



30 May 2014

Position Paper on Macroeconomic and Tax Policy

1. Executive Summary

The successful development of the Latvian economy continued in 2013, and, despite a slowing down in the rate of growth, Latvia has maintained its place among the fastest growing economies in the European Union. The Latvian government's determination to observe a policy of strict fiscal discipline has earned it and Latvian lawmakers a significant level of credibility in the eyes of its European peers and is well acknowledged, as reflected by a steady improvement of international credit ratings¹. In addition, in a significant step towards further integration into Europe and further improving credibility and predictability, the Latvian government successfully managed the conversion from the Lats to the Euro in January 2014. This important step will certainly provide additional stimulus for the development of Latvia's economy in the years to come.

Recent economic trends show that that the recession phase in the euro zone has now eased into a phase of modest growth, while the global economic outlook continues to gain in strength. This creates positive preconditions for future export growth, with Latvia predicted to maintain its position this year as the most rapidly growing country in the Eurozone. However, old concerns we have had regarding the Latvian business environment remain and new concerns have arisen. First, we note the relatively low level of foreign investment activity at present, which poses significant risks for Latvia's development in the long term. With approximately 15% of tax receipts in Latvia currently originating from the foreign investment community, lower investment levels raise the risk of lower tax receipts in the future, which turn leads to reduced flexibility in implementing reforms to support prioritised improvements in education, healthcare and public services.

A second cause for concern is low labour productivity, which continues to be one of the most significant hurdles to future growth in the Latvian economy. Although unemployment continues to decline in Latvia, driven by positive economic trends, it is clearly approaching the level of structural unemployment at which constraints on further development and increasing social risks will become more and more evident unless further structural reforms are implemented.

A third cause for concern, the Russian-Ukrainian crisis, underscores the importance of the consistent application of a balanced and clear vision for the long-term development of the Latvian economy. The Latvian economy must become structurally stronger, so that it can more readily adapt to the negative consequences of the Russia-Ukraine crisis and similar events. Key areas of focus in this regard are promoting further diversification of export markets and energy sources.

A final area of concern which we take the opportunity to highlight in this executive summary is a perception in the foreign investment community of slow progress in setting the highest possible standards with respect to the professionalism, integrity and transparency of Latvian public

institutions, such as the State Revenue Service, the Court System, Bankruptcy Administrators and Customs services.

In this year's High Council Meeting, FICIL places strong emphasis on the need both to accelerate the implementation of previously planned reforms which were begun and outlined during the recent economic crisis (e.g. energy, education, health care), and to implement new structural reforms. To strengthen Latvia's ability to attract higher levels of Foreign Direct Investment (FDI) over the long term, the government and public institutions must also maintain a balance between, on the one hand, implementing appropriate levels of sectorial regulation designed to promote transparency, accountability, sound governance and fully open markets and, on the other hand, providing non-regulatory stimulus for development. In FICIL's view it is also crucial to avoid erratic regulatory or legislative changes that are not backed by sufficient impact analysis. Failure in this respect may result in new legislation having a different or even opposite effect to what lawmakers originally intended. Legislation with unintended consequences in the business area would also have a direct and negative impact on the both the investment climate and legal certainty for all investors, whether foreign or domestic.

It is the strong view of FICIL's membership that continued steady progress in addressing the above concerns will remain critically important for realizing Latvia's potential as a small, open economy on the crossroads of trade between Western and Eastern Europe.

2. Recommendations

Return firmly to the reform agenda outlined and commenced during the years of economic crisis and push ahead with new structural reforms

The growth trends of the last three years have demonstrated Latvia's capacity to come to terms with very severe macroeconomic challenges. It is without doubt that the rapid return to a growth economy after such a deep crisis in large part was due to the effectiveness of government actions and the willingness of the population to accept them. The recovery was also to a degree supported by the substantial availability of EU funding and more recently by the gradually recovering economies in the Eurozone and elsewhere. However, maintaining the pace of current growth in the longer term will require much more than relying on the fading effects of actions taken during the crisis years. In addition, the increased tensions emanating from the currently unfolding situation in Ukraine have already started to put pressure on the Latvian economy, negatively affecting growth expectations.

Slow growth in Europe and increasing geopolitical tensions underscore the need for the Latvian government act proactively and to continue a resolute strategy of structural reforms designed to strengthen Latvia's long term competitiveness. Our evaluation of the pace of recent government reform shows that it has clearly slowed over the last year. This trend must be reversed and structural reform should be accelerated or the Latvian economy will perform below its potential, leading to a negative impact on tax revenue growth, structural employment levels and the ability to counter current demographic trends.

