

## IMPROVEMENT OF VAT SYSTEM OF LATVIA

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### Abstract

Since the beginning of the year 2008, Value Added Tax (hereinafter – VAT) revenues numbers started to drop with continuing downtrend. Urgency of the research is related with the high importance of VAT revenues on the State budget because they comprise more than 50 per cent of the Central government basic budget income. The basic budget is the source of financing the state administration, health care, education, defense, including also employment costs; contributions to the international organizations, inter alia, operating payments to the Budget of European Community, financing economic development and social projects (for example, the projects of European Regional development fund and European Social fund) and other state expenditures. Therefore VAT collection is crucially vital to the macroeconomic situation in the country. On 09 March 1995 Latvia adopted a VAT type of turnover tax to replace, as of 1 May 1995, the old cumulative turnover tax. The Latvians refer to the VAT as *Pievienotās vērtības nodoklis*, abbreviated as PVN. The VAT Law (Saeima, 1995) has been amended by the VAT (Amendment) Act 2004, which implemented, as of 1 May 2004, the provisions of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of turnover taxes within the European Community (the Sixth Directive has been replaced by Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (hereinafter referred to as Directive 2006/112/EC)). VAT is a turnover tax levied at each stage of the production and distribution. Liability to VAT rests with the person supplying the taxable goods or services or importing goods into Latvia. However, the supplier is allowed to deduct from his VAT liability on supplies made, the amount of VAT paid and properly invoiced to him in relation to purchases affected by him, or VAT paid by him at importation (Art. 10, Para. 1, Clause 2 VAT law). The actual burden of the tax is therefore borne by the final consumer. The objects of the research are VAT revenues and VAT legislation. The purpose of this research is to develop proposals for improving of VAT laws, regulations and administration that would positively affect VAT levy. The formulated hypothesis that VAT revenues closely relate to retail turnover has been confirmed within the research. Concrete proposals about the necessary amendments in the current VAT legislation are outlined in this research. In order to increase VAT revenues, the limitation of VAT refund are required in the cases when taxable transactions have not been started yet, especially in the field of real estate. Amendments in the VAT law are crucially necessary for the rights to deduct VAT in the acquisition of luxury cars which practically are not used for business purposes and taxable transaction. In order to ease administrative burdens for small businesses (annual turnover do not exceed LVL 100,000) which use cash accounting scheme, here idea about VAT cash accounting should be promoted as well. The result would be that small business does not pay VAT until its customer has paid. At the same time VAT can be reclaimed on its purchases when the company has paid its suppliers. This principle would ease VAT accounting and relieve cash flow in small sized companies. In the present situation, all companies use standard VAT accounting and VAT must be paid just after the invoice has been issued.

### Keywords:

Value Added Tax (VAT), VAT application, Taxation, Budget, VAT revenues, Tax legislation.

### Introduction

VAT collection is crucially vital to the macroeconomic situation in the country. **The scientific problem** looks at increasing VAT revenues by finding solutions for required changes in the present VAT law simultaneously maintaining compliance with European Union law.

Taking into consideration fast changing VAT legislation and overall economic situation, the **novelty**

of the research is submitting topical proposals.

**The objects** of the research are VAT revenues and VAT laws and regulations. **The aim** of this research is to develop proposals for improving of VAT laws and regulations and administration that would positively affect VAT levy.

The economic nature of VAT is a general consumption tax. Therefore the logical conclusions arrive that VAT

revenues should correlate with home consumption. The main part of home consumption is the amount of retail sales. Consequently, the research **hypothesis** is formulated that VAT revenues are closely related with retail turnover.

In order to achieve the aim of the research, **the tasks of the study** are structured as follows, namely: to find relation between VAT revenues and retail turnover by using correlation ratio analysis method, discover the factors which cause a negative influence on VAT revenues, analyze European Union laws and regulations in VAT field, study the practice of other Member States and establish recommendations for improving of VAT levy.

To examine the hypothesis and to perform the tasks of this research, particular **research methods** are used: calculation of correlation ratios and the analysis of VAT laws and regulations within the scope of Latvia and European Union. The data sources about VAT revenue in 2008 – 2009 from the State Revenue Service of the Republic of Latvia (hereinafter – SRS), the law about the State's budget 2009 (Saeima, 2008), the data of Finance Ministry and Central Statistical Bureau are used.

### Decrease of VAT payments

The revenues of VAT in January and February 2009 are 152.22 million LVL, which is 64.65million LVL (including 10.32 million LVL levied VAT for goods

revealed for free circulation) or 29.8% less than in the relevant period of the year 2008 (SRS, 2008-2009). Estimated VAT plan is fulfilled for 77.5% or the missing amount is 44.18 million LVL.

