informal economic activities and tax evasion is most common in developing countries, but in recent decades, this trend is similar for countries with economies in transition. Carter (2013) also believes that in many developing countries, the majority of small and medium-sized enterprises, and in particular ME, are to a greater or lesser extent operating in the shadow economy. According to him, informality among the above listed groups of companies is fairly widespread in many countries with an average income level. Makedonskiy (2005) believes that the essential factors for configuration and operation of the tax system are relative size of the shadow economy, the level of corruption (also by the tax authorities) and the consent of the taxpayers to comply with tax laws. Carter (2013) states that developed countries, in the framework of a long-term strategy aimed at stimulating taxation on the basis of the financial reporting, gradually restrict the application of special tax regimes. He believes that poorly designed tax policy in relation to the small business, as well as the improper tax administration can result in serious leakage of tax revenues and social security contributions. According to him, in some cases, tax exemptions and benefits are not offset by the benefits of the state and society in terms of increased economic

growth, employment and productivity of small (and medium-sized enterprises).

The reasons for the possible differences in the approaches to the taxation of various types of micro-enterprises

Maikilijs and Robertss (2012) believe that when analysing and the developing tax policy, it is important to take into account the heterogeneous nature of enterprises, which is characteristic for ME. According to Carter (2013), ME are the companies that are unlikely to have incomes above the personal tax threshold (above the subsistence level). Such enterprises are likely to be a family business and, as a rule, do not hire employees. While in accordance with the European classification, ME is an enterprise, which employs fewer than ten employees, its value of net turnover (per year) or the sum of the total assets should not be equal to or be greater than € 2 million (European Commission, 2008).

According to Carter (2013), taking into account significant level of ME heterogeneity, there is a great diversity both in the theoretical approaches and approaches in different countries towards the design and operation of a simplified tax regime for small businesses (Carter, 2013). He states that none of the simplified regime models is suitable for all cases. Carter (2013) finds that in fact many countries are struggling with the trade-off between system simplicity and fairness, as well as the ease of tax burden for particular ME activities. According to Carter (2013), ME sector and small businesses in any country includes street vendors, who barely reach the income of subsistence level, highly paid professionals, companies with a substantial net turnover, as well as innovative start-ups and other types of enterprises. Based on these facts, Carter (2013) considers that an important factor for the proper tax policy design is a thorough understanding of the significant heterogeneity of ME (and small businesses) in different countries.

Rationale for the introduction of tax exemptions and benefits for small businesses

According to Carter (2013), in many countries the emphasis is put on the development of small (and medium) enterprises due to the fact that small business is a source of employment, innovation and economic growth. According to OECD data (2015b), promotion of small business is an effective mean of creating jobs and reducing poverty. According to Carter (2013), exemptions and benefits may take the form of reduced tax rates, tax holidays for start-ups, special tax incentives for hiring labour or investing in R & D.

The analysis of the current situation shows that in many countries there are different forms of exemptions and benefits for small businesses. The US Congressional Research Service, (2002) points out that tax incentives should be aimed at promoting a certain type of behaviour of a particular group of taxpayers or at assisting taxpayers in certain circumstances. Toder et al. (2002) believe that the introduction of tax benefits and exemptions must be accompanied by justification, which provides the answers to the following questions: why the introduction of a specific tax credit in fact is necessary; what goals targets the introduction of tax benefit, and how to evaluate the success or failure of this measure; what can become an evidence that the introduction of tax incentives would achieve stated objectives at an acceptable cost; why the introduction of tax benefits is better than the direct budget expenditure to achieve stated objectives. Hungerford (2006) finds that the tax expenditures are an important source of fiscal support, and are used to achieve a variety of economic and social objectives. He believes that the provision of tax benefits and exemptions can be justified if they are: smoothening market failures; aimed at solving urgent problems; not introducing unnecessary complexity to the tax legislation; not distorting the behaviour of economic agents; more effective as judged based

on the comparison of costs and benefits than the programs creating direct costs. Malinina (2010) points out that the introduction of tax incentives and benefits, as well as the tax exemptions, not only has a direct effect, which results in the tax revenue reduction, but also has an indirect effect, which is much more complicated and not always appears to be a loss to society. Altshuler and Dietz (2008) found that the use of tax incentives

aims at addressing specific problems, such as investments for economic growth.

