THE COMPANY’S INSOLVENCY IMPACT ON TAX COLLECTION PROCESS

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Abstract

Tax revenues are the key source of finance for the government’s budget. The state administration redistributes and allocates tax revenues for performing the state’s basic functions in order to ensure the overall development of the country and its population’s wellbeing. The availability of credit resources declined owing to the global crisis 2007–2009, which negatively affected the growth of Latvia’s national economy, and the total tax revenue decreased by 26.80% in 2009 compared with 2008. Latvia’s government, to secure the financing of its budget, stabilise Latvia’s financial system, raise the country’s competitiveness, borrowed in foreign financial markets EUR 4.5 billion. The present research examined Latvia’s economic development and tax collection dynamics after Latvia’s restoration of independence and its accession to the European Union and assessed the effects of the global crisis on the solvency of enterprises and tax revenues and how Latvia contributed to the foundation of new enterprises and the improvement of the business environment. Research methods employed: the monographic method was used to examine, assess and analyse literatures and legal acts, describing findings and interpretations; statistical observation, compilation and grouping of information, calculation of statistical data, analysis of causal relationships and data generalisation; logical analysis and synthesis. The graphic method was employed to show the relationships identified and their nature and form. The logical and constructive methods were used in analysing results and making judgements. The present research found that the insolvency of companies significantly affects the tax collection process and reduces total tax revenues. In 2013, a tax debt of EUR 267.59 mln was written off in Latvia because tax payers were liquidated, while in 2014 taxes totalling EUR 1 263.63 will not be potentially collected. The authors presume that research on the effects of company insolvency on tax revenues has to be continued in order to improve tax collection and design tax policy instruments aimed at restoring the solvency of enterprises facing problems.

Keywords: insolvency, Latvia, tax revenue, limited liability company

Introduction

Government budget revenues are mainly comprised of taxes paid by the country’s individuals and businessmen. The government, through tax policies, improves the business environment, controls it, and also seeks to ensure stable tax revenues for a long period.

Latvia is a small country, and it is interested in attracting investors as well as active entrepreneurs wishing to start their own business from Latvia or in Latvia, thus contributing to the country’s economic growth and recognition in the world. Accordingly, the government is interested in the country they represent to be rated positively and have high rankings in international studies, as well as to be among the best, especially in the fields related to entrepreneurship development and business environment stability. However, while seeking to achieve a high rank in some particular area, the country’s overall development has to be evaluated or, for instance, it has to be made sure that easing the procedure of registering a new enterprise and reducing the initial equity capital for a newly established enterprise will not create problems in another area in the future, for example, it will not be difficult to collect the previously calculated taxes.

The research aim is to identify the effects of insolvency of enterprises on tax revenues (collection) in Latvia.

Based on the aim, the following research tasks were set:
- to examine Latvia’s economic development and tax collection dynamics after Latvia’s restoration of independence and its accession to the European Union;
- to assess the effects of the global crisis 2007 on the solvency of enterprises and tax revenues; to assess Latvia’s business start-up rank, compared with Lithuania and Estonia;
- to analyse the dynamics of registration of LLC in Latvia, the number of completed insolvency cases and the effect of insolvency cases on tax revenues in Latvia.

The following qualitative and quantitative methods were employed: the monographic method – in examining, assessing and analysing literatures and legal acts, selecting only the information related to the present research, describing findings and interpretations; statistical methods, i.e. statistical observation, compilation and grouping of information, calculation of statistical data, analysis of causal relationships and data generalisation; logical analysis and synthesis. The graphic method was employed to show the relationships identified and their nature and form. The logical and constructive methods were used in analysing results and making judgements.

The present research used the World Bank’s Doing Business studies, the Register of Enterprises of the Republic of Latvia and statistics of the State Revenue Service.

Research results and discussion

At the end of 1991, Latvia’s independence was recognised de facto and changes occurred also in the economic environment – a transition from a planned economy to a market economy took place, which enabled individuals to transform from employees into employers and establish their own enterprises. Along with these changes, the insolvency and bankruptcy of enterprises and companies emerged as an urgent problem, as individuals lacked sufficient knowledge and experience in business management and, what was the most
important, in establishing an accounting process and in budget planning in order to ensure sustainable development of an enterprise.

However, in the world, insolvency problems were a focus in the 1920s-30s – after the First World War and in 1929 when the USA’s stock market collapsed and the Great Depression began.

Between the two World Wars, the economic environment of most industrial countries was shaken by a crisis of unprecedented dimensions. Unemployment mounted to record levels and was stubbornly persistent. With it came a wave of social discontent. In England, the crisis began in 1921 and continued with little interruption through the 1930s. Severe depression conditions were later in reaching the United States, but when they arrived with the 1929 crash, their force was greater (Barber, 2009: 223).

The greatest advances in economic thinking in the twentieth century have been associated with the name and work of John Maynard Keynes. His most important contributions were produced in the years of the Great Depression. It was then that he formulated his General Theory of Employment, Interest and Money, a work that broke sharply with the orthodox neo-classical tradition. Keynes argument was that the governments had a major responsibility for regulating the economic climate in ways that would permit the market system to achieve its full potential. He noted that an unregulated market system was likely to be chronically unstable and incapable of assuring the full utilization of productive resources (Barber, 2009).

So governments, by passing various regulatory legal acts, increase the control of the entrepreneurship environment and, by means of available instruments, can foster the development of the market or hinder it. For instance, during the crisis, the government may make an order to the private sector for certain services/goods, thus ensuring that private entrepreneurs do their business and have resources for continuing their economic activity. If the government can stimulate the development of entrepreneurship, it has to create instruments so that entrepreneurship may be terminated in a controlled way both through the usual procedure and through using instruments for insolvency and bankruptcy.

Nowadays any nation has developed its own procedure that prescribes the way how a company is liquidated and is aimed at completing this process as fast as possible, at facilitating meeting the obligations by the enterprise (entrepreneur) being in financial problems and, if possible, at restoring its solvency.