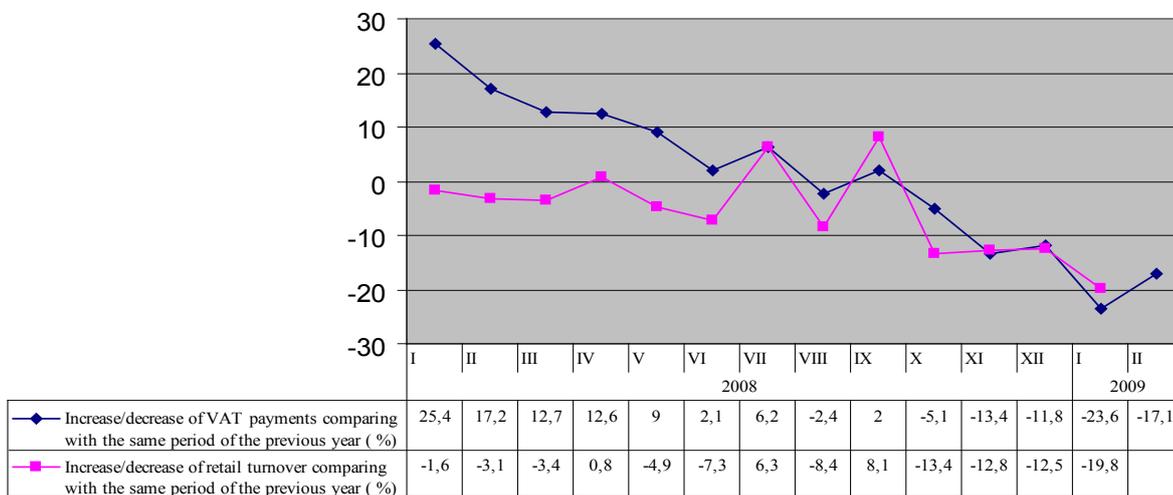
The main factors negatively affecting VAT revenues are decrease of Gross Domestic Product (hereinafter – GDP) and drop in retail turnover.

There was observed the decline of economic development and insignificant growth of GDP (+1.6%) in the first six months of the year 2008 in the economic of Latvia, afterwards the GDP data of summer half of 2008 refused any signs of improvement. GDP shrank by 4.6 % in the third quarter and 10.3% in the fourth quarter. Total GDP decreased by 4.6% in the year 2008.

The drop of the GDP was justified by decline in the said industries: in trade of 8.3%, in manufacturing of 6.5% and construction of 2.6%. There was shrinkage also in financial sphere of 6.6 %.

Data of the first quarter of the year 2009 maintain concerns about continuing GDP decline. For example, data obtained for January 2009 indicate that the output of manufacture decreased by 23.9% and retail turnover shrank by 19.8% in comparison with the January 2008.

Moreover, the retail turnover in January 2009 declined both against November 2008 by 4% and December 2008 by 12.5%. Here must be noted that decline in retail turnover has a continuing trend and has been reducing during the last months (Fig.1).



**Fig. 1. Increase/decrease of VAT payments within a period 2008 – 2009 in comparison with the same period of the previous year (%)**

The most falls of the retail sales is indicated in non-food and food consumer goods, according to the data of Central Statistical Bureau (2008-2009).

Ministry of Finance estimating GDP drop is 13.2% in 2009.

Insignificant drop in retail sales was noticed already in January 2008, although VAT payments increase remained, that can be explained by VAT payments made

by other industries than retail. For example, the certain industries indicated apparent increase of VAT payments during the first two months of 2008:

- Electric power, gas and heating supply (+63%);
- Wholesale trade (+14%);
- Construction (+42%);
- Real estate (+19%);
- Financial services (+99%).

Since the summer half of 2008 the recession of other economic industries started, VAT revenues started to decline as well. Analyzing the VAT payments patterns of other industries than retail sales, conclusions are that in January and February 2009 significantly decreased VAT payments made by wholesale trade (-29.4%), cars' and motorcycles' wholesale (-56%), and construction (-30.3%) industries. The payments made by retail sales in 2008 remained at the same level as in the previous period, however in the year 2009 they decreased by 8.5% (Figure 1). Similarly, VAT payments made by financial business declined by 2%. Observed VAT payment reduction is drawing conclusion that decline in retail sales continues in the next months of the year as well.

In order to evaluate relation between VAT (x) revenue and the increase/decrease of retail turnover (y), the correlation ratio must be calculated.

Correlation ratio (r) formula is expressed by the following formula (Kraštinš, 1998):

$$r = \frac{\sum_{i=1}^n x_i y_i - \frac{\sum_{i=1}^n x_i \sum_{i=1}^n y_i}{n}}{\sqrt{\sum_{i=1}^n x_i^2 - \frac{(\sum_{i=1}^n x_i)^2}{n}} \cdot \sqrt{\sum_{i=1}^n y_i^2 - \frac{(\sum_{i=1}^n y_i)^2}{n}}}$$

The results of calculation present that in the period January 2008-January 2009, correlation ratio is 0.81, which means that relation between VAT revenues and retail sales is strong.

