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DEVELOPMENT OF TAXATION POLICY IN LATVIA

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Abstract. Taxation policy is one of the main instruments which can affect some national economy sectors, ensure development of any territory by special provisions in tax laws. Current Latvian tax policy is mainly based on the continuation of the tax policy followed since the tax reform of 1995, generally the system goal was to ensure capital inflow and capital market activities, with the aim to increase foreign direct investment and promote the development of the national economy. Research of current status of taxation policy and quality of state budget revenue sources enabled to suggest some short run solutions, to ensure competitiveness of domestic supply, shifting incentives from dividends and income distribution to investments in real economy; and also generating state revenues with goal to reduce domestic demand. Implementation of prepared recommendations gives a premise to ensure development of Latvian national economy and also competitiveness of Latvian tax system.

Keywords: taxation policy, business environment, tax competition, tax harmonization.

1. Introduction

Taxation policy is one of the main instruments which can affect on some national economy sectors, ensure development of any territory by special provisions in tax laws. Decisions in tax policy generally can distort competition circumstances thus not achieving initial policy goals, so introducing new policy measures benefits gained by national economy should be evaluated, specific taxpayer groups or state budget. New policy measures implementation or in other words tax reforms is an on-going process, with tax policymakers and tax administrators continually adopting their tax systems to reflect changing economic, social and political circumstances. Over the last two decades, almost all countries have undertaken structural changes to their tax system which have significantly altered the way these systems function and their economic and social impacts. In some countries, for example, many of the Eastern European economies in transition, the reforms have been profound and implemented over a very short period of time. In others, most of the European countries, the reforms have been a gradual process of adaptation but which over time have substantially redesigned their tax systems. These tax reforms have been driven by the need to provide a more competitive fiscal environment: one which encourages investment, risk-taking, entrepreneurship and provides increased work incentives. At the same time, governments are aware of the need to maintain taxpayers' faith in the integrity of their tax systems. Fairness and simplicity have become the byword of reformers. Fairness requires that taxpayers in similar circumstances pay similar amounts of tax and that the tax burden is appropriately shared. Simplicity requires that paying your taxes becomes as painless as possible (not something easily achieved in modern societies) and that the administrative and compliance costs of collecting taxes are kept at a minimum. These reforms, however, did not until recently lead to a fall in the overall tax burden (measured by the tax-to-GDP ratio). Main point of the analysis if tax system needs changes is if tax system ensure stable revenues to cover public sector expenditures, if tax burden is internationally competitive and fair, and if tax system ensure stable growth in the economy. So necessity of tax reform can be defined by three aspects - 1) necessity of changes in current economic situation and eliminations distortions in economic developments; 2) necessity of changes for fiscal (budget expenditure) needs; 3) necessity of changes for tax competitions between community countries.

Taxation policy reform also is a significant subject of scientific researches. Unfortunately for Latvia, scientific literature devoted to tax policy problems mainly has descriptive nature. For example professor L.Kavale [1] describes current tax policy situation, at the same time promotes main idea of protection of national interests of Latvia within EU tax harmonization. As to tax reform trends author mentions broadening implementation of reduced value added tax rate, as necessary steps is mentioned that Latvian government have to expand list of excise tax taxable goods, keep unchanged low corporate tax rate, at the same time to reduce rate of mandatory social insurance contributions. In another article [2], the author comments on the significant tax developments in Latvia during 2006, which included changes to the penalty regime (with effect from 2007), new tax holidays, and amendments to the rules for interest and bad debts. The author also reports on the further corporate income tax and personal income tax changes introduced in 2007. Some approaches in scientific literature [3] focuses on problematic issues in the application of the Latvian law On Company Income Tax. The practice of generating artificially high tax deductible expenses and artificially low taxable income found in Latvia are described. Latvian tax system also is described in researches on tax policy in older EU member states/ For example, as mentioned in [4], with lower rates and less complexity, the tax systems of the newer EU economies have added to the pressure on the Union's older members to act. Tax system of Latvia in international scientific sources is mentioned as tax system of low corporate tax rates and simplified tax regime, which creates tax competition to other EU member states. It seems to us, that insignificant attention is paid in scientific literature to Latvian tax system as entire unit. At the same time it seems, that insufficient investigation is made in connection with tax policy and fiscal situation in field of public expenditure pressure. We have to agree with professor D.Baran [5] that public expenditure burden is one of problematic issues with connection with low tax burden. As shown in [5] for Slovak Republic, and also, to our opinion it is true for Latvia, that EU older member state experience is not suitable for Central and Eastern European countries, inflexible labour market, generous social programs, employment advantages (especially in public sector) leads to higher tax burden. Also insufficient seems attention paid to impact of taxation on structures of national economy in Latvia.