Researches of various foreign scientists regarding enterprise insolvency problems indicate that these problems relate to the financial position and, to describe it, various terms are used: insolvency, bankruptcy, financial distress, failure (Sneidere, 2009: 11).

One of the classic studies of ratio analysis and bankruptcy was performed by Beaver (1967). Beaver found that a number of indicators could discriminate between matched samples of failed and nonfailed firms for as long as five years prior to failure. In a subsequent study, J. Deakin (1972) utilized the same 14 variables that Beaver analyzed but applied them within a series of multivariate discriminant models. Although J. Deakin achieved a high classification accuracy in the development sample (more than 95 percent for the first three years prior to failure) there was substantial deterioration in the classification accuracy in the hold out sample one year prior, a result that J. Deakin noted “cannot be explained by the presence of any unusual events peculiar to the sample used.” The significance of this finding is that it is premature to conclude from test results from a development sample that valid empirical relationship has been detected (Caouette, Altman, Narayanan, 2008).

E. I. Altman’s Z-Score models (1968) are based on a multivariate approach built on the values of both ratio-level and categorical univariate measures. From the original list of 22 variables, the final Z-Score model chosen was the following five-variable: (1) working capital / total assets, (2) retained earnings / total assets, (3) earnings before interest and taxes / total assets, (4) market value of equity / book value of total liabilities and (5) sales / total assets (Caouette, Altman, Narayanan, 2008).

In 1977, E. I. Altman, R. Haldeman and P. Narayanan (1977) presented a second generation model with several enhancements to the original Z-Score approach. Their purpose was to construct a measure that explicitly reflected recent developments involving business failure and accounting reporting changes such as lease capitalization. The new model, which was named ZETA, was effective in classifying bankrupt companies up to five years prior to failure – with over 90 percent accuracy one year prior and over 70 percent accuracy up to five years prior to failure. The inclusion of retailing firms in the same model as manufacturers did not appear to affect the results negatively. Its seven variables are: (1) return on assets, (2) stability of earning, (3) debt service, (4) cumulative profitability, (5) liquidity, (6) capitalization and (7) size of total assets (Caouette, Altman, Narayanan, 2008).

E. I. Altman and G. Sabato (2005) have built a Z-Score-type model for SME (small and medium-sized enterprises). This model employs five financial ratios: (1) short-term debt / book value of equity (leverage), (2) cash / total assets (liquidity), (3) EBITDA / total assets (profitability), (4) retained earnings / total assets (coverage) and (5) EBITDA / interest expenses (account) (Caouette, Altman, Narayanan, 2008).

The above-described models are mainly based on summarised accounting data. If some error is made in keeping records, the result obtained from using the records is misleading or incorrect. Besides, no data on off-balance liabilities may be included in these models, for example, an enterprise’s guarantees to credit institutions for loans given to third persons; therefore, the data obtained in a simulation are not precise.

The human factor is essential in the routine of any enterprise – in collecting data, in keeping records, in analyses, as well as in performing routine functions. The above-described models use historical data and an enterprise’s own collected data; yet, it is probable that in a certain moment – while making an analysis – it is
found that the enterprise’s performance is all right, the risk of facing insolvency is low, and particularly at that moment the enterprise’s manager invests in a business deal that turns out to be unsuccessful in the future and the enterprise faces financial problems.

In the business environment, any enterprise is associated with other enterprises, governments, employees and other factors. Accordingly, the enterprise’s solvency can be affected by the external environment, for instance, the government and its tax policy, the attitude of cooperation partners regarding making payments for the services/goods received etc.

The risks of external environment that affect the enterprise’s solvency may be divided into the following categories: (1) political/ regulatory/legal, (2) economic, (3) social and (4) technological. Political/ regulatory/legal risks are understood as governmental rules, restrictions and reliefs for entering the market. However, economic risks involve an industry’s cycle, interest rates, consumer demand, a particular industry’s alignment with the overall economic cycle, whether the price of products matches their cost and other factors. Social risks are as follows: an industry’s stability, stability changes (positive or negative) according to social taste or fashion changes, industry’s record on pollution etc. The technological issues affect the industry/company in two main ways: the product obsolete and likely superseded by a better new product (‘better’ might be in terms of price or quality) and a fundamental change in the cost structure of manufacturing the product (Fight, 2004).

E. I. Altman’s Z-Score model (1968), a second generation model with several enhancements to the original Z-Score approach developed by E. I. Altman, R. Haldeman and P. Narayanan (1977) and a Z-Score-type model for small and medium-sized enterprises constructed by E. I. Altman and G. Sabato (2005) are based on financial indicators that are obtained by combining in different ways and analysing annual report data which are sufficient to have comprehensive and as complete as possible information about an enterprise. After examining the overall performance of an enterprise, various researchers found that non-financial factors exist, which affect an enterprise’s solvency, for example, management style, employee loyalty, technologies etc. Thus, non-financial failure prediction models were developed.

J. Argenti’s A-Score model (1976) is based largely upon nonfinancial variables. J. Argenti emphasizes the need to know a customer intimately and that there are certain detectable symptoms of potential failure that need to be analysed. J. Argenti suggested criteria for identifying (1) defects, imperfections: in an enterprise’s management and recordkeeping, cash flow planning, (2) errors, for example, in implementing or in failing to implement projects and (3) symptoms or characteristics, which result from the faults and errors made earlier. This model is quite subjective in that it relies on common sense rather than a purely quantitative driven model. The model instead relies on a set of common sense factors which are meant for identification and subsequent analysis (Fight, 2004).

In general in the world, research focuses on enterprise insolvency causes, as the insolvency and bankruptcy of any enterprise affects:

- the enterprise’s creditors, including employees who, because of the insolvency of a cooperation partner, cannot recover their investments or regain them in a limited amount (only partially);
- the country in which the enterprise is registered and the business is made, as government institutions are not able to collect the previously calculated taxes or collect them in a limited amount (only partially);
- residents of the country – because of many insolvency cases that result in bankruptcies in which the government is not able to collect the previously calculated taxes, thereby decreasing government budgetary revenues, the government might lack resources for implementing various important social projects, for instance, construction or renovation of infrastructures, which, in its turn, does not foster business development and increase tax revenues.

