PricewaterhouseCoopers SIA - MindLink.lv. Published: 06.02.2024

Ministry of Finance completes evaluation of CIT reform 1/6/24

Director, Tax, PwC Latvia
Vita Sakne

The tax reform in Latvia involved changing its corporate income tax (CIT) system from 1 January 2018. Six years after the new system was put in place, the Ministry of Finance (MOF) has evaluated the CIT reform and prepared an evaluation of the impact of the CIT reform in 2018–2023 and a proposed scenario of further action. This article explores the purpose, content and key findings of this evaluation.

The purpose and content of the evaluation

The evaluation serves as a basis for tax policy objectives that will go into the national tax policy framework for 2024–2027 to be drawn up by 31 May 2024, and offers extensive insights into the results of the CIT reform based on data analysis.

The evaluation analyses key indicators such as shareholders' equity, profitability and profit figures, as well as looking at other business drivers, such as labour costs and export market indicators. The analysis includes a comparison of several indicators across the Baltic States, Poland and the EU average, plus by industry and by corporate structure. It also looks at the impact of the CIT reform on national budget revenues.

The evaluation of the impact of the CIT reform in 2018–2023 and a proposed scenario of further action, which includes an extensive assessment and a large statistics section, is available from the MOF website ("Information reports and studies").

Key findings

The purpose of the 2018 CIT reform was to improve corporate profitability, productivity and financial indicators (including equity) to drive investment through better access to bank loans.

The statistics show that equity rose (94% companies with a positive equity in 2021) while total liabilities fell. At the start of the CIT reform, it was assumed that improving financial indicators would improve access to bank loans. The MOF finds, however, that companies are still using their own funds to finance their business and the role of bank loans in business financing has diminished. This trend is particularly apparent in long-term loans, with short-term liabilities remaining quite unchanged. So the analysis suggests that the current CIT rules promote the accumulation of reinvested profits but the level of equity against GDP is still low compared to the EU. The general level of productivity in Latvia lags far behind Lithuania and Estonia, with significant differences by industry.

After the CIT reform, retained earnings for the current year increased significantly. From a generally negative profit indicator (– EUR 1,682 billion) in 2014, Latvian companies had accumulated slightly more than EUR 6 billion in retained earnings according to their results for 2021.

When the CIT regime was changed, budget revenues were expected to shrink because tax had already been paid on profits made before 2018 and not all of the profits had been distributed in dividends. The evaluation mentions a retained earnings figure of around EUR 10 billion by 31 December 2017. Yet post-reform profits were increasingly distributed, so CIT revenue grew year on year. In June 2023, for example, 8,518 taxpayers paid dividends to their shareholders and CIT to the government (a 27% increase on June 2022) totalling EUR 121.3 million (up from EUR 44.3 million in June 2022). This means CIT revenue grew from 2018 to 2023 to reach 1.16% of GDP. However, on this indicator Latvia lags far behind its neighbours and the EU average, where CIT revenue is 2.9% of GDP.

An alternative scenario of CIT development is the option of going back to the classical model, which charges CIT on annual profits. The evaluation states that fundamentally changing the core CIT principles such a short time after the previous reform may indicate volatility of the business environment and negatively affect investors' trust. This means we cannot achieve the goal of this reform unless we keep the current CIT system with the changes approved by Parliament. Remember that the latest key amendments to the CIT Act effective from 2024 require credit institutions and consumer lending service providers to make an additional payment of CIT, which essentially means paying CIT on the profit for the financial year. A repeat evaluation of the CIT reform's results would be necessary in the medium term, particularly considering equity growth and reinvested profits.