2. Current Latvian tax policy situation

Taxation policy is one of the main instruments which can affect national economy sectors, ensure development of any territory by special provisions in tax laws. Decisions in tax policy generally can distort competition circumstances thus not achieving initial policy goals, so introducing new policy measures benefits gained by national economy should be evaluated, specific taxpayer groups or state budget. New policy measures implementation or in other words tax reforms is an on-going process, with tax policymakers and tax administrators continually adopting their tax systems to reflect changing economic, social and political circumstances. Over the last two decades, almost all countries have undertaken structural changes to their tax system which have significantly altered the way these systems function and their economic and social impacts. In some countries, for example, many of the Eastern European economies in transition, the reforms have been profound and implemented over a very short period of time. In others, most of the European countries, the reforms have been a gradual process of adaptation but which over time have substantially redesigned their tax systems. These tax reforms have been driven by the need to provide a more competitive fiscal environment: one which encourages investment, risk-taking, entrepreneurship and provides increased work incentives. At the same time, governments are aware of the need to maintain taxpayers' faith in the integrity of their tax systems. Fairness and simplicity have become the byword of reformers. Fairness requires that taxpayers in similar circumstances pay similar amounts of tax and that the tax burden is appropriately shared. Simplicity requires that paying your taxes becomes as painless as possible (not something easily achieved in modern societies) and that the administrative and compliance costs of collecting taxes are kept at a minimum. These reforms, however, did not until recently lead to a fall in the overall tax burden (measured by the tax-to-GDP ratio).

Main point of the analysis if tax system needs changes is if tax system ensure stable revenues to cover public sector expenditures, if tax burden is internationally competitive and fair, and if tax system ensure stable growth in the economy. So necessity of tax reform can be defined by three aspects - 1) necessity of changes in current economic situation and eliminations distortions in economic developments; 2) necessity of changes for fiscal (budget expenditure) needs; 3) necessity of changes for tax competitions between community countries.

In Latvia current tax policy is mainly based on the continuation of the tax policy followed since the tax reform of 1995 [6]. Generally the system was build according to decisions made in 1994 - 1995. Tax system of course was also influenced by accession in EU and EU tax regulations. When tax policy was build, the main goal was to ensure capital inflow and capital market activities, with the aim to increase foreign direct investment and promote the development of the national economy. The current tax policy relies on shifting the tax burden from entrepreneurship to consumption. The strong decline in the tax to GDP ratio over the last years has been largely due to two major factors. First, the cut in social contributions; secondly, a cut in the corporate income tax rate from 25 % to 15 %. The recent developments in the tax system have been mainly targeted at abolishing discriminatory and restrictive provisions by extending the relevant exemptions. A proposed general cut of the personal income tax rate from 25 % to 15 % has been abandoned, mainly due to the perceived risk for the public finances and inflation. Nevertheless, the personal income tax rate on business income is planned to be reduced to 15 % as of 1st January 2008. Latvian tax system can be described as low tax burden system. Tax policy was not targeted on manufacturing sector, initially relatively high profit tax and property taxes in combination with high penalties and high overdue tax debt interest ratios extinguished large manufacturing enterprises.