In the whole world, credit institutions, too, assess enterprises’ solvency before granting them loans, and this information is important to investors to make decisions on investing in the enterprises. It is important to investors how every government regulates and ensures insolvency and bankruptcy proceedings, whether any creditors’ interests are protected and whether measures are taken to eliminate fictive insolvency cases.

After the Republic of Latvia restored its independence, Latvia set joining the European Union (hereinafter the EU) as one of the strategic goals.

The EU is set up with the aim of ending the frequent and bloody wars between neighbours, which culminated in the Second World War. As of 1950, the European Coal and Steel Community begins to unite European countries economically and politically in order to secure lasting peace. In 1993, the single market of the European Union was established, in which people move and goods, services and money flow as freely as in any country’s territory. In the 1990’s, communism collapsed in Central and Eastern Europe, while political division between Eastern and Western Europe ended in 2004 when ten countries joined the EU, including Latvia (European Union, 2014).

Joining the EU enabled Latvia to freely enter and use the single EU market, receive EU structural funds and to foster the inflow of financial resources of foreign investors into the country. These changes contributed to faster development of the entrepreneurship environment; consequently, 7246 Limited Liability Companies (Company whose minimal equity capital was LVL 2000 (2000 LVL = 2845.74 EUR) if the company was established prior to 31 December 2013; yet, if the company was established after 1 January 2014, its minimal equity capital is EUR 2800. Such companies are the most popular kind of enterprises in Latvia.) (hereinafter
LLC) were founded in 2004, 8786 LLCs – in 2005, which was 19.60% more than in 2004. In 2006, however, 27.83% more new LLCs were registered than in 2005, reaching a total of 11231 LLCs, while in 2007 the number of newly registered LLCs totalled 11972, which was 6.60% more than in 2006 (see Fig.1).

* Data for 2014 include the period 1 January – 27 October 2014.

Fig.1. Dynamics of registration and exclusion of limited liability companies with Latvia’s Register of Enterprises in the period from 1 January 2004 to 27 October 2014. (Source: authors’ construction based on statistical data of the Register of Enterprises of the Republic of Latvia)

The development of entrepreneurship, in its turn, contributed to an increase in Latvia’s tax revenues in the period of analysis.

The State budget is mainly comprised of taxes – a mandatory periodic or one-off payment prescribed by law for ensuring the revenues of the State budget or local government budgets (general budget or special budget) and the funding of the functions of the state and local governments (Par nodokļiem un nodevām, 1995). Budgetary revenues are allocated for executing the functions of the government, the funding of which is stipulated by legal acts (Likums par budžetu un finanšu vadību, 1994), i.e. various social projects are implemented and medical care for residents, regional economic development etc. are ensured. In Latvia, the State Revenue Service (hereinafter the SRS) ensures the recording of tax payments and tax payers, the collection of State taxes, fees and other State mandatory payments in the territory of the Republic of Latvia, as well as the collection of taxes, fees and other mandatory payments for the budget of the European Union, implements customs policies and tackles customs matters (Par Valsts ieņēmumu dienestu, 1993).

The authors, analysing an SRS annual report and statistical data for 2004, 2005, 2006 and 2007, found that Latvia’s accession to the EU and the development of entrepreneurship contributed to increases in the tax revenues administered by the SRS in the period concerned (see Table 1).

Table 1. Percentage distribution of tax revenues administered by the State Revenue Service in Latvia in the period 1 January 2004 – 31 December 2007 (Source: authors’ construction based on annual reports and statistical data of the State Revenue Service, 2004-2007)

<table>
<thead>
<tr>
<th>Kind of tax</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EUR mln</td>
<td>%*</td>
<td>EUR mln</td>
<td>%*</td>
</tr>
<tr>
<td>Total tax revenue administered by the SRS, incl.</td>
<td>2827.73</td>
<td>14.05</td>
<td>3572.40</td>
<td>26.33</td>
</tr>
<tr>
<td>value added tax revenues</td>
<td>692.47</td>
<td>5.98</td>
<td>963.43</td>
<td>39.13</td>
</tr>
<tr>
<td>enterprise income tax revenues</td>
<td>181.91</td>
<td>16.10</td>
<td>257.07</td>
<td>41.32</td>
</tr>
<tr>
<td>personal income tax revenues</td>
<td>619.70</td>
<td>18.58</td>
<td>724.60</td>
<td>16.93</td>
</tr>
<tr>
<td>state compulsory social insurance contributions</td>
<td>942.50</td>
<td>15.35</td>
<td>1110.72</td>
<td>17.85</td>
</tr>
</tbody>
</table>

* Percentage change from the pervious period
The SRS-administered tax revenues increased 26.33% in 2005 compared with 2004. The greatest increase, 41.32%, was observed for enterprise income tax revenues, and, in total, EUR 257.07 mlm were collected in 2005. The next greatest increase was presented by the value added tax, which was collected by 39.13% more, amounting to EUR 963.43 mlm. The increases in revenues of both taxes indicate that the turnover and profit of enterprises from their transactions increased in 2005. A 30% increase in the number of newly established LLCs in 2006 compared with 2005 and a small number of liquidated LLCs in the same period contributed to the overall tax revenue increase by 30% in 2006 compared with 2005, and just like in 2005, the greatest tax revenue increases were observed for the enterprise income tax and the value added tax, 40.48% and 37.43%, respectively, in comparison with the previous year. However, in 2007, the number of registered new LLCs, compared with 2006, rose only 6.60%, and this in some respect was associated with the global financial crisis that began in the USA in 2007 and soon reached Europe, too, resulting in smaller investment and lower demand for goods and services. The starting global financial crisis did not make a direct negative effect on tax revenues in 2007, although the number of excluded LLCs reached 9373 in 2007, which was equal to 78% of the total number of new enterprises in the period of analysis. The total tax revenues increased 34.40% in 2007 in comparison with 2006. The revenue of value added tax, in 2007 compared with 2006, increased 29.27%; yet, the increase was smaller than in 2005 and 2006, which indicated that the global financial crisis was going to affect Latvia. The greatest tax revenue increase was observed for the enterprise income tax, 57.50%, compared with 2006, and this increase was the greatest in the period from 1 January 2004 to 31 December 2007, as a lot of new LLCs were registered in 2006 and enterprises presented good economic performance results (see Fig.1 and Table 1).

