ANALYSIS AND RECOMMENDATIONS

FOR THE REPUBLIC OF LATVIA

INCOME CONTROL SYSTEM FOR PUBLIC OFFICIALS AND NATURAL PERSONS

Prepared by:

STEPHEN VASAK, ESQ.

Senior Tax Attorney
International Business & Technical Consultants, Inc.

Assisted by:
Zane Krecere

Project on Behalf of World Bank

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CHAPTER I: Objectives of Assignment and Analyses of Current Situation

1. Objective

Prior to starting this report, sincere appreciation is extended to the Latvian Government employees for their honest and helpful assistance. Their dedication and motivation for a better Latvia is without question. It is hoped this report helps in achieving our mutual goal for a better Latvia.

The Objective of this assignment is to improve the income control system of Latvia for public officials and natural persons to prevent legalization of proceeds derived from criminal activity.

This paper is divided into two parts. The first part, Chapters III, IV and V, focuses upon controlling the income reporting of public officials, which includes the functions of the Corruption Prevention and Combating Bureau (KNAB) in monitoring the activities of public officials. The second part, Chapters VI, VII and VIII focuses on controlling the income reporting of the general public, which includes the effectiveness of the direct tax laws and the State Revenue Service (Tax Administration) in monitoring the general public.

2. Current Situation

The Parliament of Latvia adopted the Law on the Prevention of Conflict of Interest in Activities of Public Officials (hereinafter referred to as the "Law") on 18 April 2002. The Corruption Prevention and Combating Bureau also known as KNAB (hereinafter referred to as "KNAB") became effective and operational from 1 February 2003. KNAB's function is three fold: prevention of corruption, combating corruption and education of society on corruption issues.
A comprehensive control system over income of public officials and natural persons has not been introduced in Latvia, which is a reoccurring problem in combating corruption. There are obstacles for examining the legitimacy of the origin of a person's assets in cases where expenditures exceed income and asset increases exceed legally acquired income.

In cases where annual income of a person exceeds four times the amount of untaxed minimum, the person must file an income declaration (annual tax declaration). However, most taxpayer's do not file annual income declarations. Current legislation provides a non-filing penalty in the amount of 20LV, which is approximately 30 Euros or 40 US dollars.

The Cabinet of Ministers, KNAB and representatives of various government ministries to include the Minister of Finance and the State Revenue Service established a working group to study and recommend a concept on the improvement of income control of individuals. The working group is considering the filing of annual asset declarations by all taxpayers above a certain threshold of income, increasing the penalty provisions for not filing or paying the tax, issues relating to indirect evidence, burden of proof and several administrative initiatives.

3. Laws Reviewed

a. Law on Prevention of Conflict of Interest in Activities of Public Officials
b. Law on the State Revenue Service
c. Law on Taxes and Fees
d. The Criminal Law
e. Personal Income Tax Law
f. Enterprise Income Tax Law
g. UN Convention against Corruption
h. Council of Europe Criminal Law Convention on Corruption and Civil Law Convention on Corruption

4. Meetings

a. Diana Kurpniece, Head of KNAB Public Relations and International Co-Operation Division
b. Alvis Vilks, Deputy Director of KNAB
c. Dace Timane, Senior Specialist KNAB, Public Relations and International Cooperation
d. David Taurinsh, Deputy State Secretary, Ministry of Finance.
e. Ilze Jurca, KNAB, Head of Division of Control of Activities of Public Officials
f. Signe Bole, KNAB, Division of Investigations

g. Inara Petersone, Deputy Head of Department on Tax Policy, State Revenue Service
h. Anita Locane, Head of Corruption Prevention Department, State Revenue Service
i. Modris Adlers, Prosecutor's General Office, Head Prosecutor of the Extremely Significant Cases Investigation Division
j. Aleksejs Loskutovs, Director of KNAB

CHAPTER II: Summary of Recommendations

Introduction

While KNAB's staff is competent to perform their mission, they perform under handicapped conditions. Its size, 124 staff versus 68,000 public officials, non-recognition of illicit enrichment (Art. 29 of the Law "On Prevention on Conflict of Interest" though recognizes illicit enrichment there we would suggest replace wording "non-recognition" with "having no sufficient/precise legal framework/provisions for sanctioning illicit enrichment"), and a non-presumptive Burden of Proof, impede KNAB's productive capability.

If the determinative factor of anti-corruption measures were solely based on the degree of deterrence, Latvia's current situation would have a minimal affect on deterrence.

Between KNAB and the SRS, they examine and audit one-half of one percent of public officials.

Latvia needs to adopt illicit enrichment as a criminal offense for both public officials and natural person's enforcement of income control. It also needs to recognize presumptive proof and indirect methods of evidence to prove corruption and tax evasion.

Latvia needs to increase the staff level of KNAB to permit it to accomplish its mission as mandated by law i.e. 34 more investigators and shift of SRS Corruption 64 member Department receiving filed public official declarations to KNAB to maintain supervisory control of declaration verification and in assisting examiner and investigators retrieve information from the SRS database.

The State Revenue Service must also redeploy staff from administrative to collection and audit enforcement. It is loosing far too much tax revenue through non-filings, tax avoidance and tax fraud. Only 8% of the tax administration staff is assigned for collection and audit duties, but the international average is 30%. (Data submitted by SRS: by 1 January 2006 there were 5354 employees from which 1332 were employed in tax collection and 747 in auditing process. Together this is 39 % from all SRS employees).
According to calculation of the consultant all SRS employees were taken into account including administrative personnel.

Specific Recommendations

For the Chapter III: Income Control of Public Officials

1. KNAB should implement the concept of a vertical, integrated government agency system focused on prevention, educational, training of public officials among the various Government departments.

2. It is suggested there be a shifting of Government selected, motivated employees from Government Departments and Agencies that are over staffed into KNAB's examination and investigative divisions.

For the Chapter IV: Corruption Enforcement Procedure by KNAB

A. <u>Illicit Enrichment and Indirect, presumptive Burden of Proof</u>

1. Latvia having ratified the UN Convention against Corruption, which mandates the crime of illicit enrichment, should adopt illicit enrichment as a criminal offense against public official criminal violations and also for tax fraud for the crime of tax evasion.

2. Latvia having ratified the Council of Europe Criminal Law Convention on Corruption and the Council of Europe Civil Law Convention on Corruption, which suggest presumptive Burden of Proof, should amend its Judicial Burden of Proof to allow presumptive evidence based on indirect methods of proof.

B. Third-Party Information Declarations

A third party information declaration process is a valuable KNAB resource for its simplicity and quick verification and investigation of a public officials' income and asset declaration.

C. Audit and Risk Base Planning

In addition to examining public officials based upon general public allegations and complaints, KNAB should implement a risk, based analysis approach to selectively choose public officials for examination. Until such time as it has an adequate number of examiners and investigators, its current random examination process should be designed using the principles of a risk based analysis approach to selective examinations

D. Penalties

A working group is currently evaluating and recommending increases to penalty provisions. Therefore, it is recommended the working group adopt a level of financial penalty that is sufficiently high to deter most officials and certainly lower level officials.

E. Investigator Manuals and Training

KNAB's Division of Control of Actions of State Officials and the Division of Investigations require formal manuals and regular training sessions to encourage consistency of performance and results.

For the Chapter V: Public Official's Income and Asset Declaration

1. KNAB should consider whether it is economically feasible to require all 68,000 public officials to file Asset and Income Declarations or limit such filings to pre-determined levels of salary or authority.

2. Best international practice and Latvia's Law on Prevention of Conflict of Interest, Chapter II, suggest information inclusion of a public official's spouse and dependents into the public officials' income and asset declaration. *However, Latvia's public official declaration omits financial and asset reference to a spouse and dependents. The declaration should*

be amended to include financial and asset information of a spouse and dependents.

For the Chapter VI: Income Control of the General Public

Regardless of whether Latvia adopts general public annual asset declarations, net worth declarations or pre-populated income declarations, it is recommended that *an information compliance system be adopted through the implementation of third party information declarations to discover non filers, the accuracy of information reported on annual income declarations*, creates quick assessment of tax for expedited collection and as an aid to both the collection and audit functions of the State Revenue Service and KNAB's investigations of illicit enrichment.

For the Chapter VII: State Revenue Service

The SRS staff is above the international average number of staff per taxpayer, the cost of administration exceeds the international average, but the efficiency of tax collection is considerably below even some of the better developing countries in South America and only slightly above the struggling developing countries in South America. Comment by SRS: in comparing practice and experience of other countries it has to be noted that SRS along with tax administration also administrates customs matters (then the question is how many people are employed directly by customs headquarters, comment by Dace), disclosure and prevention of financial crimes as well as administration of turnover of excise goods. That all crucially increases number of SRS staff which according to calculations of experts is administrative personnel.) Reason: the amount of audits and the number of collection and audit officers in relation to the total SRS staff are substantially below the International average. The SRS should shift some of its resources from administrative functions into the collection and audit functions in order to increase its tax collection efficiency. When analyzing capacity of the CPCB reference to total number of employees is given where a part of them is also doing administrative work.

1. The SRS needs to re-evaluate its current system of pre-recording, recording and post recording procedures.

2. The issuance of personal code numbers to natural persons should be a function of the SRS Regional Offices in-order to immediately register all natural persons into the SRS database.

3. The recording process needs to evaluate:

- Centralized processing location-the fewer office locations involved in this function, allows for greater consistency in the process.
- Information reporting program management (IRP) – third party information declarations was discussed in Chapter VII. This system allows the SRS to run an annual cross match of these information declarations against the filed income declarations. Discrepancies will be address either through correspondence or office or field audit.
- Implementation of e-filing and greater use of internet for downloading forms.

5. Collections

There are dozens of suggestions and the reader is requested to read this Chapter section.
In summary:

1. Empower collection inspectors by giving them full responsibility for collection actions in their area of responsibility, including:
   - the ability to enter into installment agreements (subject to approval by the Collection Unit Chief, or higher authority in appropriate circumstances)
   - the authority to serve administrative summons for documents
   - the authority to secure delinquent returns
   - the authority to take administrative enforcement action against bank accounts and other funds held by third parties that belong to the taxpayer and to inventory and seize property
   - to record liens after non-payment of Notice of Demand as opposed to waiting for audit assessment
   - to determine jeopardy assessment based on experience rather than taxpayer initially taking action to dispose property.

2. Establish an effective strategic planning process across the STS, including establishment of long-range goals (1–5 years) for collection. Additionally, establish an annual work plan that identifies priorities for the year and leads to achievement of the goals of the Strategic Plan.
3. Establish a method for analyzing the list of tax arrears by value and age to determine whether existing write-off procedures are effective in

eliminating old debts that cannot be collected and to assist in assessing the effectiveness of collection activity.

6. Audits

As with Collections, there are dozens of recommendations due to the low level of annual audits. The Audit staff consists of only 5% of the SRS staff and audits only .00009% of natural persons. Comment by SRS: 747 employees are dealing with audit which is 14 % from all SRS employees. In 2005 704 physical persons were audited – 0, 03 % from all the inhabitants of Latvia or 0, 07 % from all the employees and self-employed persons. Please, be advised that 465 physical persons were audited during the first 6 months of 2006. Substantial planning systems and shifting of resources is required. Third party Information declarations should be used for initial tax assessments, instead of the audit division, providing the audit division more time to expand its risk based audit analysis. See Chapter VII for recommendations.

7. Law on Taxes and Fines

The Law on Taxes and Fines by omission fails to implement many International Best Practice Articles to strengthen prevention and enforcement. Amendments are suggested.

For the Chapter VIII: Direct Tax Laws

1. Latvia should implement provisions for Micro Enterprises to help reduce the shadow economy.

2. The Enterprise Income Tax Law provisions should be compared to EU directives concerning taxation of parent-subsidiary, mergers, permanent establishment and transfer pricing.

CHAPTER III: Income Control of Public Officials

1. Introduction

Experts in many fields of specialty agree it is easier and less costly to prevent fraud and corruption than it is to detect it. The key elements for KNAB in creating and fostering a "preventive" environment against fraud and corruption among public officials are: strengthening financial management systems, evaluating internal control systems to identify and correct weaknesses and heightening public awareness.

