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POSSIBLE IMPROVEMENTS OF CORPORATE INCOME TAX IN LATVIA

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Abstract. In the European Union, most taxes are as equal as possible between member states within the interests of each member state. At the same time, some taxes can create a lot of competition between countries. Corporate income tax is a tax that affects competitiveness between member states, including Latvia, Lithuania and Estonia. It was especially relevant in 2023 and is becoming more and more relevant in 2024, when many international companies choose a country where to build their central office or production in the Baltic region or decide to continue or expand their presence in a given country.

Keywords: corporate income tax, tax system, tax in Latvia.

JEL Classification: P1.

1. Introduction

Since ancient times, tax issues have faced conflicting opinions, conflicting interests and goals. Interests are usually shared in the interests of the public sector, with the vision of public interest representatives regarding the development of the national economy, economic growth or the social and ecological vision of the specific territory, where in contrast the interests of the private sector are to conduct business, receive infrastructure, employ employees and provide the public sector with a certain amount of money and employees.

More than thirty years have already passed since the tax system has been maintained in the territory of the Republic of Latvia. There have been several reforms, usually with the aim of improving the system and obtaining a relatively logical balance between the development of the business environment, social policy, employment, the country's economic environment, infrastructure development and other factors. (Piketty et al., 2014) At the same time, as Latvia has borders with Russia, Belarussian, Estonia and Lithuania, from economical perspective it is essential to be equal to an investment-attracting economy, especially compared to those neighbouring countries which, are European Union countries (Leontyev, 2023).

If changes in global prices or other events can be considered as finite and long-term transitory challenges, where in some cases tax adjustments must be made for a certain period, then at the same time there is a global long-term vision (global direction) in the direction of sustainability. It is the vision of the United Nations to reduce the confounding issues of ecological and social problems to make the planet Earth suitable for habitation and living from the point of view of human existence (United Nations, 2023). At the same time European Union has the same approach (European Commission, 2020), with specific goals ((European Commission, 2021).

Looking at taxes from the point of view of their optimal taxation, the foundations can be traced back to around 1970 (Wanniski, 1978, p. 14). In particular, you can look at the question – at what point should taxes be different depending on the applicable asset, and at what point should they be unified (Atkinson & Stiglitz, 1971, p. 98). An important prism of taxation is from the question of whether taxes should be linear, or when they should aim to be non-linear –basically progressive (Mirrlees, 1976, p. 336). An important turning point in the review of these theories was the creation of A. Laffer's curve, which made it possible to look at the tax issue not only from the point of view of taxation and the theoretical approach of social justice – the largest beneficiaries pay more, but also from the point of view that higher taxes, expressed in percentage terms, do not always ensure higher budget income, which, as a result, can be used to achieve national goals more quickly or with

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better quality (Laffer, 2004). At the same time maximum of it, can be done with best possible income (Balatsky, 2003, p. 65). As fiscal aspect of it was quantitative assessment of burden, when the most of money comes into state treasury (Balatsky & Ekimova, 2011, p. 211). Likewise the connection of efficiency and equity in tax policy should be assessed (Bejakovic, 2020, p. 136).

The scientists are all the time meeting the task of optimal taxation in the search for a tax system that maximises social welfare of the society and citizens of each country under any restrictions. From Adam Smith time the theory of the best approach and how much government should involve itself into economy, has changed (Hayes, 2024). At the same time the approach that manufactures or trade are more connected to uncertainty than land and tax on land will not make such uncertainty than tax on trade or manufacture (Butler, 2011). However, in the case of Latvia the authors can not use an integrated approach to suggest the best option to it. Decisions to improve the tax system, by governments and ministries of finance, to make their fiscal function, are taken on onboard and analysis with change of any tax suggestions are made all the time. At the same time more and more scientists are making suggestions to it.

The Latvian case shows that more and more scientists are making analyses of tax system. At the same time in the case of Latvia theoretical issues are more connected to the government spending (Žubule, 2012, p. 210) and state budgeting issues. (Sproģe, 2010, p. 213) The scientists all the time makes suggestions and some highlight, that the situation as it is, should not be continued in the future.

From one point authors understand that in the budget theory that the most effective budget reforms are possible precisely in the area of government spending, because traditionally the state so-called non-productive expenses and also uncontrollable expenses are formed in budget spending, which reduction is also the main task of the government.

From other point some research was made by authors in the analyses, how and in what way for the government budgeting purposes is to attract fundings. As government need for additional money can be made by tax increase or borrowing the money from financial markets, it is usually the question of government and government debt management perspective, on the possible direction on resource attraction (Avotiņš et al., 2017, p. 7).

