Policy Briefing Series [PB/05/2018]

Taxation of Withdrawn Capital: Recent experience from Georgia and Latvia

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Introduction

Background

- Ongoing discussion about replacing the Corporate Profit Tax (CPT) by a Tax on Withdrawn Capital (TWC, also "Exit Capital Tax")
- German Advisory Group has published a Policy Study (PS/01/2017) on this study including a comparison of the two systems and recommendations
- Also published Policy Briefing (PB/03/2017) on limited international experience (Estonia, Macedonia, Moldova) with this type of tax
- Now, two more countries have introduced TWC
  - Georgia: Since 2017
  - Latvia: Since 2018

Content of this Policy Briefing:

- Summary of reforms in Latvia and Georgia
- Analysis of first results data (Georgia), current expectations (Latvia):
  - Fiscal impact and budget compensation
  - Investment/economic effects

Georgia: Summary of tax reform

History

- Tax on distributed profits was introduced in January 2017
- Financial institutions/companies will only move to new tax in 2019

Motivation

- Improving the investment climate and increasing investments in Georgia
- Tax reform in context of wider measures aimed at improving infrastructure and business climate in Georgia

Key features

- Applies to resident companies and permanent establishments
- Tax rate remains at 15% as for previous CPT
- Tax base: Distributed profits, equated payments (non-business expenditures etc.)
- Arm‘s length principle for transactions with related parties
- Self-assessment and payment of tax each month
- No carry-forward of losses in new tax system

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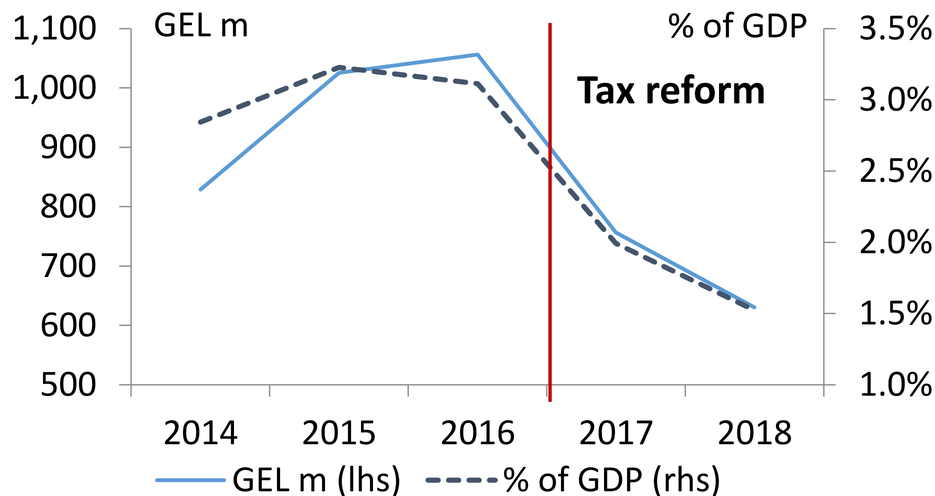
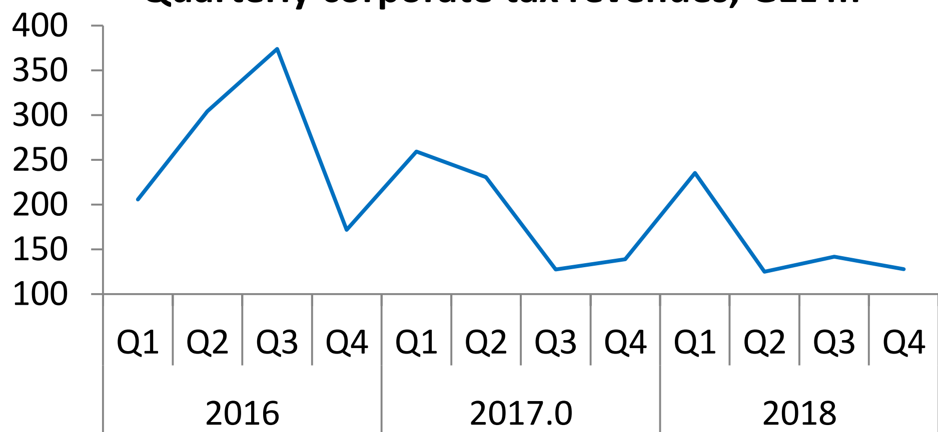
Georgia: Fiscal effects of tax reform





Source: Ministry of Finance of Georgia, IMF WEO

- Significant decline of corporate tax revenues after reform in 2017
  - Old CPT system: revenues around 3% of GDP
  - New TWC system: revenues at 1.5-2% of GDP
- First year after introduction (2017) only partial impact of reform
  - CPT final payments for 2016 are made in 2017Q1
- Seasonality of tax revenues, first quarter of each year stronger
  - probably due to timing of profit distributions and remains of old tax system