2. Current Situation

The Latvian Government employs approximately 68,000 employees. Public Officials, as defined in Section 4 of the Law, includes the Executive and Legislative Branches, and the Government's Ministerial, Departments, Institutions and Agencies high and lower level employees.

Pursuant to Section 5 of the Law, KNAB, as well other agencies, shall control the implementation of the Law. In addition, pursuant to the Law establishing KNAB, its authority includes the development of an anti-corruption strategy and drafting the national anti-corruption program, and the authority to coordinate the co-operation of government institutions to ensure the implementation of the national anti-corruption strategy and program.

Prevention is addressed at the national level through two means: first, a single, comprehensive and clear set of ethical standards of conduct; second, - an efficient dissemination of information to the general public. Latvia has succeeded on both measures. Latvia developed a standardized regulation of conduct for public officials, The Law on Prevention of Conflict of Interest in Activities of Public Officials (hereinafter referred to as the "Law"), and complimentary Criminal and Administrative Statutes along with a Public Official Income and Asset Declaration system designed to identify and address potential conflicts of interests and violation of ethical restrictions defined in Chapter II of the Law.

KNAB is successful in the dissemination of information to the general public as evidenced by the volume of private citizen complaints against

public officials (approximately 2,000 per year) and regular conferences with public officials.

While there is a consistency of standards and interpretation of ethical violations applicable to all public officials, there is no prevention (educational) orientated inter-governmental, vertical co-operative structure to increase communications and cooperation between KNAB and the various Government ministries, departments and agencies.

Prevention must have a priority standing through an inter-governmental, vertical coordinated prevention system. Prevention is much more cost effective than enforcement considering all the human resources involved in enforcement, which include KNAB investigators, Financial Police under the State Revenue Service, Police Investigators, Prosecutors and the judicial system.

3. Discussion

The 9th International Anti-Corruption Conference (1999) held in Norway, (ww1.transparency.org) conducted a survey of representatives of many KNAB type organizations from many varied countries. Unlike many organizations, which complained they do not have legislative mandates to implement their anti-corruption policy, KNAB does have a mandate to draft policy and implement such policy.

According to the same survey, most of the organizations do not have inter-government vertical control measures for either prevention or enforcement, they merely serve in an advisory capacity to government institutions and their recommendations are often ignored. All, however, agreed that a reduction in corruption would occur if they had inter-government vertical control measures. Germany, France and the Slovak Republic, while not participants in the Anti-Corruption forum, indicated they also have no inter-government vertical control measures.

Vertical integration is a two-prong approach: Prevention and Enforcement.

KNAB does utilize the proactive prevention approach of conducting training sessions for government officials of various departments to discuss the Law, definitions of corruption, code of ethics, violation of the Law and

enforcement. However, the government departments are independent; each may have its own prevention program, its own Code of Conduct and/or Code of Ethics, Internal Affairs department, Internal Control Officer, investigative staff, internal Hearing Commission. These Internal Affairs departments may or may not report an investigation to KNAB, but will certainly inform it when asked. If the Prosecutor's Office determines that KNAB or another agency would be more suitable to conduct the department's investigation, the file will be transferred to KNAB or the other agency.

At a forum conducted by OECD, December 5, 2001, Jane S. Ley, Deputy Director of the United States Office on Government Ethics addressed the issue of how the United States implements inter-government vertical control measures. Building upon its institutional systems, the Three Branches of government, Executive, Legislative and Judiciary have developed Government ethics programs designed to prevent, address and manage individual conflicts of interest and the appearance of those conflicts. The common elements are enforceable standards of a code of ethics complemented by criminal statutes and administrative restrictions, confidential disclosure systems designed to identify potential conflicts of interest, systematic training and counseling services and effective enforcement measures. The current Latvia Law and the mandated authority of KNAB are similar to the United States. But the similarity stops there.

The largest branch of the United States Government is the Executive branch. There are approximately 250,000 government employees of the Executive Branch spread out over many Departments, Institutions and Agencies. The Office of Government Ethics (OGE), which is the United States' counterpart to KNAB, is an independent agency responsible for creating anti-corruption policy, implementing the policy and enforcing violations. Like KNAB, the OGE, drafted a single, standardized and comprehensive public officials' ethics law applying to all public officials in all departments, institutions and agencies, known as Title 18 of the United States Code, see www.usoge.gov.

Unlike KNAB, the OGE exercises maximum preventive implementation of policy through vertical inter-governmental compliance control measures, since it knows full well it is impossible to prevent corruption among 250,000 employees without such a system. The OGE, as is KNAB, is the central authority establishing the policy, direction and leadership of anti-corruption prevention measures among all the Executive Branch departments,

institutions and agencies. Similar to Latvia, each Department Head is primarily responsible for its department's ethics program and must incorporate the OGE rules and policy and standardized ethics provisions of Title 18 by drafting a Code of Conduct within the framework of Title 18, but tailored specifically to the unique instances and activities of the department. Since each department activity is different, conflict of law may appear through varied activities not know to OGE.

The Department Head designates a person as the Designated Agency Ethics Official (DAEO) who reports only to the Department Head and to the OGE. In Latvia the Department Head designates an Internal Control Officer, but such officer need not report to KNAB. As in Latvia, which has Department Internal Control Officers, The DAEO has the full time responsibility for developing a departmental Code of Conduct in compliance with Title 18, the day-to-day management and implementation of the ethics program. Unlike Latvia, the DAEO reports violations, whether potential or actual, to the OGE, and conducts training sessions and workshops for department officials and employees. Unlike KNAB, the OGE has exclusive enforcement jurisdiction of all violations, unless remanded to the DAEO for minor infractions that can better be handled at the Department level. (Chapter 3 of US Compliance with Inter-American Convention against Corruption)

Unlike KNAB, the OGE maintains close liaison with the DAEO of each department, institution and agency by providing information, advice, assistance and training sessions on a regular basis and annual convention for all DAEO's to exchange information, build strong alliances among the DAEO's and publishes a newsletter distributed to each DAEO. The OGE reviews the Department's code of ethics and program implementation, makes recommendations to improve the program and implementation, advises and assists each DAEO in their conducting training sessions and workshops.

According to Jane S. Ley, this inter-government vertical support system to OGE makes it possible for the Law on Government Ethics, Title 18 US Code, to run more smoothly and have "teeth".

This framework for Institutional cooperation and integration is also strongly suggested by the United Nations in its UN Anti Corruption Tool Kit, 3rd Edition, Vienna, September 2004, page 80, which encourages Independent

Corruption Agencies be granted the power to review and comment on preventive measures developed by other Government departments and agencies. The major objectives of vertical institutional integration with the Independent Corruption Agency include the following:

- Drawing up, within each institution, an analysis of strengths and weaknesses to form the basis of a strategy and action plan for anticorruption efforts within the institution. The individual plans, thus elaborated, can be compared and harmonized across the full range of institutions. (it is among the tasks of the National Programme for Corruption Prevention and Combating for 2004-2008)
- The identification of specific risk areas of corruption within each institution.(this is also a part of the Programme)
- Developing a complete inventory of institutions and agencies. The inventory would include a brief outline of the establishment and mandate of each institution and the responsibilities each has in corruption-related efforts. It would be used to make institutions aware of their mutual existence and roles, which, in turn, would facilitate cooperation and coordination of mandates and activities.
- Developing an assessment of the mandates and activities of each institution to identify and address gaps or inconsistencies. Consideration could then be given to enhancing mandates or resources in areas identified as weak or under-resourced.

KNAB should implement the first phase of a vertical, integrated government agency system focusing on prevention by creating more interaction and liaison with department Internal Control Officers. It should conduct meetings, information sharing, assistance and training sessions with each of these officers. These officers should be mandated to implement training sessions to their respective department staff in order to maintain a consistent awareness of conflicts of interest and corruption.

Regarding the second phase of the vertical integration, enforcement, maintaining the current system of department's investigating their respective criminal violations of the Law is appropriate. However, investigations of a criminal matter, pursuant to Chapter II of the Law, should require a mandated report to KNAB, if for no other reason than to determine if the public official is already being investigated by KNAB and to prevent the two investigations from arriving at conflicting, prejudicial conclusions. KNAB,

unlike the OGE, is currently in no position to decide if it will take over the department's criminal matter or assign one of its investigators to each department investigation team in an advisory role.

Another measure used in the United States is the investigation of financial disclosures and conflict of interest of potential candidates for elected office and declared appointees. In Latvia, the initial financial disclosure is submitted upon assuming office, Sections 23(1) and 25(1) of the Law. Prior to that time, investigations are conducted by the Election Committee to confirm the candidates' or appointees' suitability for office. This confirmation process includes a search of all criminal, civil and tax records. There is no appropriate data comparison to determine the effectiveness of Latvia's suitability process compared to the United States conflict of interest and financial investigation process. It may be helpful for Latvia to know in advance whether a candidate's financial situation is a potential conflict of interest or Chapter II violation.

CHAPTER IV: Corruption Enforcement Procedure by KNAB

1. Introduction

KNAB is seriously undermanned, 124 employees, to perform its mission of enforcement applied to 68,000 public officials. As a result, efficient employment of investigative and examination planning must be incorporated into its management.

In addition, the current Criminal Law and Criminal Procedure Rules handicap the prosecution of public officials by neither recognizing illicit enrichment as a crime nor accepting indirect methods of proof.

2. Current Situation

Pursuant to Section 23 of the Law, public officials must file their income and asset declarations with the Department of Corruption Prevention in the State Revenue Service (SRS). If the declaration is completed (all questions answered) and signed, then the SRS imputes the data into its computer system. The SRS Department does not verify the information reported in the declaration and no declarations are forwarded to KNAB, unless specifically requested. After the data is imputed, the SRS Control and Analysis department may review the declarations to determine if a tax audit of a public official should be commenced. Notification of a review or decision to commence a tax audit need not be reported to KNAB, unless the audit reveals a violation of the Law's Chapter II restrictions. The SRS Audit Division has devised a risk base analysis, which lists approximately 167 public officials subject to possible audit. In 2005, 153 public officials have been asked to submit additional information, 11 public officials have complied with the request. Unless the public official is among the 167 public officials forming the risk base analysis, declarations forwarded to the Control and Analysis department will probably never be examined. As a result, there is no deterrence to inaccurate and misleading declarations.

Section 28 of the Law empowers KNAB to verify whether financial declarations filed by public officials contain information that is indicative of violations of the restrictions provided in Chapter II of the Law, i.e. Bribery, Gifts etc. In so doing, KNAB has the right to request the original or copy of

the declaration from the SRS and receive information from the public official, his or her relatives, other government agencies and third parties.

Both the Law and the Law on Taxes and Fines authorize presumptive Burden of Proof based upon indirect methods of proof. Section 29 of the Law states if the public official is uncooperative or cannot justify the source for the acquisition of property. It is presumed the public official acquired the property in violation of the Law. Section 23 (6)(1), (7)(2) and (12) of the Law on Taxes permitting indirect assessment and comparison of assets to income reported. Despite this presumptive authority in two laws neither Sections are enforceable in criminal or civil judicial matters to prove illicit enrichment or unreported income and tax evasion. As a result, the enforcement divisions of KNAB, the SRS and the Prosecutor's Office welcome judicial acceptance of illicit enrichment as a criminal offense and a Burden of Proof amendment accepting presumptive evidence created by indirect methods in both criminal and civil proceedings. The Prosecutor's Office has recommended to the Council of Ministers an amendment to the current Burden of Proof, which currently recognizes only the specific items method of proof.

The investigative divisions of KNAB consist of the Division of Control of Actions of State Officials (hereinafter referred to as CA) and the Division of Investigations (hereinafter referred to as the DI). The CA consists of 17 investigators half of which investigate the public official declarations and the other half investigates general public allegations and complaints to determine compliance with the Law. In 2005 KNAB received 2000 allegations or complaints, the CA investigated all complaints, examined 1,641 public officials and 843 declarations.