Because of the effects of the global financial crisis 2007, the number of registered new LLCs declined 25.38% in Latvia in 2008 compared with 2007, and in 2009 only 7172 new LLCs were registered, which was 19.72% less than in 2008, and this was the smallest number in the period 1 January 2004 – 27 October 2014. At the same time, the number of liquidated LLCs sharply rose. In 2008, Latvia’s Register of Enterprises excluded 3276 LLCs in 2008 and 3948 LLCs in 2009, 36.66% and 55.05%, respectively, of the numbers of new enterprises in this period. In 2010, 7344 LLCs were liquidated, which accounted for 61.73% of the number of new enterprises in that period, and this was the second greatest number of excluded enterprises since 2009 (see Figure 1).

During the economic crisis in Latvia from 2008 to 2010, companies had low liquidity indicators, enterprises lacked finances to settle accounts with cooperation partners, including employees, unemployment rose. During this period, legal person insolvency proceedings became and still are a way of liquidating an enterprise.

In 2008, 1289 legal entities initiated insolvency cases, while in 2009 when the negative effects of the economic crisis strengthened, 2149 legal entities initiated their insolvency cases, which was 67% more than in 2008 (see Table 2).

### Table 2. Distribution of the number of insolvency cases registered in Latvia by characteristic of insolvency proceedings in the period from 1 January 2008 to 31 December 2013. (Source: authors’ construction based on statistical data of the Register of Enterprises of the Republic of Latvia, Insolvency Register)

<table>
<thead>
<tr>
<th>Year</th>
<th>Proclaimed insolvency cases</th>
<th>Insolvency cases for natural persons</th>
<th>Insolvency cases for legal persons</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>number (%)</td>
<td>number (%)</td>
<td>number (%)</td>
</tr>
<tr>
<td>2008</td>
<td>1290 (-)</td>
<td>1 (-)</td>
<td>1289 (-)</td>
</tr>
<tr>
<td>2009</td>
<td>2202 71%</td>
<td>53 5200%</td>
<td>2149 67%</td>
</tr>
<tr>
<td>2010</td>
<td>2773 26%</td>
<td>199 275%</td>
<td>2574 20%</td>
</tr>
<tr>
<td>2011</td>
<td>1728 -38%</td>
<td>849 327%</td>
<td>879 -66%</td>
</tr>
<tr>
<td>2012</td>
<td>2256 31%</td>
<td>1375 62%</td>
<td>881 0%</td>
</tr>
<tr>
<td>2013</td>
<td>2392 6%</td>
<td>1571 14%</td>
<td>821 -7%</td>
</tr>
<tr>
<td>Total</td>
<td>12641 (-)</td>
<td>4048 (-)</td>
<td>8593 (-)</td>
</tr>
</tbody>
</table>

*Percentage change from the pervious period

However, the largest number of insolvency cases initiated for legal entities in the period 1 January 2008 – 31 December 2013 was reached in 2010 when 2574 legal persons were declared insolvent, and this was 20% more than in 2009 (see Table 2).

In legal proceedings, the employees of companies are classified as a specially protected group of creditors, and it is one of the reasons why, in practice, part of enterprise managers decide themselves to initiate an insolvency case for their enterprise. A special law has been passed in Latvia, which stipulates the protection
of employees in case of insolvency of an employer. In accordance with this law, the state has to establish an employee claims guarantee fund, the resources of which shall consist of: (1) a share of the State entrepreneurial risk fee, (2) gifts and donations, (3) amounts recovered by administrators; these resources are used to satisfy only employee claims in case of insolvency of an employer and to remunerate an administrator for submitting the claims of employees (Par darbinieku aizsardzību darba devēja maksātnespējas gadījumā, 2003).

As the overall economic situation worsened and the total tax revenue decreased in the country (see Table 3), the government reduced the guaranteed financial assistance for employees whose employers became insolvent. Until July 2009, employee claims had to be satisfied from the resources of the employee claim guarantee fund in the following amounts: (1) work remuneration for the last three months of employment legal relationship in twelve months before the insolvency of the employer came into effect; (2) reimbursement for annual paid leave the right to which has been acquired in the twelve months before the insolvency of the employer came into effect; (3) reimbursement for other types of paid leave in last three months of employment legal relationship in the last twelve months before the insolvency of employer came into effect; (4) severance pay in the minimal amount prescribed by law. From July 2009, the law provides that the mentioned monthly compensation shall not exceed the minimum wage effective on the day the insolvency of the employer came into effect and the total gross amount of employee claims shall not exceed four minimum wages, effective on the day the insolvency of the employer came into effect, per employee (Par darbinieku aizsardzību darba devēja maksātnespējas gadījumā, 2003). Prior to July 2009, employee claims were fully covered from the employee claim guarantee fund, whereas after July 2009 the maximum amount, before taxes, per employee could reach LVL 720 (720 LVL = 1024.47 EUR); in the period January 2010 – 31 December 2011 it was LVL 800 (800 LVL = 1138.30 EUR). On 1 January 2012, the limit on the total gross amount of employee claims that shall not exceed four minimum wages, effective on the day the insolvency of the employer came into effect, per employee was cancelled, while a provision was retained that the monthly wage should not exceed the minimum monthly wage set in the country, which was equal to LVL 200 (200 LVL = 284.57 EUR) in 2012 and 2013 and EUR 320 from 1 January 2014.

The fast economic downturn, the increasing number of proclaimed legal person insolvency cases and the raising number of liquidated enterprises negatively affected tax revenues in the period 1 January 2008 – 31 December 2010 (see Table 3).

