Tax reform

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Since the beginning of the year, political debates have been mainly focusing on reforming the tax system. Entrepreneurs have been highlighting the need for a growth enhancing tax reform as frequent changes in the current tax regulation have made the tax system complex and somewhat unfriendly to growth. In view of this, various reform strategies have been proposed. **Latvijas Banka has also come up with its "Tax Strategy 20/20" aimed at supporting competitiveness and raising the level of overall well-being. The key elements of the proposal include:**

- **Reduction of the personal income tax (PIT) rate by 3 percentage points from 23% to 20%;**
- **Unifying tax rates for different sources of income to 20%;**
- **Reforming corporate income tax (CIT) by introducing a 0% tax rate for retained earnings and 20% for distributed earnings;**
- **Widening the use of reverse charge for value added tax (VAT).**

The proposed reform is expected to stimulate economic growth through various channels. First, lower PIT rate increases the disposable income of households which in turn will be reflected in higher private consumption. Second, 0% tax rate for retained earnings motivates companies to build up equity, thus providing more financing options for investment. Estonia, which implemented the reform 15 years ago, serves as an example to follow. Furthermore, the proposed CIT regime could attract more foreign investment as it is less complex than the existing one. A lower tax burden and equal tax rate across all sources of income should also reduce the scale of the shadow economy in Latvia where it currently is the highest among the Baltic States.

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At first sight the proposed changes might seem costly in terms of government revenue. Moreover, they could raise questions of whether the reform will not result in excessive government deficit. However, when other measures, e.g the widening of the use of VAT reverse charge, and the effect on real economy are considered, the estimated impact of the reform on budget is broadly neutral in the first two years and turns positive henceforth. Since the reform supports higher private consumption, VAT and excise tax revenues should increase as well. Similarly, if changes in CIT increase investment activity, additional VAT revenue can be expected. Furthermore, broadening of the product groups covered in the VAT reverse charge regulation should be encouraged as this measure has so far proven to be effective in terms of generating revenue and reducing the shadow economy.

In the midst of the discussion, various other specific reform proposals have been put forward. However, they should be evaluated with caution as some of them incur additional costs which have to be offset by expenditure cuts and/or an increase in other tax rates.

It is important to stress that responsible action to avoid excessive deficits and ensure debt sustainability remains the paramount aim of the fiscal policy even in periods of relatively stable growth. Therefore, the implementation of the proposed tax reform in a budget-neutral way is critical at least in the medium term.