Attention should be focused on the following areas, which should remain as priorities in the government's list of tasks:

1. Reducing the shadow economy as a key means of increasing tax revenues, thereby improving economic flexibility for needed structural reforms
2. Reducing the level of structural unemployment through targeted efforts to reform the labour market, educational system and promote innovation
3. Continued focus on supporting export growth and improving competitiveness
4. Addressing demographic challenges and promoting regional development
5. Continued reforms within areas of tax policy, court system, public procurement, the State Revenue Service and other public administration offices
6. Clear communication to the public on policy goals, their implementation and evaluation

3. Rationale for Recommendations

1. Reducing the shadow economy as a means of increasing tax revenues, thereby improving economic flexibility for needed structural reforms

- a. The high proportion of the use of cash, unregistered employment and illegal tax avoidance practices in the economy substantially reduces tax revenues, adversely impacts economic and social development and distorts fair competition.
- b. The shadow economy exacerbates safety and welfare concerns for unregistered employees and their families by excluding them from insurance coverage offered to registered employees (e.g. level of unofficial payments in the construction industry).ii

2. Reducing the level of structural unemployment through targeted efforts to reform the labour market, educational system and promote innovation

a. Labour market reform

- i. Despite the improvement in economic indicators, unemployment will continue to particularly affect rural areas, highlighting the need to encourage the mobility of residents.
- ii. The issue of youth unemployment is a major concern which underscores the need for government action to motivate young people to seek higher education and to gain relevant qualifications to help develop the national economy.
- iii. The challenges of financing pension obligations points to the need to retain older citizens in the labour market, as well as the inclusion of other capable, but currently economically inactive residents. Failure to address these issues will threaten long term economic growth, create inflationary pressures and lead to lower labour productivity and reduced competitiveness.

b. Educational reform and promotion of innovation

- i. The long term growth potential of a nation's economy and society as a whole is closely correlated to the quality of its education system and the degree to which the education system includes and supports innovation. We therefore encourage a resolute reform of the education system, to significantly raise the effectiveness and quality of Latvia's vocational training and higher education as well as scientific research. With respect to the structure of educational institutions and achievement of high results, Finland can be an interesting role model.
- ii. In 2012, total spending on research and development (R&D) in Latvia amounted to 0.7% of GDP, in comparison to an average of 2.1% in the EU as a whole. Latvia has undertaken to double its R&D commitment to 1.5% of GDP by 2020, compared to EU-wide goal of 3%ⁱⁱⁱ. However, with current and projected spending on R&D less than half of the EU average, Latvia is at risk at falling well behind in economic productivity and growth compared to the EU countries and the Baltic region in particular.

3. Continued focus on supporting export growth and improving competitiveness

a. Supporting export growth

- i. Latvia's post-crisis emphasis on developing manufacturing and export has been demonstrably correct as evidenced by recent achievements. However, work on the enhancement of industrial policy and export growth, including the export of services, must be actively continued.
- ii. A focused approach on how and in which sectors to apply EU funding is required, with a view to supporting the manufacture and export of goods with high added value.
- iii. Work on the development of a sustainable energy policy, which would allow businesses to plan their costs more efficiently is also essential.

b. Increase of public and private investment in infrastructure

- i. Continued and increased investments in improvements of Latvia's road, rail and harbour facilities are crucial in order to realise Latvia's full potential as a key transit country for goods being shipped between Western and Eastern Europe, including Russia and the CIS.
- ii. Modern and well maintained transport infrastructure supports Latvia's ability to attract foreign investment into local production facilities and logistics centres.
- iii. The use of EU structural support funds for infrastructure investment remains an important consideration. However, we recommend that further efforts should be undertaken to promote expanded use of Public Private Partnerships in achieving infrastructure development ambitions.

c. Development of alternative sources of financing

- i. One of the factors limiting growth is the limited availability of financing for businesses. To date, the issue has been addressed in a rather fragmented way, with a lack of a holistic view when seeking to resolve this issue. The emphasis on the establishment of a functioning capital market should be strengthened,

including the function of the stock market, the availability of risk capital and the development of other financial instruments. iv

- ii. The issue of the operation of a Development Finance Institution (DFI) in Latvia has still not been resolved. A DFI could play a significant role in the establishment of new businesses, as well as for the development of existing ones by facilitating increases production capacity and productivity. This would in turn create better conditions for sustainable economic growth and for increases in wages with retained competitiveness.
- iii. To incentivise lending to SMEs and start-up enterprises by commercial banks, FICIL recommends the introduction of piloted and successful models of cooperation between the banking sector and DFI through the use of risk sharing guarantee instruments such as First Loss Portfolio guarantees.
- iv. The financing of infrastructure projects should also be encouraged in cases where PPP projects are employed, when economically justified.

