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**THEORETICAL ASPECTS OF
THE IMPROVEMENT OF TAXATION
SYSTEM**

Area: Economic
Sector: Microeconomic

Summary
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Introduction

One of general conditions of the national economy successful development is ordering the tax system. The attention has to be paid to the incomes of the taxes. The effective tax system enables to realize the interests of states. During the period of transition of market economy, lack of the methods of the tax control causes unsufficiently supervised tax payment system.

For the development of tax system it is necessary to found scientifically theoretical principles which are based on modelling of economical process and application of methods of the analysis of tax system.

The research will find negative principles of existing situation and will help to find way out of the existing economical difficulties and finally will help to develop successfully state economic.

The object of the research is the tax system of Latvia.

In research were used the economical - mathematical, statistical - analytical and graphic - analytical methods. The methods used in research which were used for studies of other objects and things till now.

The goal and task

The goal of the work is to develop scientifically theoretical principles about taxation and give recommendation for improvement of tax system.

The main tasks of the work are:

- 1) to make scientifically economical research of taxation system in Latvia and EU, to estimate existing problems and disadvantages;
- 2) to research how various tax rates influence the taxable object;
- 3) to research the influence of the taxes on enterprises activity and to estimate the rate of the taxes that they stimulated activity of local enterprises and what practice changes necessary to introduce in the taxation system;

- 4) to estimate tax burden on persons with different incomes and to develop practical offers about improvement of taxation system, that all tax payers have identical tax burden and to determine, which particular changes are necessary for this purpose;
- 5) to research dynamics of tax revenue, as the various factors influence tax revenue using various kinds of modelling of economical process, to predict how the result changes the situation;
- 6) to develop way of improvement of taxation system, that it corresponds to the requirements of EU and that it functions in situation when there are no borders between memberstates;
- 7) to develop way of improvement of taxation system, with the limits evasion of taxation and improves taxation process and tax administration system.

Scientific innovation

There are following scientific innovations in this work:

- 1) elaboration of theoretical general principles about essence of the taxes, about the general characteristic of the taxes, about the rates of the taxes, about influence of the taxes on activity of enterprises;
- 2) economical and effective model of tax system is worked out, which provides fiscal effect, stimulates activity of local enterprises and equalise the identical tax burden on the persons with different incomes;
- 3) the methodology is developed how to estimate dynamics of tax revenue error;
- 4) the complex of activities for improvement of tax system of Latvia is worked out, forming Baltic customs union between Latvia, Lithuania and Estonia;
- 5) the special system of payment value added tax for dealing between the enterprise of the different states of the Baltic customs union is

elaborated. The measures are developed how to improve tax system, that it accordance to the requirements of EU;

- 6) various innovations are developed, which are not used in the legislation of the Republic of Latvia yet but which need to be introduced in tax system. For example, principle of tax warehouses, the recommendation for guarantee of the taxes, improve the control of production and transportation of the goods, recommendations concerning the introduction of special information data base are developed;
- 7) the proposals concerning improvement of tax administration and its relation to taxpayers are worked out.

Approbation of research

The main scientific development and research of the dissertation were discussed at an annual scientific conference in Riga Technical university faculty of Engineer economic. The author has participated also in other scientific conferences in Latvia as well as foreign countries.

The author has participated in research work “The Analysis of tax payments at a level of regional (urban) services of the incomes and estimation of an opportunity of their increase”(1995).

The author has reviewed two educational books: Zvejnieks A. The taxes and duties. -Riga: RTU, 1996. -293 pp. and Zvejnieks A. The taxes. -Riga: RTU, 1998. -412 pp.

The author has participated elaboration of the draft legislation.

The separate parts of draft legislation elaborated particularly have already become the laws and regulations of Cabinet of Ministers and works in practises: warehouses of the excise goods, tax suspend payment system etc.