2. Situation of Latvia from macro comparison

In the case of Latvia, one of the factors that develop the national economy and economy is exactly the policy of taxes and benefits. This is confirmed in the Figure 1 by the (non)growth of the population over time.

The second important factor for the analysis of tax issues from an economic point of view is the Gross Domestic Product (hereinafter referred to as GDP). This is significant from the point of view that when comparing

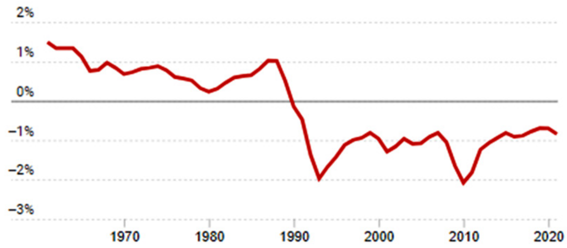

Figure 1. Changes in the population over time in percentages in Latvia (Data Commons, 2024)

countries with each other, relative assessment of tax revenues, they are assessed against GDP, and not against absolute tax revenues in monetary terms.

Table 1. Total gross domestic product million EUR (Eurostat, 2024)

Year	2018	2019	2020	2021	2022
Estonia	25,932	27,764	27,465	31,444	36,181
Latvia	29,153	30,678	30,265	33,616	39,062
Lithuania	45,515	48,916	49,829	56,153	66,791

The data in Table 1 confirm that the general trends of GDP changes are similar, and although in the case of Latvia and Estonia in 2020 there was a decrease in GDP compared to the volume of 2019, but in the case of Lithuania there was an increase, at the same time it can be concluded that the changes are relatively similar from the point of view of trends.

From the data in the Table 2 authors assess, that Latvia has not had highest GDP increase during the years 2018 to 2022 and sometimes even was the third. That leads to the fact that there is a need for changes in the tax system and CIT is the tax that can make one of the most needed economic development.

Table 2. Total gross domestic increase to previous year in percentage (Eurostat, 2024)

Year	2018	2019	2020	2021	2022
Estonia	9%	7%	−1%	14%	15%
Latvia	8%	5%	−1%	11%	16%
Lithuania	8%	7%	2%	13%	19%

Table 3. Tax revenue as a percentage of GDP

Year	2018	2019	2020	2021
Estonia	32.9%	33.5%	33.3%	33.5%
Latvia	31.1%	30.9%	31.8%	31.2%
Lithuania	30.2%	30.3%	30.8%	32.8%

According to what can be seen in the Table 3, it can be concluded that until 2020 (including) Latvia had higher tax revenues compared to GDP than Lithuania, but lower than Estonia. Looking at the year 2021, it can be seen that in the case of Latvia, less income is obtained than the rest of the country as a percentage of GDP. At the same time, realizing that the GDP is also smaller than in other countries, it can be concluded that the tax income in the case of Latvia is smaller in monetary terms than in the other countries. This creates a relatively logical problem for the public sector and its wage earners, because other conditions being equal, it is possible to provide residents with higher wages in neighboring countries, as well as to provide better paid, which is usually also of higher quality, health, education and other systems.

3. History of CIT in Latvia

3.1. CIT development in Latvia

The adopted income tax in Latvia was originally proposed in 1990, as a law "On profit tax" (Latvijas Republikas Augustākā Padome, 1990). Initially, it was proposed in the editorial that payers are both natural and legal entities. At the same time defining that natural persons who have paid the Profit tax are not subject to personal income tax.

The authors' attention is also drawn to the fact that the tax rates were relatively high, activities such as casinos, lotteries, slot machines and other income earned from winning money games were taxed at a rate of 65 percent. At the same time, all profits from business related to banking, currency, insurance and trade are taxed at a rate of 45 percent.

Due to the fact that the regulatory acts and their requirements were improved, as well as the possibilities of evasion were relatively wider, the Profit tax existed only until March 1995 (Latvijas Respublikas Saeima, 1995), when it was replaced by a new law, "On corporate income tax". Although initially the law was relatively successful for the development and economic situation of that time, an important nuance that was missing in the law was the deferred corporate income tax. This means that the tax had to be paid not on the distributed profit, but on the profit earned (Law on Tax on corporate income).

This created conditions that were not sufficiently motivating to re-invest (reinvest) capital, thus demotivating further business development and the creation of larger companies. Taking into account these factors, as well as the progress of the neighbouring country – Estonia – towards a new approach in tax application, tax changes were also made in Latvia, as a result of which the tax was applied only when the profit is distributed, but not payable when the profit is earned.