4. Continued reforms within areas of tax policy, court system, public procurement, State Revenue Service and other public administration offices

a. Tax policy

A clear vision and direction in the societal objectives in the tax area is lacking. Tax policy must reflect considered answers to the question: what is the chosen model of the welfare state in Latvia? The rapid changes during the process of developing the 2014 budget suggest that insufficient consideration is given to long term tax policy goals. In the same way, the current references to potential amendments are not specific enough and constructive dialogue and impact analysis is lacking, increasing the risks that the next changes will be adopted hurriedly and without sufficient consideration, creating unnecessary hurdles for economic activity and reducing predictability.

b. The Court System

The effective and transparent operation of the courts is an integral foundation of a successfully functioning economy. Therefore, greater efforts should be made to sort out the operations of the judicial system, to provide faster legal proceedings, greater trust in the court system and the transparency of the decisions adopted. This also includes the planned changes to the Insolvency Law. Our view is that the pre-conditions to encourage a greater interest in debtors to have honest and proportionate relationships with creditors should be created, which are not always linked with the goal to shorten the insolvency procedure.

c. Public Procurement

Although recent reforms have been implemented which have improved practices and subjected more state and municipal tenders to transparency and fair competition, very significant amounts of public funds could additionally be saved through the proper enforcement of existing regulations and by subjecting more public services at lower threshold amounts to a public tender requirement.

d. State Revenue Service and other public administration offices

A resolute commitment of the government to strengthen the administrative capacity and proficiency of the public administration offices and the State Revenue Service in

particular, in among other areas through better training, education on best practice governance principles and competitive remuneration levels for employees compared to the private sector (See Annex 1) would promote greater professionalism, efficiency, and accountability among public servants.

5. Addressing demographic challenges and promoting regional development

a. Addressing demographic challenges

Demography is one of Latvia's major challenges. Bearing in mind recent emigration trends as well as the negative birth-rate, the risk of a continued significant decline in the country's population is markedly high. This reduces the nation's prospects for economic growth and the ability to provide a maintained or improved level of public services over time. Therefore, efforts to promote an increase in the birth rate should be continued.

b. Promoting regional development

i. The regionalization of economic development reveals many shortcomings in the implementation of administrative territorial reform (ATR). Smaller territories experience significant challenges in realising positive development potential. The effects of the ATR programs which have been put into place must be better evaluated and best practice approaches identified in order to find the optimal balance between resource concentration, self-determination and the capacity of the municipalities themselves to ensure viable conditions for the development of their resources. To motivate reforms, the basic principles for the allocation of EU funding continue to be of significance. Bearing in mind that the issue of ATR is politically complex, the work on focused reforms should be commenced as soon as possible, to eliminate hurdles and create the pre-conditions for investments to develop Latvia's outlying districts.

ii. In order to mitigate the negative impact of demographic trends on Latvia's regional development), the accelerated implementation e-governance and e-services should be prioritised in order to ensure availability of public and private services to remote areas.

6. Clear communication to the public on policy goals, their implementation and evaluation

a. Broad public acceptance of programs designed to improve long term competitiveness and improve the lives of citizens can be a challenge, particularly when faced with populist opposition and where reforms may initially come at a cost (such as exposing previously protected industries to greater competition). In this respect we have observed the need for an improved evaluation of how most effectively to communicate with the public and partners about what needs to be achieved and what actions are being taken. This would allow for a decrease in prevailing public scepticism and increased support for the government's reforms.

Annex 1. Detailed Tax Policy Considerations

Key recommendations

1. Improvements in the predictability of the Latvian taxation system
2. Introduction of Alternative Dispute Resolution for tax dispute administration in the SRS
3. Increase Latvia's attractiveness as holding company jurisdiction, subject to appropriate oversight
4. Improvements in the effectiveness and competitiveness of the customs regime

I. Improvements in the predictability of the Latvian taxation system

The overall goal is to ensure that the previous commitments are met within two to five years.