The author has participated in development of the following laws of Saeima and regulations of the Cabinet of Ministers:

- The law “About the excise tax on mineral oil”;

- The law “About the excise tax on alcoholic beverages”;
- The law “About the excise tax on tobacco products”;
- Regulation of Cabinet of Ministers 23.12.1997 № 437 “Regulation about the excise tax on mineral oils to payment regard to change excise tax rate”;
- Regulation of Cabinet of Ministers 17.02.1998 № 450 “The Order about return excise tax on mineral oil products if mineral oil use as raw material”;
- Regulation of Cabinet of Ministers 17.03.1998 № 93 “The Order about return excise tax on diesel to producers of agricultural products”;
- Regulation of Cabinet of Ministers 18.02.1997 № 73 “The Order as diplomatic representatives of the USA in Republic of Latvia is authorised bay fuel without the excise tax and value added tax”;
- Regulation of Cabinet of Ministers 16.09.1997 № 321 “Regulation about the declaration of the excise tax”;
- Regulation of Cabinet of Ministers 05.05.1998 № 168 “The Order as account the excise tax on mineral oils at temperature +15 C”;
- Regulation of Cabinet of Ministers 04.08.1998 № 289 “Regulation about a mineral oils warehouse»;
- Regulation of Cabinet of Ministers 08.12.1998 № 446 “The Order about marking and supply of mineral oils“;
- Regulation of Cabinet of Ministers 15.12.1998 № 459 “The Order about marking and supply of mineral oils to producer who use its as raw material”;
- Regulation of Cabinet of Ministers 26.01.1999 № 24 “The Order as excise tax on mineral oils is apply to oil gases”; etc.

As a member of delegation of the Ministry of Finance in meeting author has participated with the delegation of European Commission regards to first round of negotiation concerning Latvia to the tax laws - 1998, 2 days, Brussels.

Structure and general character of work

The work contains 174 pages. There are 43 formulas, 21 tables, 24 pictures and 4 appendixes. Work contains 3 parts.

In first part “Tax system analysis” analysis of the taxes is given. Reason theoretical aspects of the taxes, is given explanation of

necessity of the taxes and their function. Systematised work of many economists and analysts. Analysed the influence of the taxes on activity of enterprises.

In the second part “Economical evaluation of the tax system” are investigated tax system in Latvia and described the scientific - theoretical principles to improve it. Proposals are given for improvement tax system. Attention is given how in general should be tax burden on persons with different incomes. For equal burden on all persons with different incomes the change in tax system must be mad and there is described how to reach it. The revenue of the taxes and factors which influences them are considered. The elasticity of the taxes is considered.

In the third part “Further development of the tax system” in general are given practical offers how to improve tax system and it administration. As one of probable variants how to improve tax system is considered a question of formation of Baltic customs union. In connection with this it is offered to form special system of payment of value added tax, which have not else in not one states (union of the states). To limit the tendency of shadow economy and evasion from tax payments it is offered to enter some new methods of the control of tax payments. It is considered what should be a tax administration and what should be its relation with the taxpayer.

Scientific and practical results

1. Theoretical principle of improvement of tax system

The taxes are the main source of the revenue of state. One and main component of the taxes it the tax rate. Average tax rate can be identical with marginal tax rate or different. It depends on what tax it is – proportional, progressing, regressive or fixed. It is important to analyze, how the taxes influence the activity of enterprises.

Latvia is not isolated from the external world, therefore it is important to know experience of foreign countries in creation of tax system. Especially it concerns with EU, as Latvia is going to enter it.

The system of the taxes in general in the different countries is identical as the characteristic tax is identical.

The formation of system of the taxes will be more effective, if to take principles of EU for example. However Latvia must not only listen to the recommendations of EU, but also actively must take part in legislation work of EU with the offers and development in system of the taxes and to do it already now - before the enter into EU.

2. Tax burden influence to person income and consumption

Tax burden on all taxpayers should be equal, apart from of what are the incomes of persons. In Latvia it is not so. At existent equal income tax rate and equal value added tax rate - size of summary tax burden on the persons with the large incomes is less.

The author investigated, how tax burden in Latvia influences the incomes and consumption of the persons. To understand that the author has developed the graphic image. In figure 1 the influence of tax burden on the incomes and consumption of the persons is shown.