KNAB has a Corruption Analyzing and Counter Measures Development Department, which studies and proposes random investigations. In 2005, only 30% representing 253 officials, of the declarations examined were initiated by random selection. Comments by SRS: all the declarations of public officials (68 000) submitted in 2005 were examined by SRS using risk analyses system. As the result 167 declarations were selected which is 0, 25 % from total number of declarations in 2005. All the selected declarations were examined in-depth. After evaluation and analyses of information being at disposal of SRS 143 public officials were asked to submit additional declarations. This represents .003% of the total number of

public officials. The SRS also audited 167 public officials pursuant to its risk-based analysis, which represents .002% of public officials. Together less than one-half of 1% of public official income and asset declarations were examined in 2005.

The CA (and DI) examination is limited to checking registers and obtaining bank information. If a full-scale financial examination is required, it refers the matter to the SRS in which case the CA looses control of the file. Based upon this investigation, the CA will either recommend administrative sanctions or refer the declaration to DI to initiate an investigation for a possible criminal violation of Chapter II restrictions of the Law. If the violation is administrative pursuant to Section 30 of the Law, KNAB will initiate Administrative Law proceedings. The CA imposed administrative sanctions on 216 public officials in 2005.

The DI consists of 12 investigators. The investigators have the authority to demand testimony and documents through the issuance of a summons and can apply for a lien and seizure of property by application to the prosecutor assigned to advise DI who obtains a Court Order. The prime problems DI face are: the criminal code provision not requiring immediate relatives to testify against each other; Judicial non-recognition of indirect methods of proof; and officials declaring that income or assets were legally received from sources many years prior to the investigation, which the investigators cannot disprove as long as the Criminal Law does not recognize unexplained wealth, illicit enrichment or presumptive proof. The DI conducts no formal training sessions and has no investigative manual; its investigators rely upon training sessions conducted by International Organizations.

In 2005, KNAB investigated 35 new criminal actions and 25 administrative actions. In 2005, DI's inventory of open files consisted of 68 cases, 27 cases representing 44 officials were forwarded to the Prosecutor's Office. The Court found officials guilty in only 14 of the 27 referred criminal cases .(context of information has been improvised- forwarding of cases to the court takes time and also certain period of time is required within the court system. From what has been put down in the report one might assume that persons were acquitted but in reality there have not been court hearings n these cases.)

Latvia's criminal and administrative sanctions include the recommended UN Convention and European Convention provisions regarding confiscation of illegally obtained property, corporate liability for the actions of employees, conversion of property, concealment and laundering.

3. Discussion

Deterrence (the risk of being discovered) is a prime tool in corruption prevention. KNAB has insufficient deterrence due to its lack of resources (employees). KNAB investigated 843 declarations in 2005, 70% of the examinations based upon receiving corruption allegations from the general public, a complaint or independent knowledge and 30% based upon random selection. The SRS, on the other hand, also does not and cannot verify 68,000 public official declarations. SRS examinations are confined to only 167 officials included in its risk based analysis program. The combined investigation of public official declarations is less than one half of one percent. Therefore, while Latvia's intent is in the right direction, the probability of detecting corruption through financial gain is non-existent and certainly not a deterrent. This difficulty may erroneously undermine Latvia's and KNAB's, credibility, commitment and effectiveness to combat public official corruption and income control in the view of both the general public and other countries.

The fight against fraud and corruption is a long-term, vital National effort that must be sustainable, if Latvia expects increased revenue flow from taxation, a vibrant domestic economy, International recognition of commitment and credibility and attraction for foreign direct investment. Due to KNAB's limited resources, a multi-faceted approach focusing on prevention, examination and verification leading to administrative sanctions and investigations of criminal matters is understandably difficult to implement. Since KNAB has insufficient resources to perform its monumental mission, it is suggested a shifting of Government selected, motivated employees from Departments and Agencies that are over staffed into the KNAB as a solution to the National commitment to combating corruption in Government service.

A. Unexplained Wealth, Illicit Enrichment and Indirect Methods of Proof, Burden of Proof

KNAB referred 27 criminal cases to the Prosecutor's Office for criminal prosecution against public officials. Only 14 cases, 50%, resulted in criminal convictions. It is not surprising the win/loss ratio is so small (again we have to talk about the duration of time when hearing of cases takes place), since the Prosecutors are presenting a case with "one hand tied behind them". The Criminal Justice system neither recognizes illicit enrichment as a crime, nor does the Justice system recognize a Burden of Proof based upon presumptive evidence established by indirect methods of proof such as the net worth method. Latvia, however, has ratified the UN Convention on Corruption which requires the criminal offense of illicit enrichment (Article 20) and the Council of Europe Criminal Law Convention on Corruption and the Council' Civil Law counterpart, which recognize and mandate a presumptive Burden of Proof.

The lifestyle of the public official is relatively easy to monitor, while concealed assets possibly held under the name of a family member or other nominee, is difficult to detect. If spending or assets point to unexplained sources of wealth, an investigation, aimed at uncovering hidden assets and the sources of corrupt income, would follow. In Latvia investigations are unnecessarily more difficult. According to the Latvian Criminal Rules of Procedure, Section 110, certain relatives have the right not to testify against a related accused. In addition, most officials under investigation claim having received income legally from relatives many years prior to the investigation. As a result, it is difficult to convict a public official who has transferred illicit property to a relative, or disclaim unsupportive claims of inheritance or gifts unless indirect evidence, as in the United States, UK, most EU countries and Hong Kong is permitted to prove corruption.

Article IX of the Inter-American Convention against Corruption (IACAC) advances a means of proving corruption. The provision, entitled "Illicit Enrichment," states:

"Subject to its Constitution and the fundamental principles of its legal system, each State Party that has not yet done so shall take the necessary measures to establish under its laws as an offense a significant increase in the assets of a government official that he cannot reasonably explain in relation to his lawful earnings during the performance of his functions. Among those State Parties that have established illicit enrichment as an

offense, such offense shall be considered an act of corruption for the purposes of this Convention."

Unlike the other acts of corruption in Articles VI (1) and XI that focus on improper transfers or gains derived from the exercise of governmental authority, Illicit Enrichment makes a government official's accumulation of significant wealth a form of corruption. To prove Illicit Enrichment, a State Party need not establish a link between a particular decision, or any exercise of governmental authority, and the receipt of particular benefits. The governmental official must explain the fact of wealth alone, and a failure to provide an adequate explanation would mean that the official must have traded on the governmental authority vested in him for personal gain. Article IX is, in effect, corruption without proof of either a *quid pro quo* or intent to gain illicit benefits from official action. The circumstantial evidence of unexplained wealth leads—perhaps inexorably—to the conclusion of some improper exchange or misuse of authority to benefit the decision maker.

Ownership of significant wealth, which is susceptible to proof through records maintained by third parties, such as banks and brokerages, becomes an element proving corruption in place of proving the improper exercise of authority that can be difficult to establish absent cooperating witnesses or incriminating documents. The IACAC promoted Article IX to make proof of corruption much easier by removing any requirement to demonstrate a nexus between a benefit gained by an official and a particular governmental action.

The United Nations Convention on Corruption, Article 20, also calls for the establishment of the criminal offence of illicit enrichment, applicable when the acquisition of disclosed or discovered assets cannot be accounted for from legitimate sources, but this offence is problematic for some countries because it would require the presumption of illicit acquisition, an element of the offence.

In summary, in those countries, which recognize the mere fact of having disproportionate property or income as a crime in and of itself, no other substantive crime need be proved. It forces the accused public official to prove the sources from which the property was acquired. A failure to prove that the assets are from legitimate sources "deem" that the property as acquired in an illegal manner. Therefore, a crime has been committed and no other substantive (bribes, gifts etc.) corruption crime need be proven. A sample of countries which recognize illicit enrichment either by directly

stating such in the Criminal Code, or by reference to crimes of office abuse, influence, bribery, gifts, or instead of the words "illicit enrichment" using words such as "benefit" "gain" as crimes of corruption etc.: Lithuania, Germany, Brazil, Columbia Macedonia, Croatia, Iceland, Greece, Yemen, Algeria, Costa Rica, Luxembourg, South Africa and UK. It is interesting to note, all these countries had recognized illicit enrichment as a crime of corruption even before the UN Convention on Corruption, as indicated in a report by the UN Economic and Social Council, Commission on Crime Prevention and Criminal Justice, 15 February 2002, which indicated that the position of these countries formed the basis of the UN Commission mandating illicit enrichment as a crime of corruption.

The United States does not consider illicit enrichment in of itself a criminal offense of corruption. The United States noted in its Understanding of the Convention that there are provisions in United States law that achieve the same outcome as Article IX for punishing public officials, including punishment for failure to make proper financial disclosures (similar to Section 219 of Latvia's Criminal Code) and tax evasion (Section 218 of Latvia's Criminal Code), 146 CONG. REC. S7809 (2000). A criminal tax evasion prosecution that would reach the same result, as the Illicit Enrichment provision, would involve a technique used in the United States to prove tax evasion called the "net worth" method. A net worth case is explained as following:

With an indirect method of proof, the amount of income a defendant allegedly received is shown circumstantially by adding the amounts of money deposited by the defendant over a period of time ("bank deposits" method); calculating the increase in a defendant's visible wealth, such as new homes, investments, automobiles, boats, etc. ("net worth" method); or simply documenting cash expenditures by a defendant ("cash expenditure" method). When these indirect methods of proof reveal an amount of income in excess of the defendant's income as reported to the IRS, a presumption arises that the defendant has not reported all income. The defendant bears the burden of rebutting this presumption. Government agents have a duty to investigate leads provided by a taxpayer regarding nontaxable sources of income. In indirect method cases, the government is not required to disprove every possible source of nontaxable income, or document the defendant's finances "to a mathematical certainty." (A complete explanation of indirect methods prepared by ARD, USAID/Nepal Publication, Anti Corruption

Investigation and Trial Guide, is attached as Exhibit A. Also see http://www.usdoj.gov/tax/readingroom/2001ctm/31ctax.htm for a complete step-by-step analysis of the United States Criminal Tax Manual on the computation of net worth).

In some countries there was the Constitutional argument that a shifting of the evidentiary burden of proof upon an accused may require strong justification, since this is a departure from the fundamental principle of the rule of law that the prosecution has the onus of proving every element of the case against the accused.

The Highest Courts of Appeal in both the UK and Hong Kong has rejected such a constitutional argument when it comes to crimes of corruption. The Court of Appeal of Hong Kong held "Nobody.... should be in any doubt as to the deadly and insidious nature of corruption." Accordingly, both the High Courts of the UK and Hong Kong acknowledged that, for this type of offense, the primary responsibility for proving matters of substance against the accused, beyond a reasonable doubt, rests with the prosecution. Only when it has been established by the prosecution that the accused wealth could not reasonably have come from his or her official salary does the accused have to provide a satisfactory explanation. A satisfactory explanation would be one, which might reasonably account for the wealth in excess of the salary. It is a matter peculiarly within the knowledge of the accused.

The Council of Europe follows the principles of the United States, in those countries that do not make disproportionate property by itself a crime, it is still a system of proof to make a *prima facie* case of another, separate, substantive crime. The evidentiary burden shifts to the accused, once the disproportionate income, property, or assets have been established by the State.

Transparency International has encouraged the Council of Europe to endorse illicit enrichment as a crime of corruption. In the TI comments on the European Commission Communication on "A Comprehensive EU Policy against Corruption", 30 July 2003, p4:

"We would encourage the Commission to explore seriously the "ways to facilitate the burden of proof for law enforcement authorities".

Some countries (meaning the UN Convention signatures) have introduced the reversal of the burden of proof as an instrument in the fight against corruption: the State authorities do not have to prove that an official has accepted bribes, but the official who lives "beyond his normal means" has to demonstrate that his property has been legitimately acquired."

It is interesting to compare the language in the Prevention of Conflict of Interest Law of Public Officials, which is similar to those countries referred to previously holding that benefits, betterment or gains while in public office are crimes of corruption:

Section 29(3) of the Law states:

"If a public official…. cannot justify the acquisition of income or financial benefit from a legal source, it shall be presumed that the public official has acquired the property prohibited by this Law, including financial resources, and he or she is hiding this fact from the State"

Section 12 (2) states:

"A public official is prohibited to influence…with respect to 2) issues deciding on which shall influence or may influence the personal and financial interests of the official … or relatives"

Section 13 (2) states:

"a gift is any financial or other kind of benefit…"

Section 14(5) states:

"A public official is prohibited from requesting donations … in the collection of 1) for the needs of the public official …or relatives…or 2) for needs of those natural persons or legal persons from which the public official …or relatives acquire or have acquired any type of income… or 3) for the needs of merchants where the official or relatives are members.

