tax notes international

Volume 56, Number 1 ■ October 5, 2009

Latvia Submits Tax Reform Pledges To IMF

by Valters Gencs

Reprinted from *Tax Notes Int'l*, October 5, 2009, p. 23

taxanalysts®

COUNTRY DIGEST

Latvia Submits Tax Reform Pledges to IMF

Latvia's Ministry of Finance on September 7 published a letter of intent to the International Monetary Fund, which outlines the government's plans to lower the deficit in 2010 through tax reforms and spending cuts.

The letter was signed on July 27, 2009, by Valdis Dombrovskis, Latvia's prime minister; Einars Repse, Latvia's finance minister; Ilmars Rimsevics, president of the Bank of Latvia; Irena Krumane, chair of the Financial and Capital Market Commission; and by the government's coalition party chairs.

On September 8 the Latvian government confirmed amendments to Latvia's plan for economic stabilization and growth in a recovery program providing additional measures in accordance with the letter of intent.

Primary Plans

The government is targeting 2010 budget measures that would ensure a lower fiscal deficit in 2010 than in 2009. The government must submit to Parliament a budget that complies with this goal along with any proposals necessary to implement the measures. The goal is to limit the general government deficit to 8.5 percent of GDP in line with the recommendation of the EU Council of Economic and Finance Ministers.

In the first letter of intent to the IMF (December 18, 2008), Latvia had already committed itself to introduce LVL 500 million (4 percent of GDP) in targeted expenditure cuts and tax measures. The government has set out in the new letter of intent the measures it will implement to meet this objective as a part of the 2010 budget process.

Latvia plans to institute a comprehensive plan to broaden the base of the personal income tax as of 2010 and to introduce a tax on capital. The plan includes a significant reduction or repeal of most tax exemptions and a reduction of disparities in allowances across all sources of income, including pensions and wages. Overall, these measures will yield 1 percent of GDP in 2010 revenues.

Latvia plans to abolish the special self-employed income tax regime and bring the self-employed into the standard personal income tax system. This means the tax rate of the self-employed would rise from 15 percent to 23 percent. It is believed this will support tax compliance.

Latvia also plans to institute means-tested exemptions to expand the base of the real estate tax by applying it to all residential properties on the basis of updated cadastral values. The government believes this could yield significantly more revenue (about 0.75 percent to 1 percent of GDP from 2011 onward) than previously determined. In 2010, while in the transitory regime, the tax would yield about 0.5 percent of GDP in revenue. However, this is still being debated by the government parties.

Also, a broad public service reform would harmonize remunerations across ministries and institutions and significantly reduce wage inequalities. This should generate savings of at least 0.5 percent of GDP.

Latvia also wants to stop indexing pensions, pending the pension reform.

The government also plans to carry out several structural reforms based on a series of functional audits to generate sustainable savings of about 2 percent of GDP.

If these measures are insufficient to meet the target, the government will identify and implement additional measures that would be effective January 1, 2010, and are estimated to yield 2.5 percent of GDP. The additional measures include:

- increasing the general VAT rate from 21 percent to 23 percent — it is estimated this would yield about 0.5 percent of GDP;
- making the personal income tax system more progressive by raising the average effective tax rate to approximately 25 percent for people earning more than LVL 500 per month through a graduated increase in the marginal rate — this should yield 0.5 percent of GDP; and
- securing an additional 1.5 percent of GDP in expenditure cuts during the budget process, including fundamental revisions in line with the ministries' budget bases.

In order to prepare and evaluate the implemented measures and to draft a general strategy for social security, the government is cooperating with social partners and with the World Bank. ◆

♦ *Valters Gencs, Law Firm Valters Gencs, Riga*