

STRENGTHENING VALUE-ADDED TAX (VAT) ENFORCEMENT IN LATVIA

A Europe and Central Asia
Governance Result Story



The Development Challenge



A World Bank Governance technical assistance program helped the Government of Latvia increase value added tax (VAT) compliance through better compliance risk management, improved tax audit targeting, and invoice lotteries

Tax evasion was a serious challenge in Latvia. In 2014, approximately 20 percent of the country's VAT revenue was lost to evasion, well above the average of neighboring countries like Lithuania (12 percent) and Estonia (10 percent). The percentage of lost revenue from tax evasion is known as the VAT gap,

or the difference between total tax collected and the amount theoretically due.

Faced with the challenge of raising revenue and closing the VAT Gap, the Ministry of Finance, with funding from the European Union's Directorate-General for Structural Reform Support (DG REFORM), collaborated with the World Bank on a comprehensive review of Latvia's tax system.

The World Bank team worked with the Latvian Ministry of Finance and State Revenue Service (SRS) to better estimate the country's tax gap, improve auditing and investigation abilities, and design interventions to uncover and collect undeclared income. To avoid unduly increasing the tax burden on honest businesses that meet their tax obligations, the SRS settled on a strategy to increase VAT compliance.



Tax evasion deprives governments of revenue for essential services, erodes social security, and distorts official statistics like GDP, which are important signals to investors and policymakers.



The Project

The World Bank team designed a technical assistance program for the SRS to strengthen the agency's audit functions and develop new strategies to strengthen tax compliance. **The program centered on four key areas: (1) updating VAT Gap estimates, (2) strengthening audit analytical capacity, (3) reviewing tax laws in collaboration with the Ministry of Finance, and (4) developing an updated compliance strategy,** which included training on new tools for detecting tax evasion and guidelines for better monitoring of high net worth individuals.

In 2018, the World Bank team kicked-off the program with a series of workshops with SRS officers in Riga. Experts from Austria, New Zealand, Sweden, Finland, Germany, Norway, Italy, and Ireland were brought in to deliver tailored lessons on topics like predictive analysis of VAT fraud, interagency coordination for tax investigations, and improved auditing in industries like construction, taxi and food and beverage. The workshops included first-hand experience on data analytics tools to detect firms with a higher risk of evading taxes and in person shadow audits, where trainers accompanied and coached VAT auditors in techniques to detect fraud as they conducted inspections on business premises. Particularly valued by the Latvian SRS was the review of the SRS control methodology which resulted in recommendations for change in strategy, organization and approach of the SRS's VAT Control function.

Invoices in Latvia are required to include the name, address, and the VAT registration number of the taxpayer. When a customer pays in cash, however, it is common for businesses like restaurants or retailers

to provide unofficial handwritten receipts. While businesses could record cash receipts in their books, they are generally off-the-record sales. Unreported cash allows employers to pay workers in two wages: an official wage which is declared for tax and social security purposes, and an unofficial "envelope wage" which is undeclared and lets employers avoid paying social insurance and tax liabilities. Envelope wages not only decrease tax revenues, but deprive the pension systems of future income, and lower pension pay outs for workers once they retire.

The World Bank team also supported the SRS to launch an "invoice lottery." Invoice lottery schemes provide customers with an incentive to ask for receipts by entering a monthly prize draw once they submit them in a central database. By encouraging customers to ask for receipts, sales data is recorded and taxed, making it harder for business to evade their obligations. Comparing the results from customer receipts with official business records helped the SRS improve the accuracy of the VAT Gap and assign penalties for tax evasion.

Results

By December 2019, total VAT revenues in Latvia increased by 7.8 percent compared to the previous fiscal year, a real increase of 5 percent adjusting for inflation. Revenues increased even as the country introduced legislation to lower corporate tax rates; revenues from corporate tax declined by as much as 85.3 percent, while VAT increased by almost 8 percent and personal income tax by about 13 percent.

With support from the World Bank, the SRS raised revenues even as corporate rates fell, due to the knock-on effects of VAT enforcement on personal income tax and social security contributions. When there is less evasion in business profits and revenues, there is less unreported cash. With less cash at hand, firms are less likely to pay employees envelope wages. Higher percentage of formal wage payments led to higher declarations of personal income, and to corresponding increases in social security contributions. The World Bank team expects to see a further 4 percent increase in tax revenues by the end of 2020.

Early results from the invoice lottery are also promising. In the six months following the start of the program on July 2019, consumers have submitted more than 9 million receipts, leading to over EUR372,200 in additional taxes and penalties. During the year,

16.6 million receipts have been submitted and revenue from the lottery are supplemented by 1.2 million euros. Much like increased VAT enforcement, the SRS expects the invoice lottery to raise even more revenue through knock-on effects, as businesses become concerned about issuing handwritten receipts and citizens become more vigilant about tax evasion.

In addition to the work on improved VAT enforcement, the World Bank also completed a compliance review of the country's tax laws, focusing on recommendations to improve tax audit performance based on risk analysis, and to lower compliance costs for small businesses. Other recommendations, such as specific timelines for VAT repayments, automatic access to bank accounts records, payments on account for large taxpayers, and selective prosecutions policy, have been adopted as priority actions by the Ministry of Finance and await passage into law.

Lessons and Next Steps

High-level support from the government and coordination between the implementing agencies—the Ministry of Finance and the State Revenue Service—were instrumental to the success of the project. From the onset, the Ministry of Finance laid out a clear mandate for the SRS and other agencies to combat the shadow economy and increase VAT enforcement. Close coordination between the SRS and the Ministry meant that project recommendations and

strategies could be implemented quickly through national directives, regulation and even legislation.

High-quality technical advice and peer learning from senior, international experts were key strategies in the program's effectiveness. Practical advice from experts helped the government design new VAT strategies that took into account political economy lessons and considerations from a wide range of settings.

More importantly, learning from peers helped to build trust between the World Bank team and SRS staff, whom were wary of increased scrutiny and outside expertise at the start of the project.

Improved technical capacity allowed the SRS to conduct a more detailed segmentation of the tax gap and to design programs to better levy penalties in specific business sectors such as retail and wholesale trade, and in individual taxpayer segments (large taxpayers, medium-sized businesses, small businesses).

The SRS learned from the successful first-hand experiences of countries in the EU and other advanced countries. This helped it better think through the challenges of implementing VAT enforcement reforms, and helped them devise a solution tailored to the needs of the country, ensuring local ownership.



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