We consider that the Government should proceed with a combination of the following:

1. Increasing the amount of allowances;
2. An increase in the amount of deductible interest in respect of loans for education.

II. Improvements in workforce mobility

We highlight the need to improve workforce mobility in order to make Latvia a competitive destination for investment.

In this respect, we consider that no PIT liability should arise on such benefits as: payment by the employer for relocation expenses, compensation of the second residence occupied just for the purpose of living while working in particular areas. For example a production company may rent an apartment to temporary house employees initially living in far located cities (e.g. Daugavpils, Valmiera, Valka etc.).

III. Increasing Latvia's attractiveness as a holding company jurisdiction, subject to appropriate oversight

1. Introduction of fiscal unity for companies and permanent establishments belonging to the same Group
 - We suggest introduction of these rules in order to increase the attractiveness of Latvia's holding company regime and to increase the number of Corporate Income Tax payers in Latvia.
 - This may also offset the negative consequences, which were brought about by the elimination of the transfer of tax loss regime within a Company Group.
2. Reintroduction of the transfer of tax loss within a Company Group
 - In the event that fiscal unity regime is not introduced, we recommend re-introducing the previous rules on the transferability of tax losses.
3. Reintroduction of cross-border utilization of final tax loss
 - Failure to reintroduce this specific provision may result in Latvia not being in compliance with EU law.
4. Revision of current thin capitalisation (debt to equity) rules
 - The current rules apply in an equal manner to all non-financial institutions.

- We suggest revising these rules creating exemptions for dedicated Group companies engaged solely in financing activities – i.e. financing centres.
- Alternative 1 would be to exclude the applicability of these rules to such dedicated financing centres with the Ministry of Finance establishing the interest rate spread that would be applicable to intra-group financing transactions.
- Alternative 2 would be to reduce the debt-to-equity requirements for such dedicated centres from the current 1:4 to 1:8.
- Alternative 3 would be to exclude the debt to equity rules from intra-group financing and debt factoring if the party to the agreement is located in the European Union.
- Transfer pricing rules would continue to be used to provide further assurance that interest rates are at market level.

5. We recommend excluding capitalised debt claims from the definition of taxable income for Corporate Income Tax purposes. This will ensure that both individual and legal entities are treated in the same way.

6. We recommend that any debt raised through a stock exchange located in an EU country be exempt from debt-to-equity requirements and from all withholding tax obligations in Latvia. This will facilitate the amount of companies operating on Riga's Stock Exchange.

7. We recommend that the tax law be amended so as to provide for the possibility that entities, which are not treated as separate taxpayers, may elect to be treated as such. This will increase the number of companies choosing Latvia as a place to establish their operations.

8. Actions to increase the attractiveness of Latvia as a holding company regime should be accompanied by appropriate administrative routines and applicant eligibility criteria to ensure that beneficiaries of the regime uphold high levels of corporate governance and ethical standards.

IV. Enhancement of the free movement of capital

1. Stamp duty of 2% levied on the transfer of real estate is not in line with the proportionality principle and is not competitive when compared to the tax regimes of new member states. Usually, the stamp duty is an additional burden for the acquirer of real estate.
2. We recommend considering either abolition or a very significant decrease of stamp duty, possibly compensating it with a corresponding increase in sales tax levied on the profit from the sale of land. The person liable for the tax would be the person (individual or company) selling the land. The introduction of indexation of the costs of acquisition together with allowances for business use would be another relevant improvement.

V. Suggestions on improving the cooperation between taxpayers and the State Revenue Service (“SRS”)

1. Introduction of Alternative Dispute Resolution (“ADR”) within the SRS
 - The key purpose of ADR is to assist taxpayers to resolve disputes or reach an agreement with the SRS prior to actual court proceedings.
 - The ADR would involve competent and independent persons representing the Government and the taxpayer. The mediators would work together with the SRS and the taxpayer to broker an agreement between them.
 - Specific rules will have to be put in place to provide for the nature of disputes that qualify for ADR as well as certain thresholds to ensure process efficiency. As a trial version, the SRS may

consider initially extending the opportunity for ADR to taxpayers that are included in the White List (“padziļinātās sadarbības programma”).