➢ **Fiscal impact clearly negative**

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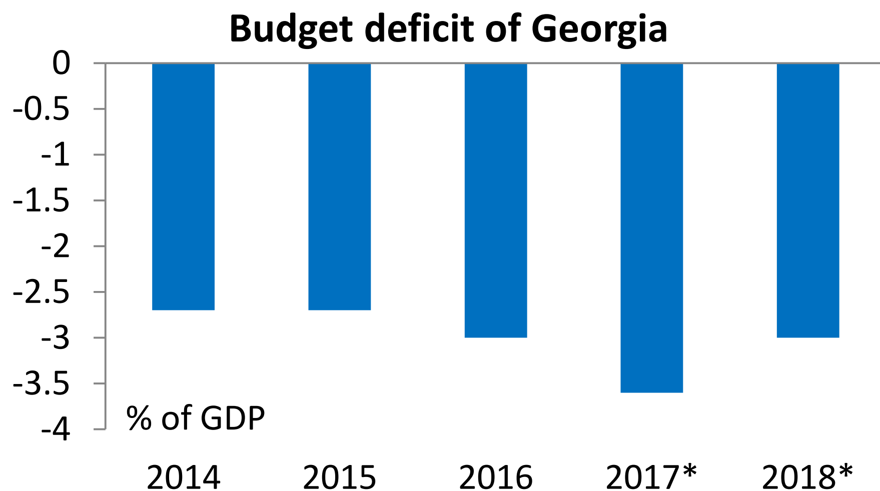
Georgia: Fiscal compensation and reform context

- Announcement of tax reform and other fiscal plans ahead of parliamentary elections led to derailment of IMF programme in 2016
- Early 2017: comprehensive set of compensatory fiscal measures was announced
- Compensation focused on sharp rates of excises on tobacco, alcohol and petrol/fuel
- New IMF programme was concluded, so far successful



*Source: IMF Country Report from Dec 2017, *forecast; Note: GFSM 1998 definition*

- No strong increase of budget deficit
  - First year corporate tax reform losses of 1% of GDP smaller than expected (1.5%)
  - Favourable external conditions also contributed, stronger revenues
- Public deficit was limited to -3.6% of GDP in 2017, planned below 3% in 2018

➢ **Strong compensation measures and positive external environment helped to keep budget deficit under control**

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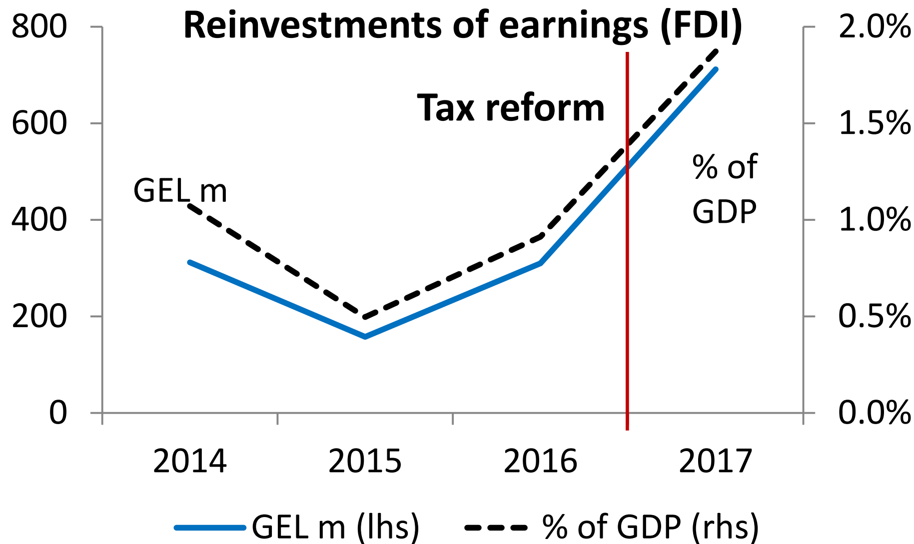
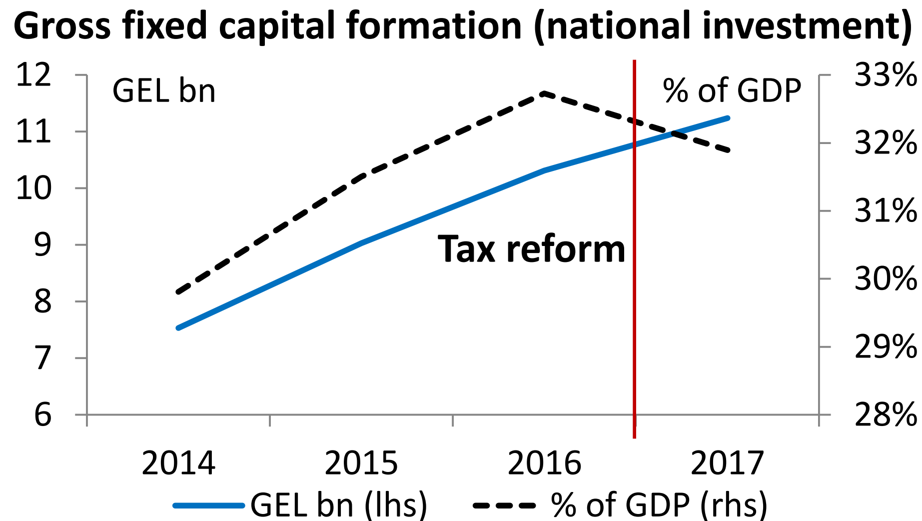
Georgia: Economic effect of tax reform