Table 3. Percentage distribution of tax revenues administered by the State Revenue Service in Latvia in the period 1 January 2008 – 31 December 2010 (Source: authors’ construction based on annual reports and statistical data of the State Revenue Service, 2008-2010)

<table>
<thead>
<tr>
<th>Kind of tax</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EUR mln</td>
<td>%*</td>
<td>EUR mln</td>
</tr>
<tr>
<td>Total tax revenue administered by the SRS, incl.</td>
<td>6998.76</td>
<td>11.95</td>
<td>5122.82</td>
</tr>
<tr>
<td>value added tax revenues</td>
<td>1589.56</td>
<td>-7.13</td>
<td>1136.08</td>
</tr>
<tr>
<td>enterprise income tax revenues</td>
<td>715.88</td>
<td>25.86</td>
<td>280.56</td>
</tr>
<tr>
<td>personal income tax revenues</td>
<td>1454.84</td>
<td>15.17</td>
<td>1037.53</td>
</tr>
<tr>
<td>state compulsory social insurance contributions</td>
<td>2372.58</td>
<td>21.06</td>
<td>1892.82</td>
</tr>
</tbody>
</table>

*Percentage change from the pervious period

The total SRS-administered tax revenue increased 11.95% in 2008 compared with 2007, amounting to EUR 6998.76 mln. Yet, the value added tax revenue was 7.13% smaller than in 2007, which clearly indicated that the business transactions taxed by this tax declined; consequently, revenues from the enterprise income tax would also decline in the next periods. The total tax revenue was 26.80% smaller in 2009 than in 2008, and only EUR 5122.82 was collected. Decreases were observed for all the most important taxes, i.e. the enterprise income tax was collected by EUR 435.32 mln, the value added tax – by EUR 453.48 mln, the personal income tax – by EUR 417.31 mln and state compulsory social insurance contributions – by EUR 479.76 mln less than in 2008. This was affected by the global financial crisis and the large number of proclaimed legal person insolvency cases, as these enterprises could pay the previously calculated taxes (see Table 3, Table 2 and Fig.1). Besides, the crisis involved one more problem – entrepreneurs started avoiding taxes –, and one of the ways how to do it was to proclaim an enterprise insolvent.

Latvia was included in the World Bank’s Doing Business studies after it joined the EU. It was a stimulus for Latvia to work more on improving its entrepreneurship environment, so that the country could get
high ranks in various categories, thus making investors interested in investing in Latvia. It was especially urgent during the 2008-2010 crisis.

Since 2002, the World Bank annually carries out a *Doing Business* study in which it looks at domestic small and medium-size companies and measures the regulations applying to them through their life cycle. The first *Doing Business* report, published in 2003, covered 5 indicator sets and 133 economies. 2014 year’s report covers 11 indicator sets and 189 economies. The project has benefited from feedback from governments, academics, practitioners and reviewers. The initial goal remains: to provide an objective basis for understanding and improving the regulatory environment for business around the world (World Bank, 2014).

According to the World Bank’s *Doing Business 2009* report chapter “Starting a business”, Latvia took 35th place, and its minimum capital, as a percentage of income per capita was 16.9%; for comparison: Estonia was ranked in 23rd place with 23.7% and Lithuania was 74th with 35.9% (see Fig.2 and Fig.3) (World Bank, 2009).

The World Bank’s 2009 study showed that starting up an LLC was more complicated and time-consuming in Latvia than in Estonia, but it was simpler to do it in Lithuania. Besides, Latvia’s rank in the resolving insolvency was very low, too, (see Figure 4), which was the lowest among all the three Baltic States that year.
The economic recession persisting in the country and the above-mentioned study triggered amendments to legal acts of the Republic of Latvia in order to foster business development in Latvia.

In 2008 Latvia passed a new insolvency law which allows for the first time financially distressed companies to continue operating by pursuing reorganisation. The reform also strengthened the qualification standards for bankruptcy administrators. In 2010 Latvia introduced a mechanism for out-of-court settlement of insolvencies to alleviate pressure on courts and tightened some procedural deadlines, and adopted a new insolvency law that streamlines and expedites the insolvency process and introduces a reorganisation option for companies (World Bank, 2014). The positive impact of the amendments was also pointed by the World Bank in its Doing Business studies (see Figure 4).

![Fig.4. Latvia’s rank in resolving insolvency in the Doing Business 2009 – 2014 among the Baltic States](Source: authors’ construction based on the World Bank Doing Business reports 2009 – 2014)

As per World Bank reports in 2009 Lithuania eased the process of closing a business with the introduction of amendments to the Enterprise Bankruptcy Law and in 2010 introduced regulations relating to insolvency administrators that set out clear rules of liability for violations of law. After that Lithuania amended its reorganisation law to simplify and shorten reorganisation proceedings, grant priority to secured creditors and introduce professional requirements for insolvency administrators and made resolving insolvency easier by establishing which cases against the company’s property shall be taken to the bankruptcy court, tightening the time frame for decisions on appeals, abolishing the court’s obligation to individually notify creditors and other stakeholders about restructuring proceedings and setting new time limits for creditors to file claims (World Bank, 2014).

In the same time Estonia adopted a new Reorganisation Act establishes a new legal procedure enabling distressed companies on the verge of insolvency to reorganize themselves, restructure their debt, and apply other measures to regain financial health and restore profitability. Amendments to Estonia’s insolvency law increased the chances that viable businesses will survive insolvency by improving procedures and changing the qualification requirements for insolvency administrators (World Bank, 2014).

Figure 4 shows how the amendments made to the legal acts aimed at raising the quality of insolvency proceedings have affected each country’s rank in the period considered. Latvia succeeded in significantly improving the procedures of insolvency; in the result, it was the leader among the Baltic States in 2012, 2013 and 2014, and its ranks showed that an insolvency case may be completed in Latvia in a shorter period and at a lower cost than in Lithuania and Estonia.