From macroeconomic situation point of view, structure of Latvian economy has changed in favour of service sectors in the last years. According to the information of Latvian Ministry of Economy [7] the share of service sectors in the value added has increased to 73.8 % in 2005 from 71.8 % in 2000. Construction, trade services, transport and communications have grown faster than other sectors of the economy in terms of both the value added and the number of employees (Table 1).

Rapid economic growth is observed in Latvia for several years. In the last years (2004–2007), GDP went up annually by 10.4 % on average. Growth was especially fast in 2005 and 2006 (by 10.6 % and 11.9 % respectively). The main impulse to the fast growth in the last years is the stable increase of the domestic demand, mainly due to substantial growth of the private consumption. Expansion of export opportunities plays a smaller role in the growth. Contribution of net exports to the growth is negative in the last three years. Situation was slightly better in 2005, when exports increased faster than imports and its growth also exceeded the increase of the private consumption (Table 2)

In 2006 the growth was faster, but bigger role in the growth was played by the domestic demand (its record growth reached 17.2 %). This was mainly affected by favourable crediting conditions (especially of mortgage crediting), but the private consumption was also favourably affected by the fast growth of wages and by leasing opportunities. Growth of exports fell to 5.3 %, which substantially deteriorated the Latvian trade balance and caused a big current account deficit at the end of 2006. In the last three years, the disposable income of households in Latvia amounts to 59.7 % of GDP on average. The private consumption expenditures were 63.7 % of GDP on average, but reached 65.2 % of GDP in 2006, therefore the net savings are negative.

According to our examination of Latvian tax system, main tax incentives are targeted for „passive incomes" recipients. For example, there is no VAT on royalties, also Latvian corporate tax regime is favourable for dividends-recipient holding companies (Article 11 of Latvian Law on Corporate income tax allows to deduct dividends from qualified companies of third countries from corporate income tax taxable income, also residents are not taxed on domestic dividends), the same is true for commercial bank interest paid to residents etc. As the result of such tax policy (Table 3) implicit tax rate on capital was very low (7.8 %) in 2004, while EU average was 25.3 %. On the other hand implicit tax rate on labour (including social insurance contributions) in Latvia was 36.2 % in 2004 and it is higher than EU 27 average.

Table 1. Structure of the Economy (%) [7]

	By value added		By number of employees	
	2000	2006	2000	2006
Primary sectors	4.8	4.0	14.5	11.6
Manufacturing	13.7	11.9	17.9	15.0
Electricity, gas and water supply	3.6	2.5	1.9	1.6
Construction	6.1	6.8	5.9	10.0
Trade, hotels and restaurants	17.9	22.4	17.7	19.1
Transport and communications	14.0	13.0	8.3	9.2
Other commercial services	23.0	25.0	12.4	14.0
Public services	16.9	14.4	21.4	19.5
Total	**100.0**	**100.0**	**100.0**	**100.0**

Table 2. Expenditure of Latvian GDP (%) [7]

	2004			2005			2006		
	Structure	growth rates	contribution to growth	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth
Gross domestic product	100.0	8.7	8.7	100.0	10.6	10.6	100.0	11.9	11.9
Private consumption	62.9	9.5	6.0	62.5	11.5	7.3	65.2	19.8	12.7
Public consumption	19.5	2.1	0.4	17.4	2.7	0.5	16.9	4.0	0.6
Gross fixed capital formation	27.5	23.8	6.6	30.6	23.6	7.5	34.4	18.3	6.5
Inventories	5.7	–	0.7	3.8	–	–4.4	3.7	–	0.2
Net exports	–15.6	–	–5.1	–14.4	–	–0.2	–20.2	–	–8.1
– exports	44.0	9.4	3.8	47.8	20.3	8.2	44.2	5.3	2.3
– imports	–59.6	16.6	–8.9	–62.2	14.8	–8.5	–64.4	17.5	–10.4