Research and Discussion

Taxation of microenterprises in Baltic countries

To start with, we would compare the tax policies applied to different forms of ME in the Baltic States, and consider the main benefits and exemptions in the taxation in Latvia, Lithuania and Estonia (Table 1).

Table 1

The main benefits and exemptions in the taxation of various forms of micro-enterprises in the Baltic States

Country/Type of benefits and exemptions	Latvia	Estonia	Lithuania
Personal income tax and social security contributions exemptions and benefits	Very significant reductions exist	Almost no reductions (Unemployment tax for the owner is reduced from 1.6 % to 0.8 %)	Individual merchant is eligible to pay social contribution taxes by 5 percentage points less than the standard rate
VAT thresholds	Less than 50 000 EUR	Less than 16000 EUR	Less than 45000 EUR
Benefits and tax exemptions applied in calculation of corporate income tax (CIT)	No other exemptions except for MET regime, Individual Merchant (IM), Individual Company (IC), Sole proprietor/self-employed	Reinvested profit is not taxed (regardless of the turnover)	The tax rate for micro enterprises with a net turnover of less than 300 million euro is set at 5 %, provided that this is the only business of the owner (and his family)

Source: author's compilation based on *Business Guide Lithuania, 2016; Sorainen, 2015*

Comparing tax policy in the Baltic States with respect to various forms of small business, we can state that as of 1 January 2017 in Latvia there was the most liberal tax policy in relation to ME (with not more than 5 employees and a net turnover of up to 100 thousand euro) in the Baltic countries. Our opinion is based on the following facts. First, the highest threshold for VAT is in Latvia. Second, starting with 2010 ME in Latvia can operate under single (imputed) tax policy, which is not the case in Lithuania or Estonia. Third, ME operating under MET regime are eligible to pay very limited amount of payroll taxes, which are several times lower than the same payments made by the similar companies in Lithuania and Estonia. It can be noted that in Latvia there is not just the most liberal of the three Baltic countries, tax policy in relation to various forms of micro-enterprises, but also that this policy is significantly more liberal than the existing tax policy in Estonia and Lithuania in

relation to ME with a turnover of up to 100 thousand euro and not more than five employees. However, we noted that there is completely the opposite relation seen through the taxation policies towards the micro-enterprises with a turnover or balance sheet value of up to 2 million euro and employing less than ten people. The best tax conditions for this ME category are detected in Estonia. First, in Estonia since 2000, all categories of enterprises have a deferred CIT payment prior to the distribution of profits to dividends. Second, Estonian companies are not obliged to make CIT advance payments, which leaves at their disposal more financial resources. Third, if the ultimate beneficiaries of the Estonian enterprises are individuals - residents of Estonia, then, unlike the situation in Latvia, they do not pay income tax on dividends. According to Prohorovs et al. (2016), as a result of these three factors, provided the distribution of 30 % of profit to dividends, Estonian companies have

64 % of profit left over at their disposal. In contrast, Latvian enterprises are left with 37 % of the profits. Prohorovs et al. (2016) believe that the introduction of the CIT deferred payment prior to the profit distribution has a very positive impact on the financial performance of Estonian companies, primarily of the small enterprises. In addition, the introduction of the deferred CIT payment reduced the level of shadow economy in Estonia and increased tax revenue in the state budget. Fourth, according to Dombrovskis (2016), the payroll costs of Estonian enterprises are a few percentage points lower than in Latvia. At the same time, Estonian tax system remains neutral to all categories of taxpayers. In Lithuania, there are two advantages offered by the tax policy in relation to the ME. First, for the companies with a turnover of 300 million euros and less preferential CIT rate of 5 % is set (Sorainen, 2015). Second, Lithuanian individual companies have to pay taxes on labour by almost 5 percentage points lower than the rest of Lithuanian companies has to pay.

In our view, exactly ME, which have an annual turnover of more than 100 thousand and a greater number of employees than 5 people can have a significant potential for further development, as well as these firms are more promising to support country's economic growth and to increase tax revenues. It is also true that they proved their viability and ability to develop as they were able to reach turnover and employee number, which exceed MET regime criteria. On the basis of the data obtained from the Lursoft, we calculated the number of registered in Latvia ME, which comply with the criteria of ME defined by EU but which do not operate under MET regime. As of 1 January 2015, 66826 limited liability companies registered in Latvia corresponded to the EU criteria for ME but did not have the ability to use MET regime. Analysis of the data shows that, in contrast to Estonia, as well as to a large extent in contrast to Lithuania, 72.6 % of ME in Latvia do not have