The mentioned research is based on one of basic principle of economic – increase of the incomes of the persons increase also consumption, but up to the certain level, after which the growth of consumption becomes less. Consumption growth dependence on the incomes is described by curve P in figure 1.

There is the proportional direct tax - incomes tax - rate and proportional indirect tax – value added tax – rate in Latvija.

It means, that at growth of the incomes of the persons, proportionally occurs growth of the direct tax, as is identical tax rate 25 % for all incomes. In result on all incomes are taxed identical tax burdens not depending on level of the incomes. Burdens of the direct tax on the consumer describe curve a in figure 1.

Burden of the indirect tax on the incomes describes curve b in figure 1. The tax rate of value added tax in Latvia is equivalent for all kinds of goods. It mean that at growth of the incomes also grows burden of an indirect tax, in general - value added tax, but it occur up to determined level of the received incomes, up to a point A' in figure 1.

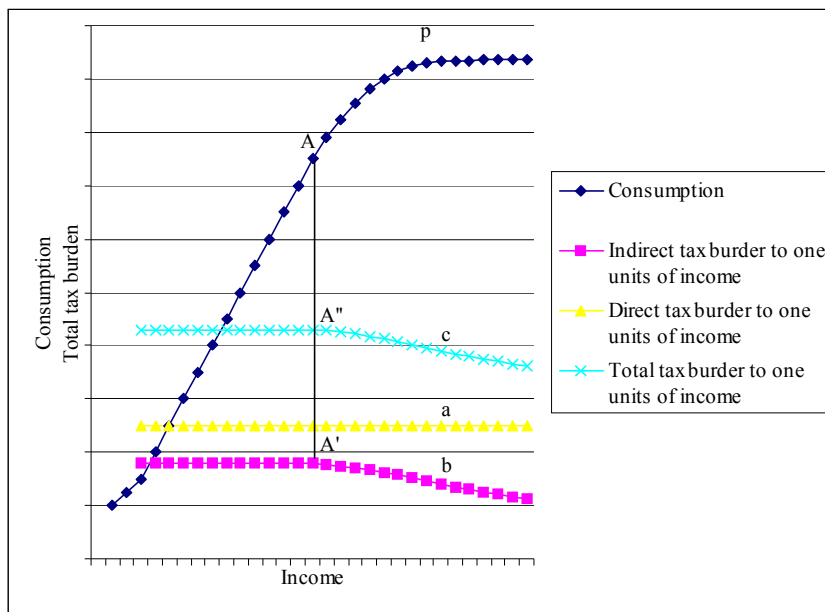


Figure 1. Tax burden to income and consumption

When incomes receive a point A' in figure 1, marginal rate of an indirect tax (value added tax) and burden of an indirect tax decrease, because value added tax is regressive, as it can be seen in figure 1. On this level of the incomes, the consumers consume less.

Summary tax burden, which is formed from direct and indirect taxes, decreases at growth of the incomes. It shows by curve c in figure 1. It means that now in Latvia the persons with higher level of income have lower tax burden as persons with lower incomes.

Therefore it is necessary to change situation in such way that all persons, apart from their incomes should have equal tax burden. The line c figure 1 should be a straight line.

For equivalent tax burden is necessary to change tax system so, that persons with higher incomes would pay more taxes. It is possible to reach:

- to changing direct (income) taxes and introducing progressive or different income tax rate and taxable higher incomes with the higher tax;

- to changing indirect (consumer) taxes and forming tax system so that persons with the higher incomes would have the higher tax burden from the part of the consumer tax;
- to applying both mentioned variants simultaneously.

Mentioned measures remove the regressive character of tax burden and are forming a situation, when on all incomes of taxpayers in Latvia would be equal tax burden.

In this case the author offers to introduce different tax rates: reduced on food products and basic on other goods, and to introduce progressive incomes tax.

3. Tax revenue assessment

The statistical mathematical analysis of the taxes dynamic allows to determine deviance in taxes revenue. This analysis the author used in research work, as some things, influence taxes revenue, at different level: at macroeconomic level, at a local level, at level separate enterprises.

For the analysis of tax system the author offers to use methods, which were used for some other statistical parameters research, but less known for analysis of the taxes revenue.