Table 3. Tax revenue and implicit tax rates (ITR) by type of economic activity [8]

	Tax revenue, % of GDP			Implicit tax rate on:								
				Consumption			Labour			Capital		
	1995	2004	2005	1995	2004	2005	1995	2004	2005	1995	2004	2005
EU27	39.7	39.2	39.6	21.5	21.6	22.1	35.8	35.1	35.2	24.2	25.3	27.3
EA13	39.9	39.6	39.9	20.9	21.6	21.8	36.0	36.2	36.8	23.4	28.4	30.4
CZ	36.2	36.8	36.3	22.1	22.0	22.1	40.5	41.7	41.3	26.4	25.4	23.2
DE	39.8	38.8	38.8	18.8	18.2	18.1	39.4	39.1	38.7	22.4	21.9	23.3
EE	37.9	31.4	30.9	20.6	20.5	23.8	39.2	35.2	33.1	24.7	8.9	8.1
IE	33.1	30.5	30.8	24.9	26.5	27.2	29.7	26.1	25.6	25.9	39.1	41.4
FR	42.7	43.1	44.0	21.5	20.2	20.2	41.2	41.4	42.1	31.2	36.9	38.9
LV	33.2	28.5	29.4	19.3	18.5	20.4	39.2	36.7	36.2	:	7.8	:
LT	28.6	28.3	28.9	17.7	16.0	16.5	34.5	36.0	35.9	15.1	10.8	11.4
HU	41.6	38.6	38.5	30.9	27.7	26.5	42.6	39.9	40.5	:	:	:
MT	27.3	34.2	35.3	15.4	17.4	19.2	19.0	21.4	22.1	:	:	:
SK	39.6	29.7	29.3	27.1	21.5	21.9	39.5	35.7	33.7	33.5	16.0	14.4

Source: European Commission Services

The ratio of total taxes to GDP in Latvia was 29.4 % in 2005, which is the fourth lowest in the EU-27 after Romania, Lithuania and Slovakia. The tax ratio in neighbouring Estonia is only marginally higher. The structure of taxation has undergone significant changes since 1995 as social security contributions, particularly those paid by employers have been cut drastically, while indirect taxes have declined less and direct taxes revenue has remained roughly constant as a share of GDP. In 2005 indirect taxes constitute the most important source of tax revenues with a share on the total of 43.9 %, relatively more than the EU-27 average. The predominance of indirect taxation is a common feature of the tax systems of the Baltic countries; as in Lithuania and Estonia, the share of indirect taxes has been growing. Direct taxes contribute only 27.2 % of total revenue compared with 31.1 % in the EU-27 average. Within direct taxation, the low level of corporate income taxes stands out; the CIT yields 2.0 % of GDP, the third lowest value in the EU-27, in line with the other Baltic countries. The low CIT revenue is linked to a reform that lowered the CIT statutory rate from 25 % to 15 % starting from 2002, but, in spite of reduction of the tax rate to 15 % in 2004, CIT revenue has increased for both 2004 and 2005. As a result, in 2005 Latvia raised the same amount of CIT revenue measured as share of GDP as in 1999, with a considerably lower statutory rate. An explanation of this fact can be found as increased also amount of paid dividends and behavioural issues of company owners, while from taxation point of view is more preferable to gain dividends (statutory rate 15 % at company level), then management fee (statutory personal income tax rate 25 % and social insurance contributions rate 33.09 %).

From the fiscal policy point of view tax burden of 29 % of GDP is insufficient to cover all general government expenditures (Table 4.).

Latvia can afford low tax rates because of grants and financial instruments given by foreign financial assistance, especially the EU, this EU policy could be criticized. How much Latvia receives in the form of grants from the EU does not depend upon the nature of tax system, but on the EU system for allocating its funds. If the EU takes exception to the low tax rates applied in some individual member states, it should implement a sweeping reform of the system of allocating its funds.