any tax exemptions and benefits. According to the State Revenue Service of Latvia, as of 1 January 2015, 6236 limited liability companies moved from MET regime to the general tax regime. 22.4 % of the limited liability companies that have used the MET regime gained the potential for further development and switched to regular taxation. And for these ME, and the rest of ME complying with EU classification the current tax policy in Latvia does not provide for benefits and exemptions unlike for similar ME in Estonia and Lithuania. In our opinion, when providing tax exemptions and benefits the principle of continuity, or the so-called escalation principle for more "senior" ME categories and for small businesses, and, perhaps, medium-sized businesses must be in place. In Latvia, unlike in Lithuania, and especially in Estonia, the continuity principle (or "escalator") of tax support for the ME growth is not implemented.

The analysis of the tax benefits and exemptions applied in the three Baltic countries, allow us to conclude that the tax policy of Estonia is the most consistent with the principle of tax neutrality with respect to the taxpayers and ME, primarily due to the introduction of deferred CIT payment until the profit distribution.

It can be assumed that as a result of the tax neutrality principle implementation in relation to all groups of companies and the introduction of deferred CIT payment, which stimulates the development of enterprises, Estonia demonstrates higher rates of tax collection per capita and the highest number of the enterprises per unit of population, given that there are no other tax exemptions and benefits for ME and for Estonian workers.

The evaluation of MET efficiency in Latvia

We would bring forward several aspects, which were affected by the introduction of MET in 2010 considering entrepreneurial activity in the country, employment level, budget revenues.

Let us consider the facts we have presented in Table 2 on the basis of data obtained by us from

the State Revenue Service (SRS) of Latvia on 3 August 2016. As seen from the data, in the first year after MET regime introduction, it was mainly

(over 70 %) used by the limited liability companies, which complied with MET criteria.

Table 2

Data of net registration of business forms operating under MET regime in Latvia

MET payers	2011		2012			2013			2014			2015		
	Quantity	Structure	Quantity	Structure	Dynamics	Quantity	Structure	Dynamics	Quantity	Structure	Dynamics	Quantity	Structure	Dynamics
Individual Merchant	498	5 %	269	4 %	-46 %	207	3 %	-23 %	132	2 %	-36 %	101	1 %	-23 %
Individual Company	61	1 %	7	0 %	-89 %	0	0 %	-	19	0 %	-	-8	0 %	-142 %
LLC	7 478	70 %	5 178	70 %	-31 %	4 613	68 %	-11 %	3 509	44 %	-24 %	2 303	32 %	-34 %
Self-employed (Saimnieciskās darbības veicējs)	2 592	24 %	1 893	26 %	-27 %	1 993	29 %	5 %	4 372	54 %	119 %	4 735	66 %	8 %
Total	10 629	100 %	7 347	100 %	-31 %	6 813	100 %	-7 %	8 032	100 %	18 %	7 131	100 %	-11 %

Source: authors' calculations based on the States Revenue Service data from 3 August 2016

The share of individuals operating as self-employed (saimnieciskās darbības veicējs) was 24 % in total amount of entities operating under MET regime. For several years, the share of self-employed persons relative to the overall net registration forms with MET regime more than doubled to 54.4 % in 2014 and to 66.4 % in 2015. In turn, the share of limited liability companies operating under MET regime relative to the overall net registration forms decreased from 70 % in 2011 to 43.6 % in 2014, and in 2015 to 32.2 %. The share of limited liability companies has become two times less than the share of individuals in 2015. It has to be noted that as of 1 January 2016 the share of the limited liability companies was 58.3 % of the total entities operating under MET regime, according to the State Revenue Service of Latvia. The share of individual entrepreneurs amounted to 3.6 per cent, the share of individual businesses totalled 0.5 %, while the share of individuals (self-employed) was demonstrating annual increase and reached 37.4 % in the beginning of 2016.