To the analysis of taxes revenue can be used such factors, as GDP, as well as other economic parameters, for example, wages. The author has developed method, how use to the earlier mentioned factors to estimate tax elasticity.

4. Tax harmonisation and approximation whit EU requirement

As EU experience shows, the mutual integration in the field of tax administration, tax system is to be improved, if it is created the economic union between the states.

For formation of economic union similar of EU, it is necessary to harmonise a lot of questions, also regards to the taxes and tax administration.

The question is what kind of union it is – is it formed as customs union only or in a wider scale as EU is for example.

Author of this work offers formation of Baltic customs union.

5. The special system of payment of value added tax

In connection with formation of Baltic customs union, the author has developed and offers to introduce in practice the special order mutual account of value added tax, which could work in Baltic customs union and decide a problem of the value added tax taxation when goods are moved from one to another country in Baltic customs union.

This order of account is based on a fact that the value added tax is taxable in each country by the established tax rate of country from which goods are brought out also in the mutual deals of different enterprises of the states of Baltic customs union. It is not import – export procedure, but intra union procedure. The revenue of tax, is brought into the budget of each country, depending on the mutual bargains of enterprises of the states.

The order developed by the author, does not work yet in anyone of the country, though it can be used not only in Baltic customs union, but also in other possible unions in the EU.

The system basically works in order, that each country administrates value added tax according to the national legislation with accordance rate, but considerate some additional conditions. As the value added tax is taxed on goods and services, it would be necessary to pay it in that state, in which particularly these goods and services are consumed. But, to avoid import-export operations between the states of Baltic customs union, and to exempt from repayment of the tax, if the goods move to other country, the author offers to make this procedure other way, i.e. as a matter of fact such, which works in the country. Export from one country in another does not exempt but is taxable on conditions of the country from which the goods are taken out according to the tax rate of this country. But import from other country is not taxable as the tax in this case was paid in state from which the goods were imported.

For example goods move from Riga in Vilnius. Now value added tax is taxable as usually in import export cases – on borders. In the figure 2 is represented value added tax taxation on borders. In Latvia the goods are taxed with 0 % value added tax after the goods are taken out (are exported) from the state, however on the Lithuanian border is able value added tax (18 %) according to the tax rate of Lithuania.

Other order could be in case of Baltic customs union. Value added tax taxation in the Baltic customs union is shown in the figure 3. In this case, the goods taken out from Latvia, are taxable with value added tax 18 % (as well as in the deals inside the country), and in this case value added tax in Lithuania must not be paid, as it is already paid in Latvia.

To make it more understandable, how the mentioned system of account works, the author of this work has developed algorithm, on which calculate the revenue from value added tax in each state. As this procedure of payments, could work not only in Baltic customs union, author has worked out the formulas, that can be possibly used also in other cases.

For a basis of account there is a general balance account, which is fund as a difference among the incomes from payment of value added tax on goods witch is brought in the country, and payments from value added tax on the goods taken out from the country.

It is possible to apply the following formula to account:

$$B_{KN} = I_{KN} - E_{KN}, \quad (1).$$

Where: B_{KN} - balance account;

I_{KN} – value added tax for imported goods in the country;

E_{KN} – value added tax for the goods whose is taken out from country.

In work were calculated I_{KN} and E_{KN} . In result B_{KN} can account from follows formula:

$$B_{KN} = (P_{1N} \times L_1) + (P_{2N} \times L_2) + \dots + (P_{MN} \times L_M) - P_N \times L_N, \quad (2).$$

Where: B_{KN} - balance account;

P_{1N} - value of the goods, witch taken out from the first country;

L_1 – value added tax rate in the first country;

P_{2N} - value of the goods, witch taken out from the second country;

L_2 - value added tax rate in the second country;

P_{MN} - value of the goods, witch taken out from the M country;

L_M - value added tax rate in the M country;

P_{MN} - value of the goods, which are imported in the concrete country;

L_M - value added tax rate in the concrete country to which goods are imported.