This led us to the third aspect – tax competition. As it is well known communities of countries such as the European Union usually decide to harmonise their tax systems. Some communities choose the tax treaty way (for example the Nordic Treaty for Scandinavian countries in the field of direct taxation), or the way of legislation harmonization (in the case of the EU – EU directives and regulations in the indirect taxation field).

Table 4. General government budget structure (% of GDP) [9]

	2004	2005	2006	2007	2008
	fact			evaluation	evaluation
Revenues	33,9	35,3	35,6	39,7	41,5
1. Tax revenues	27,2	28,1	29,3	31,5	32,5
2. Non-tax revenues	2,6	2,4	2,2	2,7	2,5
3. Gifts and donations	0,1	0,1	0,1	0,0	0,0
4.Revenues from services	1,9	1,9	1,7	1,8	1,7
5. Foreign assistance	2,1	2,8	2,4	3,8	4,8
Expenditures	35,0	36,4	36,1	39,3	40,5
1. Maintenance expenditures	31,8	32,3	31,5	34,4	35,9
2. Capital expenditures	3,1	4,1	4,6	4,9	4,5
Balance of sector	–1,0	–1,1	–0,5	0,4	1,0

How this has to proceed is judged on the basis of the common goals established by the community and the limitations to the sovereignty of states that have been accepted. According to the declared objectives of the community a state tax policy has to be harmonised with other states if it can be considered as unfair. On the other hand creation of better tax system contributes to an improvement of welfare in the EU it should not be limited by harmonisation regulations. If member state applies tax system equally on foreigners and residents this system has to be accepted as fair. Typically unfair tax treatment is unequal tax treatment of foreign and domestic investors, privileged taxation of corporation. Another possible example of unfair methods is special regulations that are not integral elements of the system and govern the taxation of receipts by offering special tax relief to holding companies. If country taxes the incomes from real investments in one way and incomes from certain financial investments in another, no justification is possible in terms of fair tax system.

The level of economic welfare of any country is fundamentally determined by the economic performance of its enterprises in whatever organisational form (sole-proprietorship including all kinds of self-employment, partnerships and corporations). From the domestic perspective, direct taxes must satisfy the criterion of fairness in that they do not impose upon certain types of income a higher or lower burden than is imposed on others. This requires that the profits of enterprises of different legal forms should bear equal tax burdens (neutrality with respect to legal form) and that capital income should not bear a higher tax burden than income from employment. In addition, there must be no special privileges for foreign companies (“ring fencing”), as this would amount to discrimination against domestic enterprises and run counter to fair international tax competition In order to gain advantage from international trade and the mobility of both physical and human capital, it is in a country’s own interest to have tax laws which on the one hand do not raise obstacles to the free exchange of goods, services and capital or to the mobility of its employees and on the other hand also help establish an attractive environment for foreign investment and highly-skilled employees. In order to meet the important criterion of transparency, tax laws should be framed exclusively according to a clear system.

According to the analysis we can be conclude that tax system of Latvia is unfair within the EU, and at the same time unfair for employment in comparison with capital, is not ensuring stable macroeconomic growth and promote separate non real economy sectors. These factors also are main causes for tax reform necessity for Latvia.

3. Current possible developments

It seems self evident, that one of the major choices facing governments in the design of the tax system is what reliance to place on the different potential sources of tax revenue. Some countries decide to have a limited number of taxes; others a very wide range of tax sources. Some rely primarily on consumption taxes; others on income and capital taxes; in some countries social security contributions are the main source of revenues. Nevertheless, main tax revenues, i.e. over 90 percent, come from three main sources: income taxes, taxes on goods and services, and social security contributions (other payroll taxes are zero or very small in most countries). Differences between countries are in part due to changes in economic structures, e.g. business cycles and the rate of inflation. Taking into account structures of taxation main possible directions of tax reform could be corporate tax system, personal income tax system and consumption tax system.