To foster the economy’s recovery and to motivate individuals to engage in entrepreneurship in Latvia, essential amendments were made in the Commercial Law (Commercial Law — a legal act of the Republic of Latvia that stipulates the legal regulation of and restrictions on business activity in the Republic of Latvia (authors’ definition)). Until 30 April 2010 in Latvia, there were legal provisions in force which provided that, if founding a company — LLC —, an equity capital of LVL 2000 (2000 LVL = 2845.74 EUR) had to be paid in before submitting an application to the Register of Enterprises (Komerclikums, 2000). However, since 1 May 2010 in Latvia, the initial registered and paid-in equity capital for an LLC could be LVL 1 (1 LVL = 1.42 EUR), and such enterprises are called micro-capital enterprises. The authors point that micro-capital enterprises may be only limited liability companies, and the mentioned relaxions do not apply to stock companies. Since 1 January 2014 when Latvia adopted the euro, the minimum capital for micro-capital enterprises is EUR 1 (LR Uzņēmumu reģistrs, 2013).
To ensure equality in the entrepreneurship environment and in order that the new legal provision does not distort the business environment, the lawmaker, in addition to the above-mentioned reliefs provided that:

1) if the equity capital of a company is less than the minimum amount of equity capital for Limited Liability Company (EUR 2800), it shall, each year, establish a mandatory reserve, making a deduction in the amount of at least 25 per cent from the profit of the accounting year;

2) if the equity capital of a company is less than the minimum amount of equity capital of Limited Liability Company (EUR 2800) and the insolvency procedure of the company has been promulgated, the shareholders thereof shall be solidarily liable for the liabilities of the company, the total amount of which does not exceed the difference between the amount of the minimum amount of equity capital and the amount of the equity capital paid up by the founders (Komercrīkums, 2000).

In addition to the above-mentioned amendments to the Commercial Law, amendments were also made in tax laws. In 2010, a special law was passed, in which criteria were defined for an enterprise that might be regarded as a micro-enterprise for the purpose of taxation.

A micro-enterprise is an individual merchant, an individual undertaking, a farm or fishing enterprise, as well as a natural person registered as a performer of economic activity at the State Revenue Service, or a limited liability company, which conform to the following criteria: (a) the participants (if any) are natural persons. The participants of a limited liability company – the natural persons – are also concurrently members of the board, (b) the turnover does not exceed LVL 70 000 (LVL 70 000 = EUR 99 601.02; since 1 January 2014 EUR 100 000) in a calendar year and (c) the number of employees does not exceed five at any time. Absent employees or employees suspended from work shall not be included in the number of employees (Mikrouzņēmumu nodokļu likums, 2010).

A businessman who complies with the mentioned criteria may pay a micro-enterprise tax of 9% on the enterprise’s turnover. The micro-enterprise tax is a single tax and duty payment that is redistributed by the Treasury as follows: (1) 0.1 percent shall be transferred into the account for the State fee of the business risk, (2) 65 percent – into the account of the mandatory State social insurance contributions, (3) 30 percent – into the account of the personal income tax, and (4) 4.9 percent – into the account of the enterprise income tax (Mikrouzņēmumu nodokļu likums, 2010).

The above-mentioned amendments in the legal acts of the Republic of Latvia fostered an increase in the registration of new enterprises in Latvia (see Figure 1). An analysis of the dynamics of registration and exclusion of LLCs in the Register of Enterprises of the Republic of Latvia in the period 1 January 2009 – 26 September 2014 shows that 65.8% more LLCs were registered in 2010 compared with 2009, while in 2011 it was 41.58% more than in 2010; yet, even though the number of registered LLCs decreased by 6.46% in 2012 in comparison with 2011 and in 2013 fell by 2.53% as compared with 2011, the overall trend remains positive and is high relative to the 2009 level when the legal acts provided no relieved conditions regarding registering the initial equity capital for limited liability companies and the size of it.

The World Bank report Doing Business 2012 notes that Latvia made starting a business easier by reducing the minimum capital requirement and introducing a common application for value added tax and company registration (see Figure 3) (World Bank, 2014).

Lithuania made starting a business easier by creating a new form of limited liability company with no minimum capital requirement in year 2013 (see Figure 3) (World Bank, 2014).

As shown in Figure 3, Estonia has not introduced special terms to make starting a business easier. The latest amendments were made in 2008 when the commercial code was amended to introduce standard articles of association. If entrepreneurs use the model forms, company registration-done electronically and without notary involvement-can be completed in 1 day. A new, fixed fee schedule lowered registration costs (World Bank, 2014).

As new enterprises entered the market, economic activity increased in the country and individuals had an opportunity to find a job, thus contributing to tax revenue increases (see Table 4).

Table 4. Percentage distribution of tax revenues administered by the State Revenue Service in Latvia in the period 1 January 2011 – 31 December 2013 (Source: authors’ construction based on annual reports and statistical data of the State Revenue Service, 2011-2013)

<table>
<thead>
<tr>
<th>Kind of tax</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EUR mln</td>
<td>EUR mln</td>
<td>EUR mln</td>
</tr>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Total tax revenue administered by the SRS, incl.</td>
<td>5450.47</td>
<td>13.58</td>
<td>6035.95</td>
</tr>
<tr>
<td>value added tax revenues</td>
<td>1364.04</td>
<td>16.17</td>
<td>1588.78</td>
</tr>
<tr>
<td>enterprise income tax revenues</td>
<td>279.49</td>
<td>75.10</td>
<td>347.00</td>
</tr>
<tr>
<td>personal income tax revenues</td>
<td>1127.95</td>
<td>1.94</td>
<td>1239.92</td>
</tr>
<tr>
<td>state compulsory social insurance contributions</td>
<td>1842.82</td>
<td>11.89</td>
<td>1991.11</td>
</tr>
</tbody>
</table>

*Percentage change from the previous period
Even though 65.8% more LLCs were registered in 2010 compared with 2009, and the total number of registered new LLCs reached 16844, which was the greatest number of new LLCs in the period 1 January 2005 – 27 October 2014 (see Fig.1), yet, the total tax revenue amounted to EUR 4798.72 mln in 2010, which was 6.33% less than in 2009 (see Table 3). The tax revenue from the enterprise income tax fell by 43.11% or EUR 120.94 mln. It may be explained by the repercussions of the economic crisis in the previous years and the increasing number of proclaimed insolvency cases (see Table 2). However, the revenue from the value added tax increased by EUR 38.14 mln or 3.36% compared with the previous period, which indicated that the changes made in the tax policy and in the field of law contributed to economic growth, i.e. the business transactions taxed by the value added tax increased.