In the table 1 is given example as in case of Baltic customs union countries must account for moving of goods in mutual trade of companies, if in all states are the identical value added tax rate. Example, on the data of statistics, Latvia would need to pay 1.44 conditional money unit to other states for export of the goods from Latvia in other states, but other states must pay Latvia 1.98 conditional money unit for import of the goods in Latvia from other states. In result Latvia receives 0.54 conditional monetary units ($1.98 - 1.44 = 0.54$).

6. New progressive proposal for improvement of tax system

Decrease of the illegal economy is one of the main tasks of all states, that is necessary to undertake to promote fair mutual competition. Latvia needs to improve tax administration and to decrease smuggle and illegal activity.

For struggle against the illegal economy, the author has developed the different offers how to improve tax administration. In this connection author offers to form special information system. It would improve exchange of the information not only on administrative territory of Latvia, but also between Estonia and Lithuania as well as other states, and not only to check legality of enterprises, but in more cases, for example, to control the movement of goods.

In this connection author has worked out the recommendations, which improve the control of the goods in movement, and, how to check accompanying documents. It is basically possible to use in such cases, when moving the goods between different territories under tax payment suspend system, i.e. in such cases, when taxes are not paid yet and consists risk, that they can be not paid.

In the table 2 is given the description of the control action of the goods movement using tax payment suspending order. The control of the documents of moving of the goods in more detail also is schematically described in work.

Table 2

**The action of control of movement the goods using tax payment
suspending order**

No.	The action
1.	The sender of the goods submits the accompanying documents in the first tax administration.
2.	The first tax administration enters the information in special information system.
3.	The time when the goods moves.
4.	The consignee of the goods, after reception of the goods, submits the accompanying documents in the second tax administration.
5.	The second tax administration enters dates in special information system and carries out (cancels) data entered of the first administration, which must be equal.
6.	In a case if the consignee has not received the goods, or not submit documents, the second administration does not enters dates in special information system, and special information system automatically inform on it of the first tax administration.
7.	The first tax administration begins to be interested, where there were goods or will claim for the tax from the sender of the goods, if the goods do not move when due hereunder.
8.	But if the sender of the goods will prove that the goods he has sent, then the consignee of the goods, who not inform the second tax administration should answer. In this case special information system informs the second tax administration.
9.	The second tax administration begins to be ask, where is the goods, or will claim the tax from consignee of the goods.

The author of work has offered to introduce also others modern things into tax system: special tax warehouse, using more the tax suspend payment system order, to introduce guarantee of tax payments not only into transit of the goods but also in some other activities of business, for example, with the excise goods, with woods material i.e. in business with such goods, which, according to the analysis of risk there would be risk not paing the taxes. The author offers to introduce also other activities in the field of the control of the goods, for example, more effective method of the productions control, check of the validity of the information and documents using elements of the analysis on risk etc.

7. Improvement of tax administration

The tax system will to work effectively, if tax administration will be effective, therefore with the minimal administrative expenditure it is necessary to achieve the maximal success. The administration of tax structure should be logical and proved, without duplication of duties. In this connection, the author has developed the variant of possible tax administration structure of Latvia.

The tax administration should be more elastic and faster follows real changes. It is necessary to make change in structure of State revenue service. Customs must run more attention to quality of the goods, its origin and protection of interests of the consumer.

It is necessary to explain and train a society about the importance of the taxes in development of economic of Latvia. The mentioned works should be carried out at all levels, beginning even from school.

The tax administration has not enough that it knows the laws of the taxes, it should understand their economic meaning (importance).

Effectiveness of tax administration would increase, if approach to the tax payers will be as to the client.