It seems to us that Latvia have to continue policy with limited number of taxes (11 state taxes), at the same time should be revised scope of taxable objects and also calculation of taxation base. Thus, it seems self-evident that in the field of corporate tax system EU have to do efforts to lay down as soon as possible uniform procedures for calculation of taxable profits or even to establish minimum tax rates for some types of incomes.

The new EU members [10] have statutory corporate income tax rates of only about 20 percent on average, ranging from a tax rate of zero for retained earnings in Estonia (21 percent for distributed profits) and 15 percent in Lithuania and Latvia, to 19 percent in the Slovak Republic and in Poland. The decline in tax rates seems to be continued in the future. Austria has reduced its statutory corporate income tax rates from 34 to 25 percent in 2005; the Netherlands will decrease the rates from 34.5 to 29 percent in 2007, Finland from 29 to 26 percent in 2007, and the Czech Republic from 28 to 24 percent in 2006. It looks like tax competition has indeed intensified in recent days. These recent developments fuel the fears of tax competition as a “race to the bottom” in capital taxation. It is argued that the increased capital mobility in a globalised world provides incentives for states to reduce tax rates in order to attract businesses. Keeping other things equal, firms choose their location in countries with lower corporate income tax rates. The strategic reduction of tax rates of one country induces another country, perhaps the one in which a firm already has branches, to follow suit such that a ruinous competition between states presumably results. Consequently, public services are said to be provided inefficiently and capital owners are accused of not paying their “fair” share of taxes. Income redistribution may not be financed to the same extent as before and welfare states are under pressure. This assessment of the recent developments has lead Germany and France to propose that EU structural funds should be contingent on minimum tax rates on corporate and capital income. Recent tax reforms in the corporate tax field can be seen as a continuation of efforts to improve efficiency in the allocation of real capital and to strengthen the competitive position of firms, while at the same time protecting domestic tax revenues and aiming for an equitable sharing of the tax burden between capital and labour income. Statutory corporate income tax rates have been reduced in many countries, sometimes significantly, and corporate tax bases have been broadened with special corporate tax preferences unwound or scaled back, enabling financing of a reduction in statutory rates. Such reductions in statutory corporate tax rates are generally viewed as attractive by investors, while also assisting tax administration efforts by reducing tax-planning pressure on the tax base. At the same time general corporate tax rate cuts benefit corporations making profits mainly through dividends and other income from overseas – profits arising from investments made overseas and in the past. Such tax relief has no direct effect on creating jobs and increasing supply of goods. As Latvia also participates in this "game", but from economic stability point of view is not successfully, an alternative strategy have to be adopted to improve the competitiveness of Latvian companies. The main alternatives is to tax dividends at fixed rate of 10 % for both types of recipients – legal and natural persons, but at the same time to provide direct support for investment in information technology to enhance productivity and tax incentives for R&D and special provisions for small and medium-sized enterprises. SME taxation regime should be in a kind of presumptive tax which replaces all major types with one [11]. Corporate income tax solution with taxation of dividends and tax incentives for R&D according to our modelling of tax receipts will be fiscally neutral.

Taking into account proportion between labour taxation and capital taxation in Latvia, another significant field is a personal income tax system. Worldwide much of the tax reform debate over the last decade has focused on what should be the basic approach to the taxation of personal income. Governments can chose between three main types of personal income tax systems [12]:

1) Comprehensive income tax - net income from all sources is aggregated (capital income, labour income, other income less all deductions) and, above the basic allowance, is taxed according to a progressive rate schedule. This implies that wage and capital income are taxed at the same rates, and that the value of tax allowances increase with income.

2) Dual income tax – combines a flat income tax rate on comprehensive net income above the basic allowance with additional taxation of gross income from labour and pensions above certain thresholds. This implies that labour income is taxed at higher rates than capital income, and that the value of tax allowances is independent of the income level.

3) Flat income tax – comprehensive net income above the basic allowance is taxed at a single positive rate. This implies that wage and capital income are taxed at the same rate, and that the value of tax allowances is independent of the income level.