The terminology of the Latvian Law clearly states: the "unjustified" acquiring of "income", "acquisitions", "benefits", "gains", shall be presumed acts "prohibited by this Law", referring to Chapter II restrictions.

The Law does not say: "may be presumed". The Law clearly adopts the UN Convention mandate that the unexplained accumulation of wealth is a violation of the Law and is, therefore, a crime of corruption.

The Latvian Law's terminology is consistent with the terminology used in the other countries stated above, which in many cases do not specifically use the word "illicit enrichment" but do hold that unexplained "financial benefit", "gains" etc during office is a violation of conflict of interest and is, therefore, an illicit enrichment crime of corruption.

The UN Convention against Corruption was ratified by Latvia, December 2005, the Council of Europe Criminal Law Convention on Corruption was ratified July 2002 and the Council of Europe Civil Law on Corruption was ratified march 2005. Despite all such Government ratifications mandating either the criminal offense of illicit enrichment or presumptive Burden of Proof, Latvia's judicial system still does not recognize the ratifications and still requires specific evidence of both unexplained wealth and a substantive charge of Chapter II restrictions, Criminal Tax evasion and other applicable Criminal Law violations. This current Burden is insurmountable, since as stated by the Hong King Court Of Appeals, specific evidence is most often impossible to obtain.

B. Third-Party Information Declarations

KNAB proposed the use of asset declarations to be filed by the general public (A complete discussion of Asset declarations is included in Chapter VII pertaining to the income control of natural persons), as a starting point to determine the current assets of the general public to detect corruption. General Public Asset Declarations, however, as do public official income and asset declarations, consist of self-declared information, which require verification. *Asset declarations address only fluctuations in assets, but are not a measure of net worth (assets less liabilities), which indicates the true nature of a person's wealth. As a result, in such countries requiring asset declarations to be filed by the general public, such as Sweden, the net worth method is used.* For example, the December 31 net worth becomes the starting net worth for the following year. The December 31 net worth for the following year is compared to the net worth at the beginning of the year to determine fluctuation of wealth. Whether an asset or net-worth declaration

is used, verification is necessary, since the document itself, despite being a signed declaration, is insufficient to guarantee the transparency and truthfulness of the included information. This is the reason verification is required with external sources, particularly on-line databases to detect irregularities.

The United States does require asset or net worth declaration filing by the general public. *Sweden, the UK, Norway as well as most Developed Countries, have incorporated into their control of income strategy a compliance information verification system utilizing information declarations filed by third parties having transactions with taxpayers*. These third party information declarations report sources and amounts of annual income, property transfers and expenses. The declarations are used by Tax Administrations to verify taxpayer self-assessments on annual income (tax) declarations and to instantly identify non-filers.

KNAB has proposed an Information Recording Process to enhance cooperation among government agencies to assist its investigation of public officials. This reporting process is directed for the main part upon the SRS, Registers, Banks and Law Enforcement Agencies, but does not include third party information declarations, since it is not the law of Latvia.

The third party information declaration process is a valuable KNAB source for the verification and investigation of the public officials' income and asset declaration. The verification process neither requires a formal audit, accounting expertise nor visitations to a public official or relative's home. It is simply an in office matter of comparing the public official's disclosure of annual transactions in the income and asset declaration of the public official, spouse, dependents and relatives with the third party information declarations filed with the SRS. As an example, an information declaration of interest earned compared to a prior year indicating an increase in interest income earned means a current increase of savings deposited into a bank account, also, it is an accurate discovery method to find every bank account and other asset, both domestic and foreign, without requiring interviews of third parties and questioning the validity and extent of their disclosure.

While an official's declaration may remain unchanged, information declarations provide a clear in office examination of the income and asset fluctuations of a spouse, dependents and relatives. As a result of the

simplicity and instant detection of discrepancies, CA and DI can verify many more public officials and their families without waiting for a SRS full audit or conducting a time consuming visitation.

Information Declarations are numerous, but for KNAB's purpose, require nothing more than access into the SRS computer database. KNAB already uses information declarations in a limited manner to cross check transaction information received from Banks and the licensing and real estate registers.

Attached, in the Exhibit B is a draft Law on Information Declarations. There may be more information declarations required by KNAB and SRS, but this draft is a starting point. Types of Third party Information Declarations (Exhibit C) Sweden and Norway can be reviewed at the web page of Sweden, www.skatteverket.se or at the US Internal Revenue site http://www.irs.gov/formspubs/index.html and Norway at www.skattedirektoratet@skatteetaten.no

C. Audit and Risk Planning

KNAB in 2005 received 2,000 allegations and reviewed 1,641 public officials from which 843 declarations were examined. Seventy percent (590) of the declarations examined were the result of general public allegations or filed complaints or against whom the CA had independent information. Thirty percent (253) of the declarations examined were based on random selection.

KNAB's examination staff consists of 34 examiners for both administrative and criminal investigations, which represents 27% of the total KNAB staff. The international average of enforcement to administration staff is 30%. While the staff assigned to enforcement appears to be properly staffed, it investigates of its own initiative only .003% of public officials' income and asset declarations, and 2% of officials subject to allegations and compliant, almost five times as many officials as are examined by a selective pre-determined risk, based process.

The use of resources investigating the validity of allegations, while a component part of enforcement, is a reactionary, uncontrolled response to corruption. It encourages omission of clandestine activities, which may never be reported, discovered or investigated. In order to achieve effective

investigation, there also need for an effective predetermined, organized long-term and annual plan of action to conduct targeted investigations. Reliance upon allegations to the exclusion of targeted investigations results in public officials, who have carefully screened themselves from public visibility and allegations, having very little probability of being discovered by the general public and having even less probability of being part of a systematic examination plan.

If KNAB is to continue expending five times more allocated hours to allegation investigations, than its examination staff should be increased by no less than an additional 34 examiners to perform exclusive risk-based pre-selected examinations. Both forms of investigations are needed for maximum deterrence and discovery. It is impossible to effectively have both forms of investigations under the current staff strength. In addition, I would recommend that the 64 member staff of the SRS Corruption Department receiving, filing and imputing Public Official Income and Asset Declarations be either made a part of KNAB for consistency and control of filing and processing the declarations and also serve as a support staff to KNAB examiners and investigators seeking financial information on public officials and their relatives. This function is time-consuming and requires assistance. If such transfer cannot be made from the SRS to KNAB, then at very least obtain a mandate that the department will serve as supporting staff to KNAB.

The International Anti Corruption Conference conducted by Transparency International, at www.transparency.org and the Government of Peru recognize that audit planning and identifying high-risk annual audits is an international best practice incorporated by both Tax Administrations and anti corruption bureaus. It is also a tool to be used by the KNAB to promote efficient public official declaration reviews with limited resources. The purpose of the plan is to allocate resources according to particular levels of vulnerability. The application of such a system requires consideration of those areas of government institutions and functions that historically hold the greatest potential for abuse. Priorities are established based upon previous audit findings and recommendations in addition to any information and complaints from the public.

Examples of areas of government, which as a rule are particularly vulnerable to corruption include:

- Collection of taxes and other sources of income;
- Procurement and contracts;
- Registers of licensing, permits and subsidies;
- Hiring and administration of personnel;
- Customs; and
- Privatization process.

The long-term audit plan would therefore focus upon these or other vulnerable government areas more particular to Latvia. The annual risk assessment plan should focus upon particular government positions within the audit plan and as stated previously, historical figures, previous findings and recommendations, and particular complaints. Finally, the annual risk base analysis should include database information.

Having selected the government areas of particular vulnerability and the names of officials with decision, making authority or greatest risk, a procedure for KNAB's full examination selection would include:

- Review all pre-selected public official income and asset declarations.
- If a discrepancy appears, examining the income declarations of the public official, spouse and dependents.
- If a public official's annual income and asset declaration included financial and asset information of a spouse and dependents, requesting the income declarations of a spouse or dependent may not be necessary prior to determining a discrepancy.

A risk based analysis system based on Government areas would produce at the very least the necessity to audit 20% of public officials or more based upon the number of decision, making officials in the pre-determined areas. KNAB neither has the resources, computer data system or time to audit 20% of the total public officials based upon a risk based, pre-determined selection of public officials in given areas of Government service.

KNAB to its credit has implemented a simplified compliance audit designed to audit public officials at random in a number that its current resources permit, which is one-third of 1% of public officials. It is apparent that one-third of 1% is not a deterrent. KNAB must increase its random selections, even if it is only 3% to 5% of the 68,000 public officials.

Until such time as KNAB can employ both a risk based analysis and random approach to examinations, its current random approach can be performed as follows:

- Selecting decision, making officials in one particular area of Government service.
- Selection of certain levels of positions spread over many areas of Government service.
- When Third Party Information Declarations are in place, selecting officials and family members who have had extraordinary purchases of property both domestic and foreign.
- More productive, however, at this time, would be the random selection of officials based upon a formal risk based analysis of selecting decision, making positions in Government areas more suitable to corruption as discussed above.

D. Penalties

The Government recognizes that the financial penalties imposed upon public officials for late or non-filing of asset and income declarations are not a sufficient deterrent. A working group is currently evaluating and recommending increases. Therefore, it is recommended the working group adopt a level of financial penalty that is sufficiently high to deter most officials and certainly lower level officials.

In the United States for example, the penalty for knowingly and willfully failing to file a public official declaration is $10,000, which is a substantial amount for low to mid-range officials. If the report is filed late without requesting and being granted a 30-day extension, there is imposed a filing fee of $ 200. In addition, failure to file can result in a reprimand; a 30 day suspension without pay; a temporary suspension up to 12 months without pay; or complete dismissal. Judicial review is unnecessary, unless the official appeals the decision of the administrative review board.

D. Investigator Manuals and Training

Both the CA and DI require formal manuals and regular training to encourage consistency of performance and results. The Head of CA must participate in and be aware of the KNAB’s annual risk assessment plan or

random compliance selection in-order to structure the CA activities and assignment of officials subject to examination.

The CA Unit provides ad hoc training, but should outline in detail the process of assigning and examining declarations for possible violations of the law to include a step-by-step approach. For example:

- Is the declaration complete, signed and timely filed;
- Has the information been compared with the records from the licensing and real estate registers and subsequently with Information Declarations;
- Has the information been compared with the prior year declaration;
- If there is a change, report the change to the Head of the Department;
- If necessary, cross check the information provided in the annual income declarations of the public official, spouse and relatives to determine fluctuations and report the changes to the Head of the Department;
- Has the examiner complied with the annual risk base assessment plan and selected the required declarations for verification;
- Has the examiner complied with the list of officials subject to allegations, complaints and independent information;
- Has the examiner opened a file and prepared a report of examination;
- And so on.

The DI has also has no formal manual or training session and relies upon ad hoc training. As a result, the DI requires a step-by-step approach addressing the procedures for investigating officials and the procedures necessary to determine if there is sufficient evidence of a violation to refer the case to the Prosecutor's Office. It must have regular training sessions addressing changes in laws affecting government officials as well as training sessions with other law enforcement agencies and the Prosecutor's Office. Attending NGO conferences is noteworthy, but does not replace or act as a substitute for a systematic in house internal control system. See ARD report or USAID/Nepal, Anti-Corruption and Investigation Trial Guide.

The Investigator's manual should include:

- List of persons to be examined;
- Documents to be reviewed to include bank records, annual income declarations, register information, information declarations, employment records, loan applications etc;
- Inventory of assets for potential seizure;
- Other information: credit card activity, foreign bank accounts, school fees for children, medical expenses, means of transportation, hired help salaries, brokerage or security firm accounts, and insurance risk valuation of property;
- List of available experts and other assistance from other government agencies.

The referral to the Prosecutor's Office manual should include the manner of determining:

- Seriousness of corruption;
- Legal decision-administrative or criminal;
- Review of past cases and outcome;
- Probability of victory;
- Availability of witnesses and documentary evidence;
- Possibility of initiating other action such as tax evasion instead of corruption;
- Official's degree of cooperation.