- The ADR regime would need to include appropriate oversight to ensure the integrity and transparency of its operations.
2. Ensure consistency in the opinions/rulings issued by the Ministry of Finance, SRS and Customs
- There are situations when the issued opinions/rulings significantly diverge on the same topic and situation.
 - An agreement should be reached that in such situations the view of the Ministry of Finance, as the competent authority to *draft* legislation should override the one issued by the SRS, who is in charge of *implementing* the law.
3. Providing guidance regarding taxpayers’ disclosures to support investigations into VAT fraud
- We are aware of situations when the SRS is challenging input VAT of Latvian taxpayers when dealing with counterparties that are under investigation (e.g. tax fraud)
 - We recommend that the SRS publishes guidance on what is expected from the taxpayers in order to prove that they have acted in good faith.
 - We recommend that the SRS regularly inform taxpayers through the VIES system.

VI. Improvements in the effectiveness and competitiveness of the customs regime

a. Losses of imported oil products

- There are situations where actual volume measurements of oil products are possible only after custom clearance.
- We recommend introducing possibility for measurement of oil products before they are put into free circulation.

b. Change of ownership of oil products

- Transfer of ownership of oil products might happen after they are crossing EU borders but before they are put into free circulation. In order to perform a custom clearance, current regulations require the Custom Service to be provided with information regarding the respective change of ownership. As result, a significant administrative burden is transferred to entrepreneur.
- We recommend legitimating the obligation for Customs Service to ensure relevant accounting of information regarding transfer of ownership necessary for operative execution and control. Therefore removing respective administrative burden from entrepreneur to the Customs Service.

c. Sealing of export load

- Processing and sealing of documentation is a time-consuming procedure and can require up to 7 hours, resulting in increased costs and reducing the attractiveness of Riga Port as a transshipment port. No exemptions are applicable for Authorised Economic Operators (AEO).
- We recommend reviewing document processing and sealing procedures for mixed supplies and to apply the best practice of other leading ports within EU (such as Rotterdam, Antwerp, Goteborg, Hamburg etc.). Possible solution might be cancellation of sealing of documents and enhancement of risk analysis procedures, as well as introduction of exemptions for AEO.

d. Communication with the Customs authorities

- Use of internal instructions issued by the Customs Service significantly increase administrative and other burdens placed on the entrepreneur.
- Communication is not efficient.
- We recommend making transparent internal instructions issued by the Customs Authorities and sharing such updated information with the entrepreneur.

e. Physical control of goods

- Multiple physical controls, no exemptions for Authorised Economic Operators AEO.
- Time-consuming procedure, lack of capacity, long waiting time.
- The Customs authorities should perform an assessment of the average time currently required for performing all risk management procedures, with the aim of reducing the time frame, and as a result lowering the costs incurred by the business entities.
- We recommend reviewing the Risk Management criteria utilised by the Custom authorities and a need for physical checks with reference to taxpayer history and reliability.
- We recommend delegation of the decision-making authority to custom officers, subject to implementation of appropriate oversight mechanisms and reconsider the capacity of custom force by potentially increasing number of officers and/or provide them with more advanced technical equipment.

VII. Improvement in the administrative capacity and professionalism of the State Revenue Service

With the public administration sector increasingly losing attractiveness as an employer, public offices such as the SRS face a growing challenge to retain talent and institutional memory. The SRS has recently reported an increasing number of employees who are voluntarily leaving employment due to lack of competitive working conditions. FICIL Members have in addition pointed out the dwindling levels of service quality, in particular with respect to large taxpayers. We wish to highlight the need to strengthen the remuneration and training of public servants in their respective vocations and implement a results based performance evaluation programme to ensure the attraction of skilled and dedicated staff to the SRS.

ⁱ The Treasury reports a steady increase of Latvia's credit ratings, from the lowest BB (BB+) in years 2009 and 2001 to BBB (BBB+) in 2013. Information retrieved from: http://www.kase.gov.lv/uploaded_files/Kreditreitings/Rating-Comparison_16.12.2013.pdf

ⁱⁱ Position paper on Macroeconomic and tax policy. FICIL, 2013. Available from: http://www.ficil.lv/hidden/HC2013%20documents/webbbb/1_Tax%20and%20Macro_LV.pdf
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^{iv} Position on Capital Markets Development. FICIL, 2011. Available from: http://www.ficil.lv/faili/2011Web/2011PP_Eng/11%2005%2020%20On_Capital_Markets.pdf