In practice, no country has fully implemented any of these three main types of income tax systems. All countries have special tax treatment for certain types of income (e.g., fringe benefits, certain types of capital income and owner-occupied dwellings), and many countries levy social security contributions only on certain types of income (mainly labour income). In other words, most countries use "semi" income tax systems.

Targeting the reduction of tax distortions, in particular in the taxation of corporate and capital income, but at the same time to redistribute income through the income tax system lead us propose to introduce dual income tax system. Analogue systems are introduced in Finland, Norway and Sweden, and to a lesser extent in Denmark, in the early 1990s. The main guiding principle of the dual income tax is to combine a progressive taxation of labour income with a flat tax on corporate and capital income with a broad tax base and a fairly low tax rate. This approach can be justified from social fairness point of view. We have to mark that Gini coefficient according to Central Statistic Bureau data increased from 0.31 in 1996 to 0.36 in 2004, so gap between low income and high income population groups increased too. Additional studies are needed on this matter, but it seems that Scandinavian model can be used only in medium term perspective and will increase tax burden on labour, which is undesirable at this moment from country competitiveness view. Main risks of progressive system are connected to the "grey economy" share growth and illegal payment increase risk.

In current situation solution for personal income tax should be improvement of tax collection and increase of personal allowances (decrease of effective tax rate) instead of reduction of nominal tax rate.

Accordingly to authors made tax receipt modeling, calculations based on household budget statistics shows that approximately 350 million LVL are can be collected as tax (25 %) from undisclosed incomes, also from "grey economy".

At the same time, in our judgement, it seems necessary to reduce taxation of low income natural persons and shift the tax burden, in the short run solution could be increase of basic allowances and broadening of tax base by abolition of non – taxable income types, such as dividends, interests, capital gains etc., currently non taxable according to the Article 9 Law on personal income tax. In 2008 basic allowance is 80 LVL per month, which increased in comparison with 2007 by 30 LVL per month, and also tax allowance for dependant persons in 2008 is 56 LVL per month, which increased by 21 LVL per month. According to Latvian Ministry of Finance [9] this increase of personal allowances generates losses in revenues 107 million LVL or approximately 12 % of planned personal income tax receipts to general government. But at the same time Central Statistical Bureau of Latvia calculated that minimum consumer basket per capita by month in January 2008 was 148 LVL. This leads us to the necessity to increase personal allowances more rapidly. For more fair tax treatment is necessary to equalize personal allowances with minimum consumer basket per capita.

Main problem connected to decrease of personal income tax burden is that personal income tax is main revenue source for municipalities in Latvia (in 2008 – 80 % of tax revenues shifted to municipalities and 20 % to the state basic budget), so compensation mechanism for fiscal neutrality of tax reduction could be redistribution of personal income tax revenues for municipalities and transfer of all personal income tax revenues to municipal budgets. This causes decrease in state budget revenues taking as an example 2008 budget by 183 million LVL [9] or 1.1 % of GDP.

From legal construction point of view while broadening tax base and excluding non-fair non-taxable incomes – capital gains and interests should be taxed at ordinary rate (25 %), and dividends, with purpose – fiscal neutrality should be taxed, taking into account tax paid on company level i.e. at reduced rate 10 %. From economic point of view taxation of these incomes will not compensate reduction of effective tax rate by increase of personal allowances, but will ensure horizontal fairness of personal income tax system.

According to author's calculation above mentioned decrease of personal income tax produce revenue redirection from state budget to municipal budgets, which generate additional deficit of state budget of 1.1 % of GDP. Main compensation mechanism for this deficit and also for ensuring of surplus of state budget is consumption taxes.