Throughout the investigation, at least on a weekly basis, the investigator should meet with the Head of the Department to discuss the manner and progress of the investigation and obtain assistance, if needed.

E. Publicity

KNAB should continue and heighten its active role in raising the awareness of the risks of fraud and corruption to foster good governance and standards of conduct. Reporting audit findings and any resultant legal action enhances fraud prevention. As a result, government officials and the public become aware of KNAB's effective internal controls and efficient detection system.

KNAB should continue assuring that the general public and the media they have freedom to receive and impart public information and in particular information on corruption matters in accordance with domestic law. This

should be done in a manner that would not compromise the operational effectiveness of the KNAB or, in any other way, be detrimental to the interest of governmental agencies and individuals, through:

- Establishment of public reporting requirements for justice and other Government agencies that include disclosure about efforts to promote integrity and accountability and combat corruption; and
- Implement measures providing for a meaningful public right of access to appropriate information.
- Cooperative relationships with civil society groups such as chambers of Commerce, professional associations, NGOs, labor unions, housing Associations, the media, and other organizations;
- Protection of whistleblowers; and
- Involvement of NGOs in monitoring public sector programs

CHAPTER V: Public Official's Income and Asset Declaration

1. Introduction

Contrary to International Best Practice and its Law, Latvia's current public official income and asset declaration requests no information regarding the financial and asset information of a spouse and dependents.

2. Current Situation

Section 2 of the Law states that the purpose of the law is "to ensure that the actions of public officials are in the public interest, <u>prevent the influence of a personal or financial interest of any public official, his or her relatives or counterparts</u> upon the actions of the public officials"

Section 1 (6) of the Law defines "relative" as meaning father, mother, grandmother, grandfather, child, grandchild, adoptee, adopter, brother, sister, half-sister, half-brother, spouse.

Section 9 (4) of the Law prohibits a public official from receiving any kind of financial benefit either directly <u>or through intermediation.</u>

Section 10 (1) addresses prohibitions of the official, as well as relatives from being shareholders or partners of commercial companies doing business with the State.

Section 12 of the Law addresses an official using his or office for the purpose of influencing other officials for the benefit of the official and his or her relatives.

Section 13 of the Law prohibits the official from receiving gifts, directly or indirectly.

Section 14 of the Law prohibits the official from receiving donations directly or through intermediation of other persons for the needs of the public official or the needs of his or her relatives.
Section 15 of the Law addresses various conflicts of interest if the official and his or her relatives have a financially beneficial interest in the outcome to include ownership or supervisory interest in commercial companies or as individual merchants.

Section 16 of the Law prohibits transfers or use of property by the official and his and her relatives for less than full consideration.

Section 21 of the Law requires public officials to provide information to a higher public official regarding financial interests, stockholding, partnership and supervisory interest in commercial companies or individual merchants for both him or herself and his or her relatives.

Section 24 of the Law specifies the contents of the information to be included in the public official's declaration of income and assets. Except for listing the names, addresses and personal code numbers of the official's relatives no requirement exists for the inclusion of relatives' income, properties and ownership interests in commercial companies or any other reference to the provisions of Sections 2 through 21 stated above regarding beneficial interests of both the public official and relatives.

The initial verification of a public official's filed declaration is, therefore, limited to the information the official declared concerning only him or herself. There is no indication provided on the declaration to judge whether a

relative's assets may have increased during the same time period the official's assets remained unchanged. Therefore, while a declaration may appear correct on its face, it is not a clear indication of the personal or financial interest of any public official, his or her relatives or counterparts, which is mandated in the purpose of the Law, Section 2. As a result, a verification of the declaration requires examiners and investigators to interview and demand documents from relatives to determine if their property interests, income and assets are from legitimate sources as opposed to nominee status or conflict of interests in behalf of or with the public official.

3. Discussion

The Government working group created to study natural person income control has recently gave its support to recommend all natural persons having to file asset declarations along with their annual income declarations and this requirement also applies to public officials. It is recommended that the general public asset declaration accompanying the annual income declarations of public officials, not be a substitute for a public official also having to continue filing an income and asset declaration pursuant the Law on the Prevention of Conflict of Interest. A general public asset declaration does not address the specific Chapter II restrictions of the Conflict of Interest Law and is totally inappropriate for KNAB's mission to investigate violations of those restrictions.

In many parts of the world, the argument is advanced that one of the key instruments for maintaining integrity in public service are income and asset declarations that indicate the assets and liabilities of all those in positions of influence as well as those of their immediate family members. See Bernard Pulle, Conflicts of Interest Avoidance: Is There a Role for Blind Trusts? In Current Issues Brief 14, 1996-97, http://www.aph.gov.au/library/pubs/CIB/1996-97/97cib14.htm.

The question posed is whether declarations are an instrument for maintaining public official integrity. In a vibrant democracy such as the United States, income and asset declarations work because of third party enforcement. In elections, opposing candidates, for example, will scrutinize each other's declaration and make it an issue if an opponent seems to be living beyond his or her means.

According to a Best Practice Report in Combating Corruption issued by the OSCE, www.osce.org/item/13568.html having accepted the argument in favor of declarations, several questions follow: to whom should disclosure be made? What matters should be included? How broadly should disclosure requirements apply to members of an official's family? What access should the media and members of the public have to these declarations? And, in the case of career public servants, what levels of seniority must be required to submit to this process.

Filing procedures of Public Official Financial Declarations vary from Country to Country. In some countries such as France and Peru, the declarations are filed direct with the Corruption Bureau; in others, such as the United States and Slovakia declarations are filed with department heads to verify completeness of information and signature.
In Norway there is no independent Corruption Agency or public official declaration except for an annual income declaration, which is filed with the Tax Administration.

In the United States the department heads forward the verified declarations to the Office of Government Ethics. In Slovakia the declarations are not forwarded and remain with the Department Head. In Latvia the declarations are sent to the State Revenue Service, which verifies completeness and signature before imputing the data into its computer base. The declarations are not forwarded to the KNAB, unless specifically requested, instead the declarations are forwarded to the SRS Control and Analysis Department. If the official is included in the SRS Audit Division's risk based analysis, the declaration is forwarded for auditing. SRS included 167 officials in its 2005 risk based analysis, audited none, asked for additional information from 153 officials, only 11 responded.

Since procedure is determined by capabilities, the process in Latvia currently serves its best interest, since KNAB does not have the computer database to impute declaration information. However, it is recommended that at some point in time the 64 member staff of the SRS Corruption Department be transferred to the KNAB. In so doing, coordinated investigations and consistent supervised control over the verification processes can be implemented, and the examination risk based analysis would be enhanced.

The 64 member staff would still impute information into the SRS database and retain records at the SRS for tax audit purposes.

Regarding who should file the declaration, countries vary, for example: Turkey, Brazil and the Philippines require all public officials to file and Albania, India, Kenya, Korea, Slovakia, France and the United States limit the filing to persons above a certain salary or authority level. Germany requires no public official declarations. In Norway every individual is obliged to declare his/her own income.

According to the OSCE study previously referred to, it is usually neither necessary nor practicable to subject every member of the public service to a disclosure process; normally, such a process applies only to officials at or above a fixed level of seniority or those in certain positions. In both cases, the purpose is to target public servants whose positions place them in a position with sufficient potential for illicit enrichment. Examples commonly include:

- Those who are responsible for Government expenditures and the allocation of contracts or other benefits;
- Those who have discretion in dealing with public funds or assets;
- Those whose positions entail access to valuable confidential information or information that can be used to gain wealth or advantage outside Government;
- Those whose decisions carry economic impact on others; and
- Those responsible for audit and watchdog functions in such areas.

In the United States the declaration of assets is required of each officer or employee in the executive branch, including a special Government employee as defined in section 202 of title 18, United States Code, who occupies a position classified above GS-15 of the General Schedule or, in the case of positions not under the General Schedule, for which the rate of basic pay is equal to or greater than 120 percent of the minimum rate of basic pay payable for GS-15 of the General Schedule. It is applicable to each member of a uniformed service whose pay grade is at or in excess of O-7 under section 201 of title 37, United States Code; and each officer or employee in any other position determined by the Director of the Office of Government Ethics to be of equal classification; each employee appointed pursuant to section 3105 of title 5, United States Code; any employee not described in

paragraph (3) who is in a position in the executive branch which is excepted from the competitive service by reason of being of a confidential or policymaking character, except that the Director of the Office of Government Ethics may, by regulation, exclude from the application of this paragraph any individual, or group of individuals, who are in such positions, but only in cases in which the Director determines such exclusion would not affect adversely the integrity of the Government or the public's confidence in the integrity of the Government; the Postmaster General, the Deputy Postmaster General, each Governor of the Board of Governors of the United States Postal Service and each officer or employee of the United States Postal Service or Postal Rate Commission who occupies a position for which the rate of basic pay is equal to or greater than 120 percent of the minimum rate of basic pay payable for GS-15 of the General Schedule; the Director of the Office of Government Ethics and each designated agency ethics official; any civilian employee not described in paragraph (3), employed in the Executive Office of the President (other than a special government who holds a commission of appointment from the President; an officer or employee of the Congress as defined under section 109(13); (11) a judicial officer as defined under section 109(10); and a judicial employee as defined under section 109(8).

In Slovakia, declaration filing is limited to parliament, members of the Government, judges, prosecutors and police.

In Latvia, Section 23 of the Law mandates all public officials as defined in Section 4 of the Law to file disclosure statements with the State Revenue Service, except for certain officials who file direct with KNAB. Discussions regarding the necessity of all 68,000 government employees needing to file declaration were conducted. The concern being the administrative capability of verifying and examining each declaration and the time needed for such verification. Thus far, KNAB is satisfied with the current system, since disclosure by all is in the best interest of the public and affords the public a transparent opportunity to assess corruption.

The remaining issue is the content of the Income and Asset Declaration. In Latvia, despite Chapter II of the Law regarding restrictions and prohibitions with respect to public officials and the mandated information required of a public official and his or her relatives, the Declaration is limited to the transactions, assets and liabilities of only the public official. Aside from a

listing of relatives, no questions are focused upon the financial information of a spouse and dependents. The OSCE study indicates that it would not be unusual for a corrupt official to use the extended family as a conduit to receive ill-gotten gains. The Latvian form, however, being thus limited to the public official's information provides no face value information of corruption without the necessity of interviewing and gathering third party information about spouses, dependents and relatives. A rather time consuming procedure, considering there are only 17 examiners in the KNAB.

The role of the wife in corruption of public officers was highlighted at the Second Annual Conference of the Transparency International in Accra, when renowned human rights and anti-corruption campaigner, Akoto Ampaw, came to the dispatch box and invited authorities to include spouses and children in the declaration. He thought it was an "astonishing contradiction in Ghana's efforts at combating corruption in political office and public life" that spouses were never made to be part of the accountability process.

Best international practice suggests the inclusion of a public official's spouse and dependents into the declaration. Privacy is of course an issue. However, in all countries there is a separation of information into public and confidential sections of the declaration. The interests of family members are disclosed, but in confidence. The argument for this approach is that members of a public official's family have a right to privacy, and it should be sufficient for the disclosure to be made on the record, but not on the public record.

Exhibits D and E are the forms of Declarations for both the United States and Kingdom of Bhutan; each such disclosure requires spouse and dependent information. The United States form is rather complicated, but is attached to indicate contents and subject matter and its process of income and value ranges as opposed to specific amounts. The Bhutan form is attached, since it is similar to the Latvian form in contents and simplicity, but it includes information concerning a spouse and dependents and provides additional questions regarding dates when assets were acquired and the source of funds, which is strategic information in determining the legality of increased wealth.

Exhibit F is a proposed amended form of the Latvian Declaration statement incorporating information regarding spouse and dependants and financial information similar to the Bhutan form. As previously stated, International Best Practice, and all transparency organizations would suggest that Latvia's declaration form include spouse and dependent information. The additional columns regarding asset acquisition and source of funds are included to provide a more accurate examination of a public official's life style without having to conduct personal interviews and seek third party information regarding relatives or having to visit the public officials home, all of which is time consuming by the limited resources of KNAB.