The reported trend shows that, since 2014, the MET regime started to be used mainly by the private persons, whose activity is not (or not

completely) defined as entrepreneurship. It can be assumed that the substantial part of the self-employed operating under MET regime have chosen this mode in order to reduce the payment of personal income tax and social security contributions. The Law on Microenterprise Tax, which came into force in Latvia on 1 September 2010 (Mikrouzņēmumu nodokļa likums, 2010) states that the regime applies not only to Individual Merchant, Individual Company, agricultural or fish company, to a limited liability company, complying with the relevant ME criteria, but also to the self-employed. But in the Law on Microenterprise Tax, introduced in 2010, the main goal was not stated. On 13 May 2015, an addition has been made stating the purpose of the Law: the law aims to reduce the administrative and tax burden on micro-enterprises, especially in the business' start-up period, as well as on the sectors with low-income potential, while respecting the society's general interest in fair competition and social security. On the basis of the goals of the Law adopted in this edition, it is not obvious that in addition to ME, the law should apply also to the self-employed (saimnieciskās darbības veicējs), since they are

in fact not ME. Besides, the operating activity of individuals does not fully reflect the essence of the entrepreneurship and, as a rule economic activity of private persons is not aimed at the significant future business growth and, therefore, does not need to attract financial resources from external sources to finance business growth. In this case, the beneficial taxation of this group of individuals should be aimed at reducing the poverty level (Carter, 2013). One of the goals Law on MET targets is the society's general interest in fair competition and social security. If guided by this provision of the Law, MET benefits can be applied only to individuals, which belong to the socially vulnerable groups of the population with low income. One can conclude, based on the goal of the Law to apply MET during the start-up phases of the business, that the duration of the preferential ME tax treatment can/should be limited. However, as of 15 January 2017, the above mentioned provisions of the Law were not changed. It should be noted that neither in Lithuania, nor in Estonia there are similar to MET tax regimes, according to which individuals are exempt from social security contributions and personal income tax (Table 1).

In our opinion, as well as, in the opinion of Toder et al. (2002), it is necessary to regularly compare the positive and negative effects of preferential tax regimes (MET) and their impact on economic growth and population's welfare. Evaluation of the effectiveness of tax policy should be in short-, medium and long-term and, if necessary, change the direction and the form of tax support (of micro-entrepreneurship). Another application area of the Government's efforts to increase the number of taxpayers is to reduce the impact of factors negatively affecting the tax morale of the taxpayers. According to Makedonskiy (2005), these factors include the relative size of the shadow economy, the level of corruption (also related to the tax authorities) and the consent of the taxpayers to comply with tax laws.

So, the next dimension of the MET efficiency evaluation is its impact on the formal employment stimulation (and the impact of tax fairness on the rate of formal employment and on the ratio of the employees to the number of residents in the Baltic states) (Table 3).

Table 3

The share of employed in the total population in the Baltic countries during the 2006-2015

Country	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Estonia	46.5 %	47.1 %	47.3 %	42.9 %	41.2 %	43.8 %	44.7 %	45.3 %	45.6 %	46.6 %
Latvia	44.7 %	46.2 %	46.3 %	40.9 %	39.5 %	40.8 %	41.9 %	43.1 %	43.1 %	43.9 %
Lithuania	43.0 %	44.0 %	43.7 %	40.8 %	39.5 %	40.5 %	41.6 %	42.7 %	43.9 %	44.8 %

Source: authors' calculations based on Eurostat data

In Latvia, in 2014-2015 the ratio of employed to the total population was the lowest among the Baltic countries. In 2015, the share of employed in Latvia in relation to the population size was 2.74 percentage points lower than in Estonia and almost 1 percentage point lower than in Lithuania. Although in 2007 and 2008, the share of employment in Latvia was just 1 percentage point lower than in Estonia and more than 2 percentage points higher than in Lithuania. Since 2011 and through to 2015, an increase in the

growth of employment in Latvia and Estonia was about 3 percentage points. Increase of the proportion of employed in the population in Lithuania for the period was 1.2 percentage points higher than in Latvia.

However, Lithuania and Estonia did not introduce during this period any benefits and exemptions for ME or other groups of companies. Based on our analysis, we can conclude that MET regime introduction in Latvia did not increase the employment rate. Moreover, of the three Baltic

countries, Latvia is the only country, where the ratio of employed to the population has not reached the level of 2006. This can be explained by the lack of the effective and acceptable to the taxpayers tax policy, low tax fairness and, as a result, a lower level of tax moral of the potential taxpayers in Latvia. Lower tax moral and higher level of the shadow economy in Latvia was confirmed by Putnins and Sauka (2015). If Latvia was able to engage in the employment the same share of population as in Estonia, then more than additional 50 thousand people would take part in the contribution to the state budget and social security payments.