Source: Geostat

- „Reinvestments of earnings“ (difference between profits and distributed profits of FDI companies) more than doubled in 2017
- But:
  - Relatively small (2% of GDP in 2017)
  - Unclear whether amounts are really invested (or parked on bank account)

- Main indicator for investment: Gross fixed capital formation
- No above-trend increase in 2017
- GDP share decreased from 33% in 2016 to 32% in 2017

➢ **No evidence of positive impact of tax reform on investment in first year**

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Latvia: Summary of tax reform

History

- Long debates whether adopt neighbouring Estonian model of corporate tax
- Introduction of corporate tax reform in January 2018 in context of positive fiscal space and good growth momentum

Motivation

- Promoting the competitiveness of the Latvian economy
- Strengthen equity base of companies to stimulate investments
- Reduce the size of shadow economy

Key features

- Comprehensive tax base including profit distribution, non-business related expenditures, excessive interest to related parties, transfer price differences etc.
- Tax rate of 20% on the gross distributed amount. 0% PIT on dividends to individuals
- Monthly tax self-assessment and payment
- Partial carry-over of losses accrued before tax reform
- Comprehensive tax reform package including increase of tax-free PIT threshold; revenue-raising measures in PIT, excises, overhaul of tax administration

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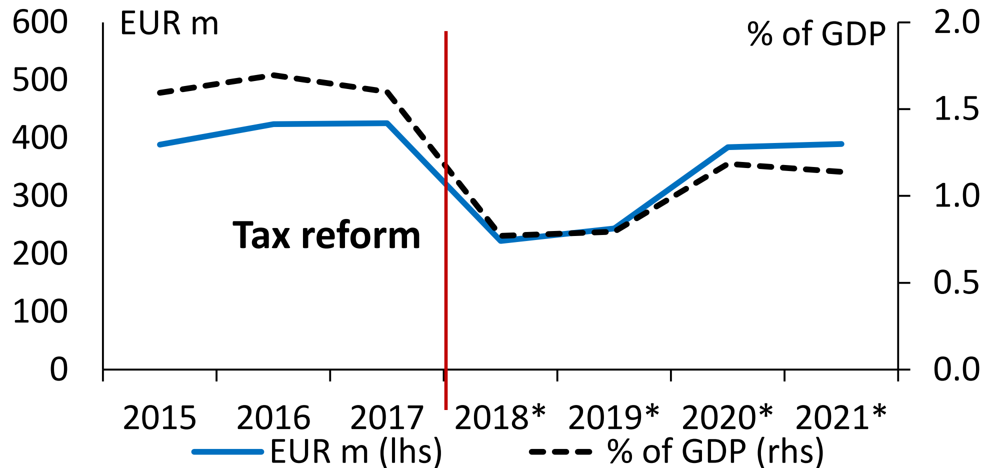
Latvia: Fiscal impact



- Latvian government expects 0.8% of GDP CIT revenue loss in first year 2018
- Gradual, but not full recovery to 1.2% of GDP (earlier around 1.7%) until 2020
- ➢ **Significant expected CIT revenue loss in short and medium term**

- First CIT revenue turnout data is high: 2018Q1 4.8% higher yoy than 2017Q1
- Reason: Taxes on 2017 profits (by old system) are paid in 2018Q1
- Generally, CIT revenues so far in line with Latvian government expectations
- ➢ **Important not to be confused by high first quarter results after reform**

- Differences between Latvian and EU Commission expectations of CIT reform impact:
- Latvian government expects most losses (0.8% of GDP) in 2018
- EU expects main losses (0.9% of GDP) in 2019
- ➢ **Unclear whether full fiscal impact of reform will hit in 2018 or 2019**

Latvia: Fiscal compensation and reform context

Reform context

- Full tax reform package includes higher threshold for PIT (lower revenues), also higher excise tax rates, improvement of VAT collection, improvement of tax administration
- Reform package is a clearly formulated set of revenue-raising and decreasing measures
- The state fiscal service is well-organized and reformed