4. Recommendations

1. KNAB should consider whether it is economically feasible to require all public officials to file Asset and Income Declarations or limit such filings to pre-determined levels of salary or authority.

2. KNAB should amend its Declaration Form to include request for information of a public officials spouse and dependents.

CHAPTER VI: Income Control of General Public

A. Introduction

Latvia appointed a working group of several representatives from the Minister of Finance, KNAB, the State Revenue Service and others. This group is to study varied options for general public income control. Their findings and recommendations will be presented to the Council of Ministers.

B. Current Situation

Latvia operates under a taxpayer self-assessment system of preparing and filing annual income declarations. However, the effectiveness of the pre-recording, recording and post-recording process is in doubt. Many taxpayers do not file returns, despite earning income, delinquency rates are high and collection rates poor. As a result, unpaid and delinquent taxes are at an all time high, approximately 600,000,000 lats in 2005, representing almost one-third of total tax collected revenue. Comment by SRS: in 2005 tax income was 2 657 069 500 LVL. Accumulated tax debt in 2005 was 364 800 00

LVL which is 13, 7 % from total tax income and not 1/3 as mentioned in the report.

The working group discussed the implementation of annual asset declarations to be filed with annual income declarations. The purpose is to determine the status of national wealth and in particular to serve as a starting point for the calculation of individual wealth, which can be used by the State Revenue Service and KNAB to determine unclaimed wealth.

The options regarding filing asset declarations have ranged from a zero bracket requiring all to file, mid-range basket affecting some of the general public and high-end bracket affecting the wealthier members of the general public. A decision has recently been made requiring all natural persons to file asset declarations with their annual income declarations. The working group had also considered a system of pre-populated returns, wherein the State Revenue Service prepares and submits annual income declarations to the general public for confirmation or adjustment.

C. Discussion

1. Annual Asset Declarations

Available research indicates no country requires the sole declaration of assets by the general public to be attached to annual income declarations. However, some countries do require a net worth declaration (assets less liabilities) and from the results of such a declaration levy a wealth tax as a percentage of net worth exceeding a certain threshold. In the European Union, only France, Spain, Greece, Luxembourg, Switzerland and Sweden impose a wealth tax at a low rate above a certain threshold. Countries which have had wealth taxes and abandoned such tax in the past five years are Austria, Denmark, Netherlands, Germany and recently Finland. Countries which have never had a wealth tax are Norway, Belgium and Great Britain.

In the United States there has never been a requirement to file individual balance sheets to an annual income declaration.

Whether the countries listed above have or do not have a requirement for filing an annual balance sheet or net worth statement, common to all such countries is a compliance information system consisting of third party

information declarations. These countries all know that taxpayer prepared Asset or Balance Sheet Declarations and annual income declarations must be viewed from the perspective that taxpayers may fail to accurately provide information. As a result, a verification process must be in place prior to or in conjunction with the asset or balance sheet recommended declaration system.

In the United States and other countries having no asset or balance sheet declarations, third party information systems are used to verify annual income declarations. In Norway, for example, Elisabeth A. Landmark, the head of the legal and auditing department in a June 14, 2006 in written response to a letter from KNAB on May 23, 2006, stated:

"In Norway there is an extensive obligation for, e.g., employers, banks, insurance companies, investment funds and stock companies to report income etc. to the tax authorities on a yearly basis. The taxpayer always receives the same information. The Norwegian system is based on the reporting of assets and income of the tax payers to the tax authorities from third parties like employers, banks, insurance companies, investment funds and stock companies."

Whether Latvia adopts an asset declaration or a no tax net worth declaration system it is not the issue, due to its high rate of unfilled annual income declarations and its high rate of uncollected taxes and revenue loss, it should follow the lead of the other EU countries and the United States and adopt an information compliance system.

A sample draft of a Third Party Information Law is attached, which can also serve as the basis for amendments to the Direct Personal Income and Enterprise Income Tax Laws or the Law on Taxes and Fees or become the basis for a regulation to the Law on Taxes and Fees (Exhibit B). Types of third party information declarations is attached as Exhibit C, further samples can be found in the web site of Sweden, www.skatteverket.se or for the United States at www.irs.gov/formspubs/index.html. Exhibit C lists the types of declarations used in United States and Sweden, which may serve as a basis for customizing additional third party information declarations to the draft law. Further regarding types and usage, Denmark has 20 types and Spain has 29 types of information declarations. Those information

declarations reporting transactions to which a withholding of tax applies, would list total income and amount paid to the SRS.

Third parties are required to file annual information declarations reporting on income, asset and expense with the Tax Administration usually 60 days prior to the date for filing annual income declaration. In some cases, third party information declarations are filed during the year as transactions take place. Through the process of matching the information on these third party information declarations with the taxpayer's self-assessed information on the annual income declaration the Tax Administration is able to determine whether a taxpayer receiving income has filed an annual income declaration or if filed, whether the self-assessed information has been accurately reported to the Tax Administration. As a result, an assessment of tax is possible without the need for a lengthy, formal audit. Most important, however, is that collection and enforcement procedure follows assessment. The faster a tax is assessed, the faster it can be collected.

According to the 2001 Tax Conference conducted by the Asian Development Bank, "…information reporting systems appear to operate as a most effective stimulant for voluntary compliance. Research reveals income that has been reported on information returns is much more likely to be declared by taxpayers. In many ways information reporting is much more effective than audits in disclosing unreported income. Most of the income that is disclosed by matching information returns with tax returns would not be discovered on an audit. Given the cost-effectiveness of information reporting and matching program, there would appear to be almost no limit to its use". http://www.adb.org/Documents/Events/2001/Tax_Conference/tax2001.asp, Article by Niel Brooks.

The preparation of a third party information declaration is not a burden for financial institutions, legal persons, and professionals such as accountants, lawyers and notaries, especially if electronic filing is permitted. However, it would be an imposition upon natural persons, but the circumstances for natural person filing is limited. Another consideration is the privacy of such information declarations. By its very nature, it is system that reports most of an individual's annual transactions. Therefore, taxpayers must be assured that the information obtained and on file with the Tax Administration will only be used as a verification tool to confirm the accuracy of annual income

declarations and other government based information reporting requirements, such as information relevant to KNAB or the Office of the Laundering of the Proceeds from Crime.

In order to use information declarations as a verification tool, the Tax Administration must have a database of all taxpayer identification codes, information returns must be accurately completed and timely filed, a cross checking system must be in place (usually computer based analysis) and an effective method of handling discrepancies between the information declaration and annual income declaration. Unlike the present SRS system relying exclusively upon taxpayer interviews and field audit investigations, the information reporting system provides an accurate system of attaining tax information through an office assessment without the necessity for field audits.

2. Government Pre-Calculated Annual Income Declarations

If a Tax Administration had the appropriate computer system and if all third parties timely filed information declarations, the Tax Administration is in a position to calculate annual income declarations in behalf of taxpayers.

According to a survey conducted by OECD dated March 2006, "pre-populated returns" have been developed in Denmark, Estonia, Finland, Iceland, Norway, Sweden, Singapore, Australia, France (in a test district), Chile and Spain.

The OECD study confirmed that all of the countries preparing pre-populated returns have comprehensive systems requiring third parties to report income, asset and expense related information. That all these countries have made considerable progress in establishing comprehensive electronic reporting arrangements with third parties. The OECD study also confirmed the conclusion of the Asian Development Bank study, wherein it confirmed "the process of capturing and matching large volumes of third party income reports with tax records have been highly effective in detecting unreported income and resulted in the collection of substantial amounts of additional tax revenue". www.oecd.org/dataoecd/42/14/36280368.pdf

The purpose of a pre-populated return is to reduce the burden of taxpayers having to file annual income declarations. In terms of pre-populated return benefits, the OECD report indicates:

- Reduced compliance burden for taxpayers.
- Greater certainty for taxpayers that all income and expenses are reported and claimed on the income declaration.
- Improved imagine for the revenue service resulting from a more personalized service to the taxpayer.
- Faster processing of income declarations.
- Quicker refunds.
- Elimination of much of the work associated with raising amended assessments resulting from taxpayer errors and traditional post-recording verification processes.

The initial procedure in each country was to have taxpayers confirm the information on the pre-populated return or advice of any adjustments. In more recent years, a number of countries have taken the approach that no response means confirmation and acceptance of the accuracy and completeness of information. Taxpayers in all countries, except Finland, permit confirmation or advice regarding adjustments electronically either by telephone or Internet.

In terms of cost, the following factors must be considered:

- Revenue Bodies have typically 6 to 10 weeks to complete processing of third party information reports in order to timely prepare and issue pre-populated returns. Therefore, substantial information processing systems are required.
- Automated systems to receive taxpayers' responses to the pre-populated returns to include SMS, telephones and Internet.
- Provisions for the communication to the taxpayer of adjustments by the Internet.
- Evaluating whether a risk associated with revealing to taxpayers all known information may encourage some taxpayers to not disclose other income not revealed in the pre-populated return.

The OECD reports that those countries implementing the pre-populated return system have made considerable progress and are deriving benefits

from the system to include a reduction in taxpayer compliance burdens, reduction in administrative costs due to efficient data processing, reduced taxpayer errors resulting from self-assessment, and reduced post recording verification.

The implementation of pre-populated returns requires a considerable administrative effort. In particular the report notes the following of particular importance:

- Comprehensive third party information system to timely report income, asset and expense information.
- A capacity for third party information to be accurately and rapidly reported to a revenue body using a system of taxpayer identification codes with taxpayer records.
- A capability of quickly dealing with taxpayer adjustments, which involves optimal use of technology by third parties, the revenue authority and taxpayers.
- A simple legislative Direct tax framework limiting the amount of adjustment action required of taxpayers.

D. Recommendations

1. A decision to adopt an asset declaration, net worth declaration or pre-populated return system is a political decision. All of the systems have positive and negative factors to include administrative costs and general population reaction and considerations. Therefore, no recommendation is intended.

2. Regardless of what decision is made, it is recommend that an information compliance system be adopted through the implementation of third party information declarations to determine persons who should have filed annual income declarations, but did not, to determine the accuracy of information on the annual income declarations, and as an aid to both the collection and audit functions of the State Revenue Service and KNAB.

Third party information declarations need not be implemented all in the same year, there is a cost attached to this system, which may not be within the current SRS budget. But Latvia should remember that the effectiveness of such a system increases tax revenue flow, which more than offsets the

implementation costs. **Currently, Latvia's tax revenue flow is at the mercy of the taxpayer through tax avoidance, failure to file or register as a taxpayer with no system to detect non-filers and inaccurate reporting of income.** As a result, it is suggested that third party information declarations be phased in with income information declarations being the first to be implemented i.e., interest, dividends, pension, gains from sale of stock and property; in the second phase those declarations that are required to be submitted by institutions and legal persons; and in the final stage all other forms of declarations. SRS comment: we are kindly asking to delete the part in bold.

There are developed and implemented effective information systems at SRS (NIS data storage, ASIS, SESAM, and VAT Expert) which help to disclose cases of unpaid taxes.

3. The First phase of implementing income information reporting coupled with the existing register reporting of movable and immovable property will not only increases tax revenue flow, it is also a key tool for detecting illegal income and preventing its conversion into legally obtained income status. Legal income is subject to third party information reporting whereas illegal income will not be so reported. Therefore, increases to wealth or life style not confirmed by third party income information declarations are indications of illicit enrichment triggering an immediate investigation.

4. Another benefit to the first phase of the information declarations concentrating on income is its function as an indirect method for recording individuals into the SRS database. While individuals have personal identification numbers, they are not necessarily included in the SRS database as taxpayers. SRS reports that individuals are included when they file annual income declarations or licensing and real estate registers report an individual's transaction activity. Since third parties will be mandated to issue information declarations requiring individual identification numbers, the information system will effectively register all individuals.

CHAPTER VII: State Revenue Service

A. Introduction

Pursuant to the Law on Taxes and Fees, the State Revenue Service (SRS) is mandated with the responsibility of enforcing taxation laws and collecting taxes. However, based upon the minimal authority of tax collectors to collect pre-audit tax arrears and the minimal number of audit staff and annual audits performed, there is little deterrence impact on tax avoidance, tax evasion and corruption.

B. Current Situation

The SRS employs approximately 5,148 personnel as of 2004.