3.2. Current CIT structure

In order to ensure a competitive approach to company income, starting from January 1, 2018, the Corporate Income Tax Law is in force, the most significant difference from the previous law is the exact moment of taxation, as well as the rate, because in this case the rate is higher, for that reason, that the taxable base is significantly smaller. (Latvijas Republikas Saeima, 2017)

In 2018, the change of approach took place in parallel in two countries, Latvia and Estonia. In contrast to Latvia's approach, when a 20% tax on the distributed profit has to be paid, in the case of Estonia, an additional motivator to pay tax regularly was chosen. This meant that if the company makes regular tax payments and the tax paid in the previous three years is not less than the amount paid, then the tax rate is applied in the amount of 14%. (PricewaterhouseCoopers, 2023)

A situation where, under the same tax conditions, a discount (that is, a lower tax) is applied to regular taxpayers leads to a situation where most taxpayers pay tax regularly. In a united European Union, if two countries offer different tax systems, there are many variables that can be used to choose which country is better to do business. If two neighbouring countries offer a similar tax system, but one of the countries offers additional discounts, then, without a detailed analysis, it is understandable that it is better to do business in such a country, because the lower tax rate motivates investments, which can then be made cheaper to get the money back.

Table 4. Summary of corporate income tax rates (Ministry of Finance, 2022)

Country	Year	Base rate	Lower rate	Comment
Estonia	2020	20% (paid income)	14% (paid income)	Special rule un constant 3 year tax payment.
	2021			
	2022			
	2023			
	2024			
Latvia	2020	20% (paid income)	No	No.
	2021			
	2022			
	2023			
	2024			
Lithuania	2020	15% (received income)	5% (received income)	Lower tax if less than 10 employees and income burden.
	2021			
	2022			
	2023			
	2024			

The rates shown in the Table 4 can be interpreted as very similar approaches between Latvia and Estonia, but a different approach in the case of Lithuania.

Comparatively, the income of the Corporate Income Tax in relation to the GDP also indicates in which country entrepreneurs are more motivated to do business, for which the country then receives higher taxes.

As can be seen in the Table 5 the 2018 tax changes in the 2019 income show that, in the case of Latvia, the income has decreased significantly. This is especially significant in the data of 2019, but also in the data of 2020 and 2021, lower incomes appear.

Assuming that the laws are relatively similar, and both countries offered the possibility to pay tax in the ratio of 20/80, but in Estonia, by making regular tax payments, the ratio could be reached at 14/86, then it can be concluded that such a relief is significant.

Table 5. VAT income to GDP % (Organisation for Economic Co-operation and Development, 2023)

Country	2018	2019	2020	2021
Estonia	1.997	1.834	1.637	1.53
Latvia	1.055	0.156	0.723	0.855
Lithuania	1.519	1.554	1.575	2.136
Latvia vs. Estonia (percentage difference)	–47%	–91%	–56%	–44%

At the same time, when the Ministry of Finance carried out the assessment of the changes introduced in 2018, it was immediately defined that it was planned that tax revenues would decrease in the initial stages, as well as the fact that the assessment of these changes cannot be carried out earlier than in 2020 (Ministry of Finance, 2019).

3.3. Potential progress for Latvia in CIT issues

On the other hand, when carrying out an assessment in 2020, it is concluded that the CIT reform cannot be unambiguously assessed in relation to the original goal – to increase investments. This is related to the conclusion that investments in actual prices follow very closely the dynamics of acquisition of European Union funds (Ministry of Finance, 2020).

At the same time, the Latvian scientist A. Prokhorovs realized that "the introduction of the deferred VAT payment in Estonia has ensured an increase of additional tax revenues in the Estonian budget in the amount of approximately 50%". This points to the fact that in the case of Estonia, the CIT has provided enough income to keep the system going (Prohorovs, 2017, p. 150).

Looking at tax issues from the point of view of the assessment of internationally recognized experts (The International Tax Competitiveness Index), where international tax experts recognize the Estonian tax system as the best since 2014, in the case of Latvia in 2022 the Corporate Income Tax system is better than Estonia's, and other tax systems are indicated as worse than the Estonian system (Bunn & Hogreve, 2022).

Table 6. International assessment of tax systems for the end of 2022

Country	Place	Total assessment	CIT	PIT
Estonia	1	100	2	1
Latvia	2	89,90	1	4
Lithuania	8	76,90	3	11

Looking in the Table 6. at the issue from Latvia's position and abstracting from Estonia's performance, one could interpret the reform as a failure from the point of view of tax revenues (which was also initially taken for granted), at the same time, being aware of Estonia's experience, it can be seen that a small additional motivator to pay tax was missing.