Based on our analysis, it can be assumed that the increase in the number of self-employed in Latvia in the period from 2011 to 2015 could have occurred mainly due to the introduction of MET regime, which significantly decreases the tax burden for the self-employed.

When analysing efficiency of the MET introduction, budget revenues cannot be ignored. Table 4 presents the data on growth of the tax collection and GDP growth prior to and post MET introduction. MET introduction primarily affected the payroll taxes (personal income tax and social contributions), which posted lower growth during the period from 2010 to 2015 as compared to GDP.

Table 4

**Growth rate of GDP and four main taxes collection during the 2006-2015
(year over previous year)**

GDP and taxes	2008	2009	2010	2011	2012	2013	2014	2015	2010-2015	2007-2015
Real GDP growth	8 %	-22.7 %	-4.7 %	13.0 %	7.8 %	4.2 %	3.7 %	3.1 %	36 %	7.8 %
VAT	-11 %	-27.9 %	7.5 %	14.7 %	15.7 %	7.0 %	5.5 %	5.0 %	57 %	8.3 %
Personal income tax	13 %	-31.0 %	10.0 %	2.2 %	12.1 %	4.3 %	5.7 %	3.4 %	30 %	11.9 %
CIT	27 %	-60.0 %	-40.2 %	62.8 %	25.9 %	3.9 %	-1.8 %	6.8 %	123 %	-32.1 %
Social contributions	11 %	-11.7 %	-12.4 %	13.3 %	9.9 %	1.7 %	2.9 %	2.8 %	34 %	15.2 %

Source: authors' calculations based on Eurostat data

In the longer time period from 2007 to 2015, the growth of the payroll taxes collection exceeds GDP growth rate and, therefore, MET did not adversely affect the state budget revenues (Table 4). However, it should be noted that the tax collection to a major extent should have been affected by the economic conditions in the country as well as the change in the shadow economy size.

One of the main principles of the efficiency of tax policy is minimal distorting impact of taxes on the taxpayers behaviour (Hungerford, 2006). The tax system also needs to conform to the principles of fairness, including the application of the tax exemptions and benefits (Carter, 2013).

According to the Ministry of Finance of Latvia, social security contributions per employee paid

by the companies operating under MET regime in 2016 were 38.2 euro per month, and in 2017, they are expected to reach 61.9 euro per month (Leta, 2016). The average gross salary in the private sector in 2015 amounted to 799 euro per month (CSB, 2016). Accordingly, the amount of social security contributions per employee in the private sector in Latvia in 2015 was 272 euro, while taking into account the current rate of wage growth in 2017 contributions are expected to be around 300 euro. Despite the increase in MET rate to 15 per cent, the amount of social security contributions for employees working in the company with MET regime will be 5 times lower as compared to the employees of private enterprises operating in the regular mode.

We calculated that the potential yearly budget losses in 2015 due to the MET regime introduction as compared to the regular tax system could have been 234 mn EUR at 9 % rate and 194 mn EUR at 15 % rate in case the average salary paid by companies operating under MET regime would be equal to the gross salary in the country.

To a certain extent, this amount should be covered by other payers of social security contributions and personal income tax. In the future, such a significant disparity in the payment of social security contributions will have a negative impact on the welfare of the population of Latvia and especially on poorly protected groups of population (in the form of inability to raise the value of minimum pensions and other important expenditure of social budget). Besides, infrastructure investing and other spending of the municipalities are to be reduced as substantial number of employees employed by the companies operating in MET regime contribute significantly less in terms of the personal income tax payments than the employees of the companies operating under the regular tax regime. Similarly, according to Carter (2013), poorly designed tax policy in relation to the small business can lead to serious leakages in tax revenues and social security contributions.

If we assume the complete cessation of MET regime and that there will not be any introduction of tax exemptions for small business, it is very unlikely that the forgone tax revenues amount to less than 200 million euro per year. Shortage of tax revenue limits the execution of the current functions of the state in the public interest and reduces the amount of savings for social payments for future periods, which will further increase the burden on the state budget and increase inequality. Hungerford (2006) notes that there exists a number of principles that should be observed when deciding on the granting of tax exemptions and benefits. According to him, one of those principles is the assessment of whether

the tax incentives are more effective than the direct costs of the programme to address specific problems. Let us suppose that 50 % of the aggregate positive effect of MET regime introduction in 2015 was the transition of 2046 limited liability companies under MET regime to regular tax regime (data provided by SRS of Latvia). In this case, the "price" of budget costs (in the form of tax benefits) to one limited liability company, transformed into the regular tax payer in 2015 amounted to approximately 100 thousand euro.