The collection division in 2004 consists of 200 personnel. The collection agents are divided among five regions, approximately 15 to 20 agents per regions. The Riga region has approximately 40 to 50 collection agents. There are approximately 130,000 legal persons registered in Latvia, approximately 2,000 per Region.
The audit division in 2004 consists of approximately 300 auditors. The audit department conducted approximately 1,887 audits in 2004, 1,525 audits of legal persons and 362 audits of individuals.

Taxes collected in million lats (LVL):

Year	Personal	Enterprise	Total
2003	367	93	1,823
2004	435	127	2,111

While the collection of taxes indicates a moderate gain between 2003 and 2004, there was approximately 333 million LVL of uncollected taxes in 2003, representing almost a 20% uncollected ration and **approximately 600 million LVL total uncollected taxes through 2005, which indicates that 30% of taxpayers have either failed to file or failed to pay taxes.** SRS comment: in 2005 tax income was 2 657 069 500 LVL. Accumulated tax debt in 2005 was 64800000 LVL. We are kindly asking to delete part of sentence starting with “which indicates”.
The filing date for annual income declarations is April 1, there is no electronic filing, and as a result a taxpayer must either mail or deliver the declaration to the SRS regional office of their residency. SRS comment: as from July 2001 there is an electronic declaration system at SRS. 96 % of all the documents are submitted electronically by using this system, including

annual income tax declaration of population and declaration of public official.
Registration of individuals consists of assigning each resident a personal code at birth. However, the personal code does not serve as a taxpayer identification number imputed into the SRS data base until such time as the individual files an annual income declaration or has income from employment or transactions requiring registration such as licensing or purchase of real estate are reported to the SRS. As a result, there exit many non-filers of individual income declarations not included in the SRS database because they purchased assets through nominees or earn non-employment income. Since Latvia has no third party information declaration system, the SRS has limited independent means to discover non-filers.

Registration of legal persons is conducted at the Registration Bureau, a required necessity to do business in Latvia. The Registration Bureau issues a registration number and reports the number to the SRS, which becomes the legal person's taxpayer identification number and imputed into the SRS database. As a result, the problem of non-registered, non-filers to which individuals are prone, does not exit among legal persons.

C. Discussion

Due to the large percentage of tax delinquency and unrecorded individual taxpayers, concern must focus upon the SRS procedures regarding pre-recording, recording and post recording.

Recommendations herein are based upon the following reports: United States Internal Revenue Manual; Law of Tax Administration and Procedure by Victor Thuronyl, IMF Publications; Designing a Tax Administration Reform Strategy, 1997 IMF Working Paper; and Challenges of Tax Administration and Compliance, Asian Development Bank, 2001 Tax Conference.

Prior to such discussion, however, certain benchmark indicators from an article by Mark Gallagher, published on line at www.interscience.wiley.com are note mentioning:

1. <u>Administrative cost of taxation</u>

This is a rather gross indicator of efficiency and it covers a number of differences in tax administration, economic structure and overall societal modernity. Yet, it also goes directly to the heart of the matter. How much does it cost, in administrative terms, for a government to impose taxation on its people? Internationally, the administrative costs vary widely with the richest countries generally having the lowest costs with respect to how much they collect, whereas the poorest countries have the highest costs. However, there is a considerable variance among countries of similar development levels. The **SRS ratio for 2004 is calculated in US Dollars: total taxes collected ($4,222,000/$100 divided by the number of SRS employees (5,148). In Latvia's SRS case the administrative cost of collection is $8.16 (4LV) per $100 (50LV) collected. Since the analysis is conducted in US Dollars, the administrative cost of Latvia's $8.16 is substantially higher when compared with developed countries: Spain 90 cents, UK 1.47, Canada 1.18 and US 83 cents, and the developing country of Armenia (like Latvia formerly of the Soviet Union) 1.23.** SRS comment: in 2004 tax income was 2 111 121 500 LVL thus it is rather doubtful that figure $4,222,000 in the report is correct. Currency exchange rate – 5002, 7 USD/LVL. We claim the calculation being incorrect and misleading and not to be compared with other countries. We are kindly asking to delete the text in bold.

2. **Auditors and Collection Agents as percent of administrative staff**

Obviously, the entire professional staff of the tax administration cannot be dedicated to collection and audit. Staffs are needed for recording and information technology, legal analysis and other administrative processes. However, an appropriate portion of the staff should be dedicated to collection and audit. The international benchmark indicates that about 30% of a tax administrative staff should be dedicated to audit and collection. In Latvia's case the audit staff ratio is 5% and the collection agent staff ratio is 3% for a total of 8%. As a result, the SRS should consider the substantial need for a redeployment of current employees into the enforcement process of the SRS based upon professional ability and training. The SRS would need to shift 1,000 employees to accomplish a total of 1,500 collection and audit officers to be among the international average of 30%. SRS comment: as per 1 January 2006 there were 5354 persons employed by SRS, from which 1332 are working in tax collection and 747 employees are involved in audit, which is 25 % and 14 % respectively (together 39 %) from all SRS employees.

3. Per-cent of taxpayers subject to annual audit

Too much auditing implies inefficiency and harassment. Too little calls into question the enforcement efforts of the tax administration. In developed countries about 1% of taxpayers are subject to audits in any given year. In Latvia's case assuming 1 million natural person taxpayers the audit ratio is .0001%. The audit of legal persons was at the 1% average level. Total audits of both natural and legal persons produces a percentage of .0016%, which is substantially below international average. The need to shift employees into the audit division is crucial. SRS comment: according to operational data of SRS 704 audits of physical persons were completed (0, 03 % from all physical persons) and 1214 audits of legal persons (0, 9 % from all legal persons). The purpose to audit 1 % of persons applies only to natural persons. There is no worldwide practice of auditing at least 1 % of physical persons.

4. Personal income tax productivity measure

The personal income tax is an important aspect of most tax systems throughout the world, but in most developing countries it is usually a very minor revenue source. This stems from a variety of factors, including: low compliance, high degree of exemptions and exonerations, and usually large, unreachable sectors of the economy, such as the urban informal sector and smallholder agriculture.

The nature of the personal income tax is different from place to place. The treatment of capital gains, corporate dividend income and the levels and types of tax deductions and credits that are available differ from Region to Region and Country to Country. Despite these difficulties, the personal income tax productivity measure revenue productivity of the personal income tax across a number of countries. The Personal Income Tax Productivity Measure is similar to the Enterprise Tax Productivity Measure. It is calculated by dividing the personal income tax revenue as percent of GDP by the top marginal tax rate. Applying this to Latvia's GDP in 2004, individual tax revenue and a flat 25% tax rate produces a productivity percentage of .9. Mr. Gallagher's, study among eleven South American countries indicates five received high percentages ranging from 1.2 to 1.9 and six received low percentages from .3 to .6. Latvia is below these better countries, and only slightly above the others. Again, the number of collection and audit division employees must be increased as further

evidenced by only having audited 362 natural persons out of a natural person tax base of approximately 1 million taxpayers.

5. Enterprise Income Tax Productivity

The productivity ratio of the Enterprise Income Tax is calculated in the same way as the Personal Income Tax productivity. The percentage based upon 130,000 legal person taxpayers in 2004 is thus calculated as 1.3. Using the same comparison with the same eleven South American countries, Latvia performs better, having a ratio falling between the eleven countries. Since Latvia has revoked many of the tax rebate provisions of the Enterprise Tax Law, the ratio in 2006 should increase.

6. Tax ratio

This indicator predates any efforts at establishing the benchmarking system. It is the ratio of total actual tax collections to Gross Domestic Product (GDP). Generally, the higher the per capita income in a country, the higher is the expected tax ratio. Indeed, the tax ratio for high-income countries is about 40%, according to Government Finance Statistics of the International Monetary Fund. For middle-income countries it is around 25% of GDP and about 18% in low-income countries. In Latvia total taxes collected in 2004, 562 million LV, GDP1.9 billion LV for a tax ratio of 29%.

7. Number of tax administrators per 1,000 of the national population

This is merely an indicator of the size of the tax administration and its extension into the overall population. The international benchmark, or norm, is about one tax administrator per a population of 1,000. In the UK it is 2.36, Belgium 1.98, Germany 2.10, France 1.79, USA .92, Bosnia .82, Armenia .53, while in Latvia the ratio is 2.1. This means that despite having a substantial number of staff, its collection of taxes ratio is below average, therefore, there is improper deployment of staff.

8. Findings

The above benchmarks indicate: The SRS staff is above the international average number of staff per taxpayer, the cost of administration exceeds the international average but the efficiency of natural person tax collections is substantially below developing South American countries and only slightly

above the lowest developing country averages and only average in legal person tax collections. Reason: The amount of audits and the number of collection and audit officers in relation to the total SRS staff are substantially below the International average. The SRS needs to shift at least 1,000 of its resources from administrative functions into the collection and audit functions in order to increase its tax collection efficiency, which would also reduce its administrative cost ratio.

1. Organization of Tax Administration

Since there has been no formal examination of the SRS organizational procedure, the following information generally indicates international best practice recommendations on the structural form of Tax Administration organizations to maximize efficient collection and enforcement procedure.

- Categorize taxpayers into as many segments as feasible. By grouping taxpayers within segments, the SRS practices can be specifically tailored to meet that segments unique needs. This produces greater standardization of work. This system is used in Hungary and the United States.
- Organize staff principally by functional groupings related to taxpayer segments to assist taxpayers. Hungary and United States.
- Delegate decision authority to the lowest, appropriate functional level. This develops employee trust and increases employee responsibility making them the center of the organizational structure. Slovenia and the United States.
- Create detailed job descriptions, which provide employees with well-defined missions. As a result, the SRS develops a culture that is outcome oriented and mission driven. International Best Practice.
- Form a balanced measuring system emphasizing the SRS mission by balancing priorities, evaluation of taxpayer and employee levels of satisfaction, and motivates performance. United States.
- Create a performance management system linking organizational goals to employee performance appraisals. Slovenia and United States.

2. Pre-Recording

Strong customer orientation promotes compliance and makes it easy for the taxpayer. In return, this strategy reduces tax administration costs associated

with servicing each taxpayer. Pre-recording programs use multiple methods to inform and service taxpayers:

Registration: Receive applications, conduct basic review, and coordinate issuance of taxpayer identification numbers (TIN);

Taxpayer Education: Provide information, develop guidance, and conduct outreach for taxpayers to clarify areas of tax law;

Taxpayer Pre-filing Advice: Identify case-specific issues and provide guidance to taxpayers on how to address these issues;

Taxpayer Relationship Management: Answer inquiries from taxpayers via phone, mail, e-mail, or in person and refer them to the appropriate department for resolution; notify taxpayer if problems arise with tax returns.

Research in international tax administration and compliance reveals that pre-recording programs increase compliance by providing taxpayers with the information and tools they need to meet their tax obligations. This approach increases compliance rates and reduces downstream compliance issues and associated costs. Education of the public on how to meet their tax obligation helps to avoid many downstream recording and compliance issues.

Latvia utilizes to some extent taxpayer education programs by Internet, publications, pamphlets, media announcements, and assistance programs. These programs are accentuated during the filing season but should be an on-going annual systemized program.
Registration of natural persons is a main concern. Latvia fails to impute an individual's personal code into its database until such time as a natural person initially files an annual income declaration, or initially receives income from employment, or initially is included in either the licensing or real estate register for having conducted a transaction.

Latvia incorporates a population register and issues a personal code number for each individual. This registration provides current information on the people who live in Latvia intended to meet basic information needs such as identity, address and family relationships. Sweden is similar to Latvia in its registration of individuals. However, the population registration is a function of the Tax Authority. Each region of Sweden, as does Latvia, contains a

regional tax office, which serves as the local population registration authority. The Swedish personal identity number is not only used for population basic information needs, it is also used for administrative purposes such as taxpayer identification number. Therefore, unlike Latvia, Sweden has a current record of all individuals and all taxpayers without relying upon external factors such as filing an income declaration or receiving information from a register to determine the taxpayer status of an individual. See www.skatteverket.se.

The United States has a similar procedure to Sweden, except that it assigns social security numbers to individuals and such numbers are immediately imputed into the Internal Revenue Service computer database and serves as the taxpayer identification number.