The example of Estonia also proves that, regardless of the time and basis of CIT payment, by thoughtfully introducing tax changes and incorporating certain motivational elements into them, tax revenues are similar to GDP, and the state can offer a model that is more pleasant for entrepreneurs, attracts more investment or improve the business environment. This is important when defining the country's strategic goals, at the same time it also motivates investment and reinvestment – not costs on the one hand, but a constant and relatively predictable amount of tax revenue on the other.

Looking at the case of Estonia, the authors conclude that Estonia's revenues were the most significant in 2018, which had a relatively small decline in revenues in the following years. The authors are aware that the economy does not stand still, and companies tend to expand or downsize. Similarly, in the case of Latvia, it can be observed that the total GDP is increasing and, therefore, the average turnover of companies and also the average profit.

Despite the apparent success story of Estonia, which some tax policymakers consider important and to be left behind, Estonia has decided to make CIT changes from 2025 (Dienas Bizness, 2023):

1. "Increase the rate from 20% to 22%;
2. Abolish the 14% rate for regularly distributed profits."

Recognizing the situation when entrepreneurship, on the one hand, serves as a direction of interest, influence and personal development, and on the other hand, it is a way of making profit, the payment of profit is important for most co-owners of companies. Similarly, in the financial markets, investments in capital financial instruments are valued against the return – the amount of dividends paid out.

Assuming that the most important thing from the state's point of view is to provide money for budget spending, as well as the fact that when paying CIT from income or paying it at the time of profit distribution, the income is similar, the authors identified potentially possible bonuses in the case of Latvia, so that the income of CIT in Latvia would be similar to that of Estonia in 2019.

At the beginning, the potential reasons for the reduction of CIT after 2019 in Estonia were identified. As the most important factor affecting constant tax revenues in Estonia, the authors identify the possibility of paying a reduced VAT if it is done regularly – every year. This means that if taxes have been paid in Estonia for the last 3 years, then a 14% (14/86) tax is applied to that amount in the following year. This means that entrepreneurs are interested in paying the CIT every year.

Due to the fact that this was the biggest difference, and as a result the tax revenues of Estonia are significantly higher than those of Latvia, the authors support the implementation of a similar system in Latvia. At the same time, by directly implementing the Estonian system, in the case of Latvia, for the next three years, higher taxes would have to be paid than in Estonia, which would continue to maintain unequal competition from the point of view of investment attraction and taxation.

In order to prevent worse conditions in Latvia, the authors are aware that there should not be less tax benefits in the case of Latvia compared to Estonia. The aim of the authors is to offer similar or better regulation of tax application, which would create a small advantage in the case of Latvia.

Seeing that GDP growth is constant, and only in 2020 there was a slight decrease compared to 2019, taxable income is also increasing. At the same time, it would have to grow together with the income of companies, which in the case of Estonia would have to go through a three-year phase of tax cuts, and only then would the 14% tax apply.

In the case of Latvia, in order to prevent such an attitude towards the logical and self-evident growth of the economy and GDP, which is confirmed by the GDP data, the authors are aware that a definite and logical increase in the amount of reduced tax for the amount to be paid is necessary. Although one of the indicators is GDP growth, it is not the same for all sectors of the economy, and as a result, it would be justified from the state's point of view, with the amount of CIT income against GDP, but it would not be justified against faster or slower growing sectors against GDP. Since GDP rarely grows faster than 20% per year (in the last 5 years, the highest annual growth has been 19% in the case of Lithuania), but the turnover and profit growth of some companies is faster, and some slower, the authors offer a direct tax relief of 15% compared to the previous year the amount of tax paid. The increase is not so big as to motivate to make significant savings and gradually pay less tax if a gradual increase over several years was chosen for tax optimization. At the same time, it would be sufficiently motivating for companies whose profit in the reporting year would be less than planned to take out loans to leave the reduced tax option for the following years.

4. Opinion of experts

To have an understanding of the opinions of specialists, interviews with scientists and focus groups, experts and certified tax specialists have taken place and answers received from:

- Dr. oec. Anatolijs Prohorovs – author of the monograph "Corporate income tax in Latvia and Estonia (2017)";
- Andris Jaunzemis – certified tax consultant, partner of SIA TaxLink Baltics;
- Jānis Zelmenis – managing partner of BDO Latvija, author of the publications "If we don't think in the long term, only bad news awaits us with the decreasing number of taxpayers (Hāka, Ž, 2021)" and "Global CIT reform and Latvian interests (Ķirsons, 2021)";
- Marina Bičkovska – certified tax consultant.