VAT paid during January and February 2009 totaled 245.72 million LVL. In comparison with the same period of the previous year, the VAT paid in the budget decreased by 20.8%, namely, in January by 23.6% and in February by 17.1%.

The greatest VAT payments (29.1% of the total) are made by the tax payers, whose basic business activities is wholesale trade (excluding cars and motorcycles), however in comparison with the previous year their VAT payments into the budget dropped by 29.4% or 29.6million LVL. Only few industries provide the increase of VAT payments. The greatest growth, i.e., of 40% or 6.74million LVL, was made by electric power, gas, heating and air conditioning industries. This partly can be explained with the increase of tariffs and VAT rate.

The recession in the real estate business in particular strongly negatively affects VAT revenue due to its surplus payments and rights to refund VAT for the opened, yet not finished projects.

Laws and regulations of the Republic of Latvia are already harmonized with the European Union ones, mainly with the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (2006). Therefore, developing proposals for VAT

laws and regulations in the field of VAT, European Union requirements must be taken into account.

### Proposals for the amendments of the Law 'On Value added Tax' and regulations

VAT in Latvia has been the research subject in recent years by some of finance and tax specialists, namely, Kauliņa G. (2007), Leibus I. (2008), Rankevica V. (2006) and Kuzenko M. (2008).

Inguna Leibus has driven her attention to the VAT accounting problems for self-employed persons. Individuals carrying out economic activities use cash accounting method for income and social tax purposes. VAT has to be accounted for standard account principle, though. In my opinion there one accounting principle for all tax purposes should be introduced, i.e., VAT cash accounting should be offered for small sized companies and self-employed individuals. Implementing such unified method would ease paperwork, VAT accounting and improve financial system of small entrepreneurs.

Kauliņa G. (2007) has studied VAT application problems and solutions in her doctor's dissertation in 2007. Taking into account that legislation and economic situation is fast changing, only some of the proposals given in her paper are actual today. For instance, the proposal to define unified VAT levy and deduction in the case of acquisitions using factoring should be forwarded to the amendments in the law.

Within the framework of the research the issue about VAT deduction for luxury cars is discussed. In order to improve VAT revenue as well as small business environment, certain amendments in the legislation should be made.

To improve the Section 10 of the Law 'On Value Added Tax' by defining that input tax can not be refunded for acquired or leased motorcars, except motorcars intended for drivers' training, passenger transporting, renting, as well as operational transporting means and specialized motorcars such as medical or funeral service.

In accordance with the present edition of VAT law, a taxable person has rights to deduct VAT for acquired motorcars, including luxury cars without any limitations, provided these cars are aimed for taxable activities. At the moment, the taxable person performing taxable transactions has the rights to deduct VAT even in the case if those cars are used by the companies' management staff in order to visit company business sites. As a result, the new vehicles formally are acquired by taxable businesses because of possibility to refund VAT. For example, if an individual would acquire a new car in another Member State, VAT shall be paid in the State budget. On other hand, if a new vehicle is obtained by taxable business, real VAT payment is avoided by reverse charge mechanism.

Meanwhile, other Member States act differently and certain limitations are set regarding VAT deduction if a new vehicle is acquired. These rules and conditions are reflected in the table:

Lithuania	VAT is not deductible for acquisition, lease and rent of motorcars, except if the business activities are taxi service or driving school.
Belgium	VAT is not deductible 50 % of the value of acquired, leased or rent of the motorcar except it is directly intended for business activities. The same principle is used for VAT deduction from the relevant costs such as fuel, repair etc.
Finland	VAT from the acquisition of motorcars is not deductible if only they are not directly intended for economic activities of the business.
Ireland	VAT is not deductible for acquisition and lease of motorcar itself and fuel as well. Deduction is allowed for trucks acquisition and lease, fuel and maintenance.
United Kingdom	VAT from the acquisition of motorcars is not deductible if only they are not directly intended for economic activities of the business. VAT is 50% deductible if the car is used for business needs and for private needs as well.
Poland	VAT for acquired motorcars is deductible 60% (maximum PLN 6,000 ~ LVL 1,100). VAT is fully deductible motorcar is aimed for providing lease or rent services to clients, for trucks, its lease or rents, fuel expenses. VAT is 100% deductible for maintenance and repair for all the mentioned cars.
Sweden	VAT is not deductible for acquired motorcars. VAT is deductible for the acquired, leased trucks, its fuel and maintenance costs, and 50% of the maintenance and fuel costs of the motorcars provided they are used for business purposes (limitation 3000km in a year).
France	VAT is deductible for the acquisition, lease, maintenance and fuel of trucks only. VAT is not deductible for any costs of motorcars and its acquisition or lease.
Greece	VAT is deductible for the acquisition, lease, maintenance and fuel of trucks only. VAT is not deductible for any costs of motorcars and its acquisition or lease.
Italy	85% of the VAT is not deductible in the case of buying or leasing a car for business purposes. Only 15% of the input VAT is deductible when a motorcar for business purposes is purchased or leased. Input VAT from the fuel and maintenance costs can not be deducted at all.
Czech Republic	VAT is not deductible for purchases or financial lease of motorcars, except the particular car is intended for reselling. Input VAT from the rent, fuel and maintenance costs is deductible.
Netherlands	VAT is deductible for acquisition, lease and costs of both motorcars and trucks. However, there are special conditions for VAT deduction regarding motorcars.