Entrepreneurs were very interested in founding new enterprises in 2011, 2012 and 2013, which was evidenced by the number of registered new LLCs in the mentioned reporting periods (see Fig.1). Regardless of the fact that on average 15984 LLCs were annually founded in the period from 1 January 2011 to 31 December 2013, it did not contribute to a fast increase in tax revenues in this period. In practice, the new tax changes encouraged large enterprises to divide their business and transfer it to newly established LLCs, thus optimising their tax payments and distributing their business risks. The total tax revenue rose by EUR 651.75 mln or 13.58% in 2011 compared with 2010 and by EUR 585.48 mln or 10.74% in 2012 compared with 2011, while in 2013 the total tax revenue amounted to EUR 6439.90, which was 6.69% more than in 2012 (see Table 4).

Analysing 2014 data for the period January – October, one can forecast that the number of registered new LLCs in Latvia in 2014 will be 8.65% less than in 2013. It may be explained by the fact that over the last few years, individuals established their enterprises to reach their long term goals, which is evidenced by the fact that over the last three years, on average, 860 legal entities become insolvent (see Fig.1 and Table 2).

Any enterprise, based on their financial performance, calculate the amount of taxes to be paid into the State budget and, in the form of reports, informs the State Revenue Service, which allows the government to estimate the amount of tax revenues.

During the recent crisis, a trend emerged – as the financial situation of an enterprise worsened, an insolvency case was initiated over a short period; in the result, the previously calculated taxes were not paid into the State budget.

The number of proclaimed insolvency cases in Latvia has negatively affected its economic development, as the claims made by creditors in insolvency cases are not paid in full, only partially or not at all. Most funds recovered in insolvency cases are allocated for satisfying the claims made by banks, as the banks, when giving a loan, require collateral in the form of mortgage or other assets and by selling the mortgaged property, the funds recovered are allocated for meeting the liabilities of collateral givers. It is widespread in Latvia that banks establish daughter companies which participate in insolvency auctions and purchase real estates that are resold to gain maximum revenues and reduce their losses.

The authors observed that owing to the crisis, in practice, taxes were paid minimally or not at all; in the result, the State Revenue Service was involved in approximately 90-95% legal person insolvency cases as a creditor.

According to the 2014 data, the number of proclaimed insolvency cases rose by, on average, 13% a month, and one can forecast that in total in 2014, 2454 insolvency cases will be proclaimed: 1496 for natural persons and 958 for legal persons (see Table 5), which indicates that part of the previously calculated taxes, in fact, will not be paid.

Table 5. Distribution of the number of insolvency cases proclaimed in Latvia by kind of person in the period from 1 January 2014 to 31 August 2014. (Source: authors’ construction based on statistical data of the Register of Enterprises of the Republic of Latvia, Insolvency Register)

<table>
<thead>
<tr>
<th>Kind of person</th>
<th>As of 01.08.2014</th>
<th>As of 01.09.2014</th>
<th>Change, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of insolvency cases proclaimed, incl.</td>
<td>1442</td>
<td>1636</td>
<td>13.45</td>
</tr>
<tr>
<td>Number of insolvency cases for natural persons</td>
<td>882</td>
<td>997</td>
<td>13.04</td>
</tr>
<tr>
<td>Number of insolvency cases for legal persons</td>
<td>560</td>
<td>639</td>
<td>14.11</td>
</tr>
</tbody>
</table>

As of 1 August 2014, in accordance with Latvia’s legal acts, the uncollectible tax debts of the enterprises in the process of their liquidation totalled EUR 9.05 mln, while as of 1 September 2014 it reached EUR 11.57 mln, which was 27.85% more than in August 2014 (see Table 6).

On 1 November 2013, the total tax debt administered by the SRS amounted to LVL 993.66 mln (LVL 993.66 mln = EUR 1 413.85 mln) (Darzina, 2013), while on 1 January 2014 it was LVL 995.42 mln (LVL 995.42 mln = EUR 1 416.35 mln) (State Revenue Service, 2014). For comparison, in 2014 the consolidated government budget of the Republic of Latvia is expected to reach EUR 5 047.22 mln (Par valsts budžetu 2014, gadam, 2013).
In the period January-October 2013, the SRS wrote off tax debts in an amount of LVL 188 mln (LVL 188 mln = EUR 267.50 mln) owing to the fact that the tax payers are insolvent, as well as insolvency proceedings are completed (Darzina, 2013).

On 1 September 2014, the total tax debt administered by the State Revenue Service was EUR 1 481.02 mln (see Table 6).

Table 6. Distribution of tax liabilities administered by Latvia’s State Revenue Service as of 1 August and 1 September 2014 (Source: author’s construction based on statistical data of the State Revenue Service, 2014)