According to Carter (2013), in some cases, tax exemptions and benefits are not offset by the benefits to the state and society in terms of increased economic growth, employment and productivity of small (and medium-sized) enterprises. Until the beginning of 2017, there were not any public announcements made about the results of the analysis of the MET introduction effectiveness.

Conclusion and recommendations

The present article provides an insight into the effect MET had on various aspects of the country's economics including also fiscal policy. We have also reviewed the existing approaches to the development of the tax policy in relation to the micro enterprises in the Baltic States. As a result of the study, we can conclude that even though Estonia has not introduced any special tax policy tools to support ME or small business, ME support is provided by the deferred CIT payment until the profit distribution, which was introduced in 2000. Introduction of the deferred CIT payment in Estonia provides continuity with regards to the growth of companies and their transition to the larger group of companies (the escalator principle), while this type of tax incentive is neutral to all types of taxpayers. Estonian tax policies do not provide for social security contributions and personal income tax exemptions. As a result, in Estonia the principle of tax fairness is supported more than in Latvia and Lithuania.

Despite the lack of targeted tax exemption and tax incentives for ME Estonia has by 65 % greater rate of enterprise density per capita than Lithuania and Latvia have (Prohorovs, 2017). According to our data, there are better results of innovative technology companies' development and is higher activity of the private venture capital in Estonia. We found that the Estonian tax policy addressing the micro (and small) businesses¹ is the most consistent with the principles of the efficient tax policy among the three Baltic countries.

Obtained results indicate that certain mistakes were made when developing fiscal policy for the micro enterprises. Karlis Ketners considers that the special tax regime for micro enterprises in Latvia has been designed erroneously (Dienas bizness LV, Ru, 2016). Inguna Leibus (2014) states that often MET regime is applied by the companies for tax reduction purposes creating unfair competition and leading to the reduced social security of employees. In our opinion, the existing MET regime in Latvia and ME stimulation system in general require a radical change. More detailed findings are presented in the sections of our study.

Based on the research results, we have developed a number of recommendations regarding the approaches to the development of tax policy in Latvia in relation to the micro enterprises (and small businesses).

It is necessary to exclude from the MET regime all categories of self-employed (*saimnieciskas darbības veicējs*), since their activities, in fact, are not (or not completely) an entrepreneurial activity.

It is necessary to introduce an escalating system of incentives for ME and larger enterprises following ME. According to this system, new and developing companies (in terms of turnover and/or number of employees and, perhaps, the volume of paid taxes) would be able

to continually enjoy certain exemptions and benefits provided their ability to grow the indicators mentioned before. Our analysis shows that the best form of the step stimulus (the principle of the escalator) is the introduction of deferred CIT payment until the profit distribution.

The introduction of the simplified (single) tax (as MET regime) with the purpose of reducing poverty and for particularly small family businesses that do not employ hired labour, the tax threshold of turnover of such enterprises could coincide with currently existing in Latvia threshold for registration as VAT payer (50 thousand euro). Combination of the two thresholds should greatly simplify tax administration and broaden the existing base of taxpayers. As a result of exemption from VAT, such particularly small enterprises will have a tax exemption of up to 8677 euro per year, or the ability to set the price of their products /services of up to 17.4 % per cent less than the companies that are paying the VAT.

When defining the single tax rate, one has to take into account that the amount of tax payment per employee should not be less than minimum pension and medical care, and, preferably, should also include certain minimal amount to cover other functions and services of the state.

Not only the permanent, but also the time-limited tax incentive regimes (with a possible extension of tax benefits in case of the company complies with certain conditions) should be introduced. They should correspond with the current objectives of the Latvian economy. It is advisable also to foresee that the tax incentive regime for specific companies may be extended, subject to increase the volume of tax payments or increase the volume of export sales.

Informal employment as well as the higher level of the shadow economy are more characteristic for a small business. In addition, in Latvia due to a number of reasons, the level of tax morale of taxpayers is not high, and it is

¹ According to the Register of Enterprises, there are about 160 large enterprises in Estonia.

impossible to significantly increase it in a relatively short time period, even employing administrative measures. Therefore, we believe that one of the possible directions of employee

stimulation to make mandatory social security contributions may be more obvious personalization of social security contributions of a particular employee.

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