All the mentioned taking into account, implementation of this particular provision would facilitate the growth of the VAT revenue to the State Budget.

Suggested amendments in the Section 10 of the law 'On Value Added Tax' are that a taxable person can not deduct input VAT if goods and services acquired do not refer to the carrying out taxable activities and the person is not able to prove it. The norm should be introduced together with provision that if the person within a period of one year can prove the relation of a purchase to the taxable transactions, he can deduct input VAT. In any case, the rights to deduct VAT should be set only within the time period of one year.

Paragraph 4<sup>1</sup> in the Section 10 of the law 'On Value Added Tax' should be amended about acquisition or creating fixed assets of value above LVL 5,000. Input VAT should be corrected within a period of five years according to the number or volume of taxable and nontaxable transaction carried out by particular fixed asset. The current law applies this principle only if the value exceeds LVL 50,000.

The introducing of this norm would improve VAT levy. For instance, a taxable person in 2007 purchases production line value LVL 20 000 plus VAT LVL 3,600. The taxable person deducted VAT and used this machine for taxable transaction in 2007. In the year 2008, though, the machine is not used for applicable transactions

anymore. Consequently, the fully deducted VAT should be corrected and the difference should be paid into the budget:  $3,600/5 = 720$

The norm about the law 'On Value Added Tax' is not applied to the goods and services delivered without any reimbursement to charity purposes because the norm is misused. Excluding this rule would not expand the basis for application of VAT; however it would avoid inconsistent interpretation of VAT law. For example, a company bought a new car, used it for few months and then donated it to the school. On one hand, this transaction is a charity and VAT law is not applied. On other hand, it can be taken as self-supply and VAT should be applied to residual value because VAT was fully deducted when the car was purchased.

The use of reduced rates is an optional to the Member States. In particular the reduced rate for medical devices because the norm is implemented broader than III Annex of the VAT Directive 2006/112/EC requires. In addition, the rule is difficult to administer, i.e., to check the reason for reduced rate application is possible only during the tax audit. The more efficient tools for realizing social policy should be introduced instead of applying VAT reduced rate.

Introduce the cash flow principle regarding VAT payments and deduction to the small sized companies which annual VAT taxable turnover doesn't exceed

LVL100 000 and which use cash accounting scheme. Using cash accounting VAT principle, the company does not pay VAT until its customer has paid. VAT can be reclaimed on its purchases when the company has paid its suppliers. This principle would ease VAT accounting and relieve cash flow in small sized companies. In the present situation, all companies use standard VAT accounting and VAT must be paid just after the invoice has been issued.

### Conclusions

- Correlation between VAT (x) revenue and the increase/decrease of retail turnover (y) is 0.81, which means that relation between VAT revenues and retail sales is strong.
- To improve the Section 10 of the Law 'On Value Added Tax' by defining that input tax can not be refunded for acquired or leased motorcars, except motorcars intended for drivers' training, passenger transporting, renting, as well as operational transporting means and specialized motorcars such as medical or funeral service.
- Suggested amendments in the Section 10 of the law 'On Value Added Tax' are that a taxable person can not deduct input VAT if goods and services acquired do not refer to the carrying out taxable activities and the person is not able to proof it. The norm should be introduced together with provision that if the person within a period of one year can proof the relation of a purchase to the taxable transactions, he can deduct input VAT. In any case, the rights to deduct VAT should be set only within the time period of one year.
- Introduce cash flow principle regarding VAT payments and deduction to the small sized companies which annual VAT taxable turnover doesn't exceed LVL 100 000 and which use cash accounting scheme.
- The use of reduced rates is an optional to the Member States. In particular the reduced rate for medical devices because the norm is implemented broader than III Annex of the VAT Directive 2006/112/EC requires. In addition, the rule is difficult to administer, i.e., to check the reason for reduced rate application is possible only during the tax audit. The more efficient tools for realizing social policy should be introduced instead of applying VAT reduced rate.

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