<table>
<thead>
<tr>
<th>Classification of tax liabilities</th>
<th>As of 01.08.2014 (mln EUR)</th>
<th>As of 01.09.2014 (mln EUR)</th>
<th>Change, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount – total</td>
<td>1471.75</td>
<td>1481.02</td>
<td>0.63</td>
</tr>
<tr>
<td>(actual, suspended liabilities and period extensions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual tax liabilities – liabilities which, in accordance with the law, incur a penalty</td>
<td>1033.97</td>
<td>1043.50</td>
<td>0.92</td>
</tr>
<tr>
<td>Including:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Tax liabilities uncollectible in accordance with the laws</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1. From enterprises to be liquidated until the liquidation procedure is finished</td>
<td>9.05</td>
<td>11.57</td>
<td>27.85</td>
</tr>
<tr>
<td>2. Tax liabilities collectible in accordance with the laws</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.1. Really collectible</td>
<td>148.30</td>
<td>145.37</td>
<td>-1.98</td>
</tr>
<tr>
<td>2.2. Really uncollectible</td>
<td>876.61</td>
<td>886.57</td>
<td>1.14</td>
</tr>
<tr>
<td>2.2.1. Limitation period is over</td>
<td>4.67</td>
<td>4.79</td>
<td>2.60</td>
</tr>
<tr>
<td>2.2.2. No funds to be collected and no property to be levied upon</td>
<td>871.95</td>
<td>881.77</td>
<td>1.13</td>
</tr>
<tr>
<td>Period extensions</td>
<td>60.47</td>
<td>60.46</td>
<td>-0.02</td>
</tr>
<tr>
<td>Suspended tax liabilities – liabilities which, in accordance with the law, incur no penalty</td>
<td>377.31</td>
<td>377.05</td>
<td>-0.07</td>
</tr>
<tr>
<td>Including:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Recognised as insolvent</td>
<td>337.31</td>
<td>337.05</td>
<td>-0.07</td>
</tr>
</tbody>
</table>

Regardless of the fact that in 2013 a tax debt of LVL 188 mln (LVL 188 mln = EUR 267.50 mln) was already written off (remitted), the SRS pointed that as of 1 September 2014 the government of Latvia might have to write off a tax debt in an amount of EUR 1 263.62, i.e. the previously calculated taxes in this amount would not be collected; it consists of actually uncollectible tax debts in an amount of EUR 886.57 mln and debts of insolvent taxpayers in an amount of EUR 377.05, which accounts for 85.32% of the total tax debt administered by the SRS as of 1 September 2014. Theoretically, taxpayers, which have no funds and no property to be levied upon, may initiate insolvency cases within the next twelve to twenty-four months; upon completing the insolvency cases, their tax debts owed to the government will be cancelled.

Even though the SRS points in its annual public report 2013 that its tax collection process was significantly improved in 2013, which resulted in an extra tax revenue of LVL 292.44 mln (LVL 292.44 mln = EUR 416.10 mln) transferred to Latvia’s government budget, which was LVL 57.02 mln (LVL 57.02 mln = EUR 81.13 mln) more than in 2012 (State Revenue Service, 2014), nevertheless, the authors believe that in general the situation in tax collection in Latvia may be evaluated as average.

The authors suggest that research on how the insolvency of enterprises affects the tax collection process in Latvia has to be continued in order to improve tax collection and design tax policy instruments aimed at restoring the solvency of the enterprises facing financial problems or to prompt their liquidation through the ordinary procedure without using the possibilities of insolvency proceedings; in the result, the government could collect the previously calculated taxes and allocate this tax revenue for implementing other important social projects, for example, special tax instruments might be used for regional development in order to contribute to steady increases in the wellbeing of the population in the entire Latvia.

The authors presume that informative campaigns have to be conducted in order to contribute to the population’s awareness that regularly paying taxes ensures their wellbeing in the future, as the government finances, by redistributing tax revenues, social and economic projects.

Besides, the government, by prompting the liquidation of enterprises through the ordinary procedure, would contribute to developing a well-structured and stable entrepreneurship environment and to a change in the attitude and behaviour of the society (residents), i.e. to motivating the establishment and development of enterprises for achieving long-term goals.

Conclusion and proposals

1. In the period 1 January 2014 – 31 December 2007, on average, 9833 new LLCs were registered in Latvia, while 4464 were liquidated and excluded from the register, which accounted for 45.40% of the number of new LLCs in the mentioned period. In this period, the total tax revenue was stable and tended to increase. In
2004, taxes totalling EUR 2827.7 mln were collected, while in 2007 it was EUR 6251.83 mln. The average annual tax collection increase reached 26%.

2. Owing to the global financial crisis, the total tax revenue increased only 11.95% in 2008 compared with the previous period, whereas in 2009 and 2010 it declined by 26.80% and 6.33%, respectively, compared with the previous period.

3. In 2010, Latvia made starting a business easier by reducing the minimum capital requirement and, owing to this, 65.8% more limited liability companies were registered in 2010 compared with 2009, while in 2011 it was 41.58% more than in 2010, and the overall trend remains positive and is high relative to the 2009 level.

4. In 2009, 2149 legal persons and in 2010 – 2574 legal persons – were declared insolvent, which was the highest indicator in the period 1 January 2008 – 26 September 2014. During the recent three years, on average, 845 legal persons and 1400 natural persons declared insolvency, which negatively affected tax collection in Latvia.

5. After amendments in the legal framework of insolvency and changes in the tax policy were made, since 2011, on average, 15984 new LLCs have been annually registered, whereas 2542 LLCs have been annually liquidated and excluded from the register, which accounts for 15.90% of the total number of new LLCs in the mentioned period. Since 2010, on average, the total tax revenue has annually increased by 10% in Latvia.

6. In ten months of 2013 in Latvia, a tax debt of EUR 267.50 mln, administered by the State Revenue Service, was cancelled owing to the fact that taxpayers are insolvent and their insolvency proceedings are completed.

7. According to the data as of 1 September 2014, the previously calculated taxes in an amount of EUR 1 263.62 mln will not be potentially collected by the State Revenue Service.

8. Limited liability companies which are liquidated using instruments of insolvency proceedings make an essential negative impact on tax revenues in Latvia; in the result, ensuring the execution of government functions that are stipulated by legal acts is endangered, as tax revenues make up a significant share of Latvia’s government’s consolidated budget.

9. Proposal: it is advised to develop tax policy instruments to facilitate the restoration of solvency of the enterprizes facing financial problems or to prompt their liquidation through the ordinary procedure without using the instruments of insolvency proceedings.

10. Proposal: to conduct informative campaigns and to develop tax policy instruments in order to contribute to the population’s awareness that regularly paying taxes ensures their wellbeing in the future, as the government can implement both social and economic projects fully and qualitatively.

References


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**ĮMONĖS NEMOKUMO ĮTAKA MOKESČIŲ SURINKIMO PROCESUI**

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