At the field of consumption taxes on the contrary to L.Kavale opinion [1], it seems impossible to increase excise duties due to cross border trade and smuggling risks. But at the same time significant increase of domestic demand on the one hand and also need to finance public services on other, press policy makers to discuss changes in the value added tax system and to increase standard tax rate. At the same time for social protection reasons a reduced tax rate should be introduced for foodstuffs (including beverages but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for use in the preparation of foodstuffs; products normally used to supplement foodstuffs or as a substitute for foodstuffs, currently taxed at the standard rate in Latvia. Possible increase of standard rate by 1–2 percent will reduce growth of private consumption and will create additional revenues for general government expenditure needs.

According to author's made value added tax revenues macromodelling results, with assumption of 2008 budget revenue forecast and that value added tax rate will be increased up to 20 %, private consumption will decrease by 7 %, and reduced rate (5 %) will be imposed on foodstuff consumption, tax revenues will be increased by 169 million LVL or 1.07 % of GDP, thus offsetting personal income tax reduction.

First year impact tax receipts modelling shows approximately zero impact of proposed developments of tax policy i.e. reforms can be fiscally neutral and not increasing tax burden to businesses. However this development will generate additional revenues in future years and also will stimulate restructuring of national economy by shifting tax incentives from domestic consumption, spending and passive incomes to export oriented businesses and reinvestment of profits into manufacturing.

Similar conclusions of possible tax reform are demonstrated in recent studies of IMF [10], which shows that, there is wide spectrum of recent tax reform initiatives, and by so doing has also identified key commonalities, such as the well-known spread of the VAT and a broad based trend toward reductions in direct tax rates, in duty rates, and in some countries – marked reduction in the tax wedge on labor. At the same time, however, it is evident that countries have attempted to preserve their prerogative to at least some degree of fiscal autonomy, by devising individual approaches to domestic tax policies that address the forces of globalization and other concerns, reflecting differences in the political and economic environment across countries. We agree with researchers [10], that these are major trends of tax reforms and to some extent this trends will impact also Latvian tax system.

4. Conclusions

According to the analysis we can be conclude that tax system of Latvia seems to be unfair within the EU, as for member states – donors of the EU budget and at the same time unfair for employment in comparison with capital, is not ensuring stable macroeconomic growth and promote separate non real economy sectors.

Authors, according to made tax revenue modeling suggest fiscally neutral measures with impact on structures of national economy. Research of possible solutions for improvement of taxation policy and quality of state budget revenue sources enabled to suggest some solutions for the government.

Authors made analysis of structure of national economy shows negative balance of payments and necessity to improve Latvian domestic supply. At the field of domestic supply stimulation and to ensure competitiveness of national economy authors propose to reduce labour taxes (social insurance contributions and personal income tax on wages), at the same time broadening tax base of personal income tax, shifting incentives from non taxable dividends and income distribution to investments in real economy.

Because of first step, with goal to ensure fiscally neutral tax reform and to generate sufficient state budget revenues it seems to be necessary to increase standard VAT rate to 20 %, at the same time for social and political purposes applying reduced VAT rate for essential goods (foodstuff etc.) instead of standard rate applied recently. This step of tax reform also reduces domestic demand and demand based increase of consumption prices, so ensuring decrease of inflation and negative balance of payments, thus positively impacting macroeconomic stability of Latvian economy.

In the corporate income taxation field it seems for authors that rising tax competition deny possibility of increase of corporate tax rate. At the same time authors propose to promote broadening of corporate income tax base in Latvia, abolishing non-real economy incentives, and ensuring state revenues. As to our opinion, further studies are necessary for non financial investment stimulation in Latvian corporate tax system.

Implementation of above mentioned recommendations to author's opinion gives a premise to ensure development of Latvian national economy and also competitiveness of Latvian tax system. At the same time it has to be mentioned that initial provisions of author's research was fiscally neutral tax reform. For further studies it seems, that additional calculations and tax revenue modeling needed to ensure increase of surplus in general government sector budget. This can be ensured by decreasing of gap between tax revenues and general government expenditures. Simultaneously additional effort is needed to revise general government expenditures in order to reduce expenditure side also.

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