Fiscal compensation

- Disagreement between Latvian government and European Commission on fiscal impact of tax reform package
- European Commission expects complete tax reform package to result in an increase of the public deficit by -1% of GDP
- Latvian government expects positive impact, reduction of budget deficit by 0.4% of GDP
- ➢ **Despite well-formulated tax reform package, it appears likely that the government may be excessively optimistic in its fiscal impact expectations**
- ➢ **Painful fiscal consolidation will follow if tax revenues turn out lower than planned**

Latvia: Economic impact

Economic impact

- Latvian government states it expects that the complete package of lower labour and capital taxation will strengthen investment and growth
- Also expects reduction of the sizeable shadow economy (further, specific measures aimed at de-shadowing are undertaken in context of tax reform package)
- European Commission QUEST macroeconomic modelling only points at a very small economic impact of 0.2% on the level of GDP by 2020

➢ **No ex-post evidence available, but models suggest only very small economic impact**

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Conclusions for tax reform in Ukraine

Fiscal effect:

- Both examples point at negative annual fiscal effects of TWC introduction between 0.8% and 1.5% of GDP
- Results probably fully materialise only in second year after reform: CPT revenues are partially paid in the year after profits were accrued

Economic effect

- Model analysis points to low economic effects
- Georgian evidence shows that no noticeable effect on investment should be expected in the short run
- Hence also no fiscal effects from higher growth in the short run!

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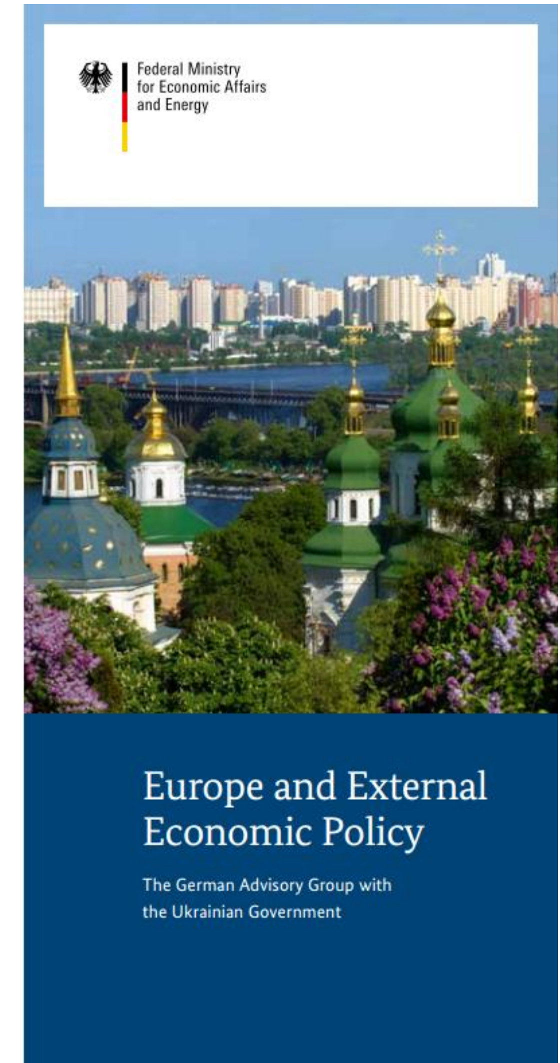

Annex: Corporate tax base in Latvia

- Dividends
- Liquidation quota (money or property received by owner after the liquidation of company)
- Expenses not related to economic activity, incl., expenses for acquisition and maintenance of the representation vehicle (these expenses are clearly defined in the Law)
- Transfer pricing difference
- Payments made to non-residents, from which CIT was not withheld (if it was to be withheld)
- Doubtful-debts written-off, in case law enforcement measures are not carried out – artificial forgiveness of debts
- Cession of debts (to related persons or at value not corresponding to the market value)
- Disproportionate interest payments (thin capitalisation rule)
- Loan to related persons – deemed profit distribution

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Annex: Special provisions of tax reform in Latvia

- The losses accrued by 31 Dec. 2017 are partially carried forward to the following years:
  - Dividends payments might be reduced by 15% of accrued losses (but not more than 50%)
  - This provision might be applied during five financial years
- 2-year transition period: “Old” tax system is to be used for taxing profits generating by 31 December 2017
  - 10% PIT for dividends to individuals
  - 20% PIT for micro-tax payers
- Tax reliefs:
  - Tax relief for donations
  - Large investment relief and special economic zones
- Compensatory measures for CPT reform and labour tax reform:
  - Increase in PIT on capital (from 10%/15% to 20%)
  - Increase in excise duties rates and in gambling tax rates
  - Amendments of taxation of micro enterprise taxpayers
  - Measures on de-shadowing of the economy and improvement of tax administration
  - The promotion of payment of tax debt