Conclusions and suggestions

As the result of research the following conclusions have been drawn up:

- 1) Latvia is not isolated from the external world, therefore it is important to know experience of foreign countries in creation of tax system. Especially it concerns to EU, as Latvia is going to enter it. The tax system in different countries generally is identical, as the characteristics of the taxes are similar;
- 2) it is important to analyze, how the taxes influence the entrepreneurship. It is important to know, how each tax influence the entrepreneurship;

- 3) tax burden on all taxpayers should be equal, apart from what are the incomes of persons. There are no such conditions in Latvia. At the existenting equal income tax rate and equal value added tax rate - size of summary tax burden on the persons with the large incomes is less;
- 4) mathematical statistical analysis of tax dynamics helps define deviations in tax revenue. There have been used such factors, as Gross domestic product, as well as other economic parameters, for example wages, in the analysis of the taxes. The mentioned factors allow to estimate elasticity of the taxes;
- 5) as shows the experience of EU, the mutual market integration improves tax administration, if it is created between the states of economic union;
- 6) as well as in EU it is necessary to harmonise a lot of questions according to formation of economic union and also in cases regard to the taxes and tax administration;
- 7) the struggle to decrease illegal economy is one of the main tasks of all states, that is necessary to undertake to promote a honest competition. And Latvia needs to improve tax administration and decrease smuggle and illegal activities.

Considering mentioned conclusions the following suggestions have been set forth:

- 1) it is necessary to creates tax system on progressive principles. It is possible to use also foreign practice, but not always. Features and difficulties of each separate country need to be taken into account forming tax system. It is necessary to create tax system in Latvia according to the standard economic principles;
- 2) in order to make equal tax burden on the person with different income, it is necessary to change tax system. In these cases progressive income tax rate must be introduced. Also different value added tax rate – the lower rate for food products and other consumer goods and the basis rate for other products – must be introduced. To stimulate local enterprises it is necessary to increase tax burden on goods, which are imported in Latvia and for this purpose to

introduce the excise tax for oranges, bananas etc, the goods which only import in Latvia;

- 3) it is necessary to analyse revenue using tax elasticity for it. It can be used for revealing evasion from the forecasts, and also forecasting tax revenue. For the analysis of the revenue can be used such factors, as GDP, as well as other economic parameters, for example wages;
- 4) to improve taxation in Latvia, Lithuania and Estonia, it is necessary to form Baltic customs union. For this purpose it is necessary to harmonise many things;
- 5) in connection with the opportunity of formation Baltic customs union, it is necessary to introduce in practice the special order for mutual account of value added tax which would solve a problem of the value added tax taxation when goods is moved from one to other country within Baltic customs union. This order of account is based on the principle that the value added tax is taxable in each country by the established tax rate of country from which goods are brought out also in the mutual deals of different enterprises of the states of Baltic customs union. It is not import – export procedure, but intra union procedure. The revenue of tax, are brought in to the budget of each country, depending on the mutual bargains of enterprises of each state;
- 6) to combat the illegal economy, it is necessary to introduce modern progressive things in tax system. There must be introduced a tax warehouses system, a tax payment suspension system, guarantee of tax payments from business activity, for example, in business with the excise goods, in business with woods material, etc, in business with such goods, where is risk, that taxes will not be paid. There must be introduced also other measures, for example, more effective method of the control production and movement of goods, check of documents etc;
- 7) the tax administration should be more flexible and faster follow real changes. It is necessary to make change in structure of State revenue service. Customs shall deeper integrate in structure of State revenue service. Customs must pay more attention to quality of the goods, its origin and protection of interests of the consumer.

Publication

On the theme of dissertation author prepared follows publication:

- The taxes rate in Latvia // Economical problem in business. -Riga: RTU, 1996. -6.-8. pp. (with co-author).
- Development of taxes system in Latvia // Economical problem in business. -Riga: RTU, 1996. -10.-13. pp. (with co-author).
- The goods witch is apply with the excise tax and its control // Economical problem in business. -Riga: RTU, 1997. -49.-52. pp. (with co-author).
- Important tendency in development of taxes system in Latvia // Economical problem in business. -Riga: RTU, 1997. -43. pp. (with co-author).
- The tax administration and taxpayers service // Economical problem in business. -Riga: RTU, 1998. -58.-60. pp. (with co-author).
- Possibility improve tax system to create Baltic custom union // Economical problem in business. -Rēzekne: Rēzeknes Higher school, 1998. -5 pp. (to hand on printing).
- Tax burden on the persons income and consumption // Economical problem in business. -Riga: RTU, 1999. -4 pp. (to hand on printing).