Question: What do you think would be the direction of development in the application of CIT:

1) Reduce the general VAT rate?

or

2) Reduce the CIT rate if profits are distributed in dividends regularly (similar to the Estonian regulation, where a lower CIT rate is applied to regularly distributed profits)?

The vision of the researchers: to maintain the existing general CIT rate, and to introduce a reduced CIT rate for regularly distributed profits by applying a factor of 1.2 to the distributed part of profit to which the reduced rate is applied. Namely, by increasing the right to apply the reduced VAT rate (compared to the previous year) to the portion of regularly distributed profits by 20% every year.

Table 7. An example of the payment of CIT according to the vision of researchers

	Year			
Profit for distribution	100 000	120 000	144 000	172 800
Tax rate	20%	14%	14%	14%
Tax payment	20 000	16 800	20 160	24 192
Money paid	80 000	103 200	123 840	148 608

If the changes proposed by the authors in the Table 7 were accepted, the tax rate would be reduced to 14%, and it would create quality competition with Estonia, from the point of view of investment attraction and accelerated economic development. At the same time, starting from December 31, 2023, the member states of the European Union must implement a directive on ensuring a global minimum tax level for international business groups and large local groups, which sets a 15% rate as the minimum. At the same time, creating a lower tax for identical business operators than those mentioned in the directive may result in the application of discriminatory regulations. The authors propose to introduce a tax of 15% rather than 14%.

Answers:

Anatoly Prokhorov: "The minimum would be to maintain the existing general VAT rate without worsening regulation. Reducing the rate for regular payers would be the best direction."

Marina Bičkovska: "I believe that Latvia could follow the example of Estonia, where CIT rates are reduced depending on the frequency of dividend payments. In this case, from the point of view of attracting foreign investments, Latvia, by implementing such a system, could return its competitive advantage, as Estonia is currently the most attractive.

However, it should also be remembered that not only tax rates affect the business environment, but also the attitude of the SRS and the banking system towards taxpayers. It can be observed that many businessmen now serve in Lithuanian banks and financial institutions, respectively, Lithuanian banks and financial institutions earn income and pay taxes in Lithuania, supplementing the budget in this way."

Jānis Zelmenis: "In our opinion, the proposed solution would complicate the existing CIT system, which would cause misunderstandings among merchants and possibly increase the level of the shadow economy in the country. Therefore, the CIT system should remain unchanged, because currently CIT is actually paid at the time of profit distribution, accordingly such a CIT system allows companies to invest in their business.

Considering that the current CIT law stipulates a rate of 20% and an applicable coefficient of 0.8, the current version of the CIT law often creates an incomplete picture of the actual CIT rate, which is actually 25%. Therefore, our recommendation would be to clarify the wording of the CIT.

In addition, we would like to draw attention to the fact that currently the government is already talking about CIT reforms, which is mostly related to the implementation of the Global Minimum Tax."

Andris Jaunzemis: "Yes, I agree with the opinion of the researchers."

5. Conclusions

1) Although initially, depending on the type of business, different Company income taxes (Profit taxes) were defined, at the end of 2022 they are unified, as well as the application of the tax is unified, which creates a less discriminatory situation compared to the historical one.

2) VAT is one of the taxes, the rates and application of which countries can compete with each other. According to the comments of the survey, Latvia's most important competitor, as well as from the point of view of the respondents, it can be concluded that Estonia has the best tax system among the neighbouring countries.

3) According to the evaluation of international experts, the Latvian CIT tax system is the best among OECD countries, and the Estonian system is the second best.

4) Several survey participants have commented that in the case of Latvia, the CIT should be equated with the Estonian CIT. At the same time, the authors have concluded that there are aspects in the application and system of the Estonian CIT, which, if improved, would make the Latvian CIT more acceptable from a business point of view.

5) Several survey respondents have pointed out the fact that the Latvian tax system, including CIT issues, is very complicated and needs to be simplified. At the same time, the authors propose relatively small improvements so as not to create excessively significant and complex changes for taxpayers.

6) The Ministry of Finance, when developing the new tax strategy, must maintain the existing CIT rate, additionally introducing a reduced CIT rate of 15% for regularly distributed profits, applying a factor of 1.2 to the distributed part of profit to which the reduced rate is applied. Namely, by increasing the right to apply the reduced VAT rate (compared to the previous year) to the portion of regularly distributed profits by 20% every year.

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