Under both the Swedish and American systems, all individuals in the country are considered taxpayers from birth and included as such in its database, unless proven otherwise. In Latvia, however, it is the opposite, all individuals are born non-taxpayers, unless proven they made income and are imputed into its database.

3. Recording

In Latvia, income declarations are filed by mail or delivery into one of the five SRS Regional Offices serving as the individual's residents or legal person's principal place of business. If a taxpayer moves to another region, then the taxpayer must notify the new region. The hard copy of the income declaration and all data therefore is imputed into the Regional Office's computer base. Other regions and the Headquarter Office have computer access into the regional computer base to retrieve data or hard copies of documents.

Best international practices for the recording process are generally referred to as Submission Processing. Basic concepts that are planned, controlled and conducted in submission processing recommended for Latvia include:

- Centralized processing location-the fewer office locations involved in this function, allows for greater consistency in the process.
- Non Filer and Stop Filer Program management- cross match programs against master taxpayer data base identification numbers to determine if declarations have been filed or if so, whether timely filed.

Another reason Latvia must input every personal code into its taxpayer data base.

- Information reporting program management (IRP) - third party information declarations was discussed in Chapter VII. This system allows the SRS to run an annual cross match of these information declarations against the filed income declarations. Discrepancies will be address either through correspondence audit, office audit or field audit.
- As in the United States and Hungary, make available all tax forms for downloading from the Internet.
- Develop an automated declaration e-filing system to reduce manual processing and taxpayers having to mail or deliver the declarations to the SRS. In Sweden, filing can be done by e-filing, phone or text message, hard copies are scanned into their computer.
- Determine if taxpayers who did not file are active taxpayers. If so, collect taxes and penalties. If not, omit such taxpayers from the active taxpayer list.
- Create taxpayer segments as discussed in the organization section. This enables the SRS to create standard subcategories within the segments of taxpayers to further identify industry and other sectors of information (See the International Standard Industrial Classification of all Economic Activities). This classification standard enhances compliance analysis in support of risk based audit selection criteria as company activities are compared to similar companies within the same classification code.

4. Post Recording

a. Tax Collection Process

The Collection Department exists at Regional levels. The Regional level performs all functions of collection to include audit and appeals.

Collection agents do not visit taxpayers. The collection agent, instead, sends an administrative notification to taxpayers that they either did not file their annual declaration or there is a discrepancy in income reported. The amount of discrepancy is based on limited information reporting by Banks and registers. The taxpayer is afforded the right to file a declaration or amend the filed declaration. The collection department is not involved in the event there is no response from the taxpayer, the agent, instead of pursuing the matter, submits a report to the Control and Analysis Department of the SRS.

An assessment of tax for collection purposes must be determined by the Audit division.

If the taxpayer responds to the collection agent's notification, the collection agent has a meeting to discuss the matter, prepare a declaration or amend a declaration. If an installment agreement to pay the tax is needed, the agent can negotiate the terms of settlement subject to approval of the Regional Director.

The fine for not submitting an income declaration is 15 LV ($30), but there is no fine if a person submits a declaration with inaccurate information.

Sections 26(1) and 27 of the Law on Taxes provide for jeopardy assessment in those cases the SRS determines the property of a taxpayer may be sold or destroyed or the taxpayer may flee. The determination process is based upon first having information that a taxpayer is disposing property prior to seizing the remaining property with the hope that the taxpayer has not disposed of all assets prior to the jeopardy assessment being approved.

As in all countries, collection of tax commences after taxes are assessed. In the United States, and other developed countries, assessment of a tax is merely the recording of the tax liability of the taxpayer. Assessment is accomplished by a designated assessment officer recording the taxpayer's name, taxpayer ID number, tax period, and nature of tax. The date that information is recorded is the date from which a notice to the taxpayer is sent and the statute of limitation for collection begins. The United States has 60 days from the date of assessment to notify the taxpayer of the assessment and demand payment and it has 10 years from the date of the assessment in which to collect the tax.

Governments in Modernized tax administration systems have third party information declarations therefore, assessments are easily, accurately and timely produced after the filing deadline, usually 6 to 8 weeks. In Latvia, since there are no third party information declarations, except for bank and register information, assessment requires an audit, taxpayer interviews and in some cases field audits, which are time consuming, limits the volume of audits based on risk based analysis and perhaps impractical due to volume. In the meantime, the collection officer is unable to collect the tax unless there is a full audit assessment or the taxpayer agrees to pay whatever

amount is assessed through the SRS limited access to third party information.

Since assessment requires no formal audit in modernized tax administrations, unless requested by the taxpayer or the taxpayer disagrees with the assessment, audit agents have more time to expand risk based analysis targets and collection officials are given responsibility for a wider range of collection activities, giving them full responsibility for resolution of the delinquency (tax arrears or late filing/non-filing of an income declaration). This arrangement includes granting collection officials some degree of administrative enforcement authority, which must be used judiciously. There is recognition of the potential for abuse of power if too much authority is granted to tax administration officials. However, those concerns must be balanced with the needs of the state to effectively and efficiently collect the revenues needed for state operations. This structure also includes granting collection officials' authority to enter into installment agreements and other arrangements to provide for satisfaction of the tax debt.

As is done in Latvia, many tax administrations recognize that advising taxpayers of their tax debt or soliciting an un-filed return is more cost-effective when such notice or return solicitation is sent by mail. They also recognize that a taxpayer should receive written notice of the liability as a first step in the collection process. This notice provides an opportunity to educate the taxpayer on the duty to pay taxes (or file returns) promptly and to warn the taxpayer of the consequences of failure to comply with the tax laws. Such notices generally provide an opportunity for the taxpayer to question the validity of the bill, to facilitate early resolution of any issues that may arise.

Unlike Latvia, in many tax administrations, individuals at lower pay grades than those involved in field collection activities issue notices and make initial contact on delinquent accounts. The lower-grade employees often are part of a support function that provides support and assistance to the field staff. Responsibilities of such a support unit include sending initial notices on delinquent taxes, responding to inquiries regarding notices sent, assisting with compliance checks if the services of a professional employee are not needed, and other functions as appropriate.

Best practices research indicates that many modernized tax administrations use a systematic method of prioritizing collection cases. Some classify cases by probability of collection, coupled with consideration of the type of tax involved, to ensure that cases of most concern to the government are worked, without regard to probability of collection. Other administrations prioritize on the basis of other criteria. In Latvia, there appears to be no formal plan of prioritizing at the Collection Division. SRS comment: "Tax administration strategy of SRS for 2005 – 2009" is developed, also "Tax control strategy of SRS for 2004 – 2006" as well as "Corruption prevention action plan of SRS for 2005 – 2008".

Based on the foregoing, Latvia's SRS should consider the following:

1) Empower collection inspectors by giving them full responsibility for collection actions in their area of responsibility, including:

    - The ability to enter into installment agreements (subject to approval by the Collection Unit Chief, or higher authority in appropriate circumstances);
    - The authority to serve administrative summons for documents
    - The authority to secure delinquent returns;
    - The authority to take administrative enforcement action against bank accounts and other funds held by third parties that belong to the taxpayer and to inventory and seize property
    - In the United States a lien may be imposed within 10 days after a Notice of Demand for payment is sent to the taxpayer and the taxpayer fails to pay. The SRS collection agent rather than sending the unpaid file to the Control and Analysis and do nothing should be empowered to secure the taxpayer's property by filing a lien.

2) Include effectiveness of collection actions, resolution of delinquent accounts, and prevention of further delinquencies as part of the performance measurement system.

3) Establish an expectation that the case actions of collection officials will be documented and made part of the taxpayer's file.

4) Establish an effective strategic planning process across the STS, including establishment of long-range goals (1–5 years) for collection. Additionally, establish an annual work plan that identifies priorities for the year and leads to achievement of the goals of the Strategic Plan.

5) Establish a method for analyzing the list of tax arrears by value and age to determine whether existing write-off procedures are effective in eliminating old debts that cannot be collected and to assist in assessing the effectiveness of collection activity.

6) Pilot a support function in a regional collection division to issue taxpayer delinquency notices, make telephone calls to solicit delinquent returns or payment of taxes, do certain compliance checks, and perform similar work that will allow collection agents to focus more on their collection work, in view of proposed increased responsibilities.

7) Review position management policies to ensure that employees have job descriptions that reflect the work they actually perform and establish new position descriptions for employees who may be engaged in lower-grade technical work, as in the proposed support function.

8) Explore alternative methods of resolving tax arrears, such as the ability to enter into an agreement to settle a tax arrear for less than the full amount due, based on financial circumstances, which is called an offer and compromise.

9) Establish guidelines for a Collection Officer to determine a jeopardy assessment situation without having to first wait for a taxpayer to perform an act jeopardizing the collection process.

10) Establish a procedural handbook for collection employees providing guidance on all work processes and combines all previous guidance and current procedures into one document that can be easily updated.

11) Train collection agents so they can effectively communicate filing requirements and obligations to taxpayers they contact in the course of their collection activities.

12) Establish a formal, written performance appraisal process for collection agents, with appropriate performance measures. Pay increases should be dependent on meeting certain performance standards.

b. Audit Process

The Regional Collection Division forwards a taxpayer's uncollected situation to the Regional Control and Analysis Division, which determines further action. If it is determined that an audit is needed, the C&A forwards the matter to the Regional Audit Division. Pursuant to a risk based analysis plan, the Audit Division has earmarked 350 individuals for audit, of this 350 individuals 167 are public officials, meaning only 183 members of the general public are considered in the risk base analysis. The audit is initiated as an office audit requesting additional information from the taxpayer. Usually 1 audit agent is assigned an individual's audit and 2 are assigned a legal person's audit, which is usually a field audit. The large taxpayer unit has its own team of auditors.

The examination is conducted on a specific items basis. Indirect methods of calculating tax due, such as the net worth method, despite the Law on Taxes authorizing such method, are not used, since the Court system does not recognize indirect methods for proving unclaimed wealth, illicit enrichment or tax evasion.

After the audit is complete and a tax assessment is determined, the taxpayer is afforded a conference discussing the outcome of the audit. The taxpayer may agree or appeal the decision to the Regional Director and thereafter to the Court.

It is concerning that so few individuals are selected for audit pursuant to the audit division risk base analysis. For best international practice in compliance risk assessment, the Organization for Economic Cooperation and Development (OECD) had a study team working on this subject. In November 2004 the study team released a report titled "Compliance Risk Management: Managing and Improving Tax Compliance." According to the study a Compliance Risk management Process is a 5-step method undertaken each year:

1) Identify the risks prevalent in society and particular to the tax process such as senior enterprise executives, entrepreneurs, professionals.
2) Asses and prioritize the risks.
3) Analyze compliance behavior such as registration, filing history, reporting history and payment history
4) Determine treatment strategies.
5) Plan and implement the strategies.

Other factors to consider are:

1) Random audit strategies. In the United States, random audits are annually planned affecting a pre-selected type of person or activity such as independent consultants, corporate executives or cash based businesses for this year and another group for the following year. In such a manner, no taxpayer can comfortably presuppose they will not be audited. Compliance is, therefore, enhanced across the board.

2) The Concept of a High Wealth Strategy used in the United States and in other countries having third party information declaration requirements. This strategy earmarks high wealth individuals for automatic cross checking of their declared income against third party information declarations.

3) The United States has a system of audit selection called the Discriminant Function (DIF) system designed to identify annual income declarations with a high probability of error and a resultant significant tax change. For example, declarations with very large deductions that appears beyond the taxpayer's financial ability because claimed deductions nearly equal income. The computer is assigned high DIF scores, declarations with high DIF scores are examined manually.

Recommendations for consideration to enhance the performance and effectiveness of the SRS audit division should include:

1) Strengthen strategic planning process for compliance functions:

- Enhance planning/strategies to address greatest compliance risks.
- Enhance quality driven productivity of compliance resources.
- Reduce taxpayer burden in complying with tax laws / regulations.
- Address compliance information strategy needs.

2) Strengthen Large Taxpayer Unit (and create a Banking/Finance Unit) by tailoring audit methodologies in accordance with best international practices:

Provide immediate training assistance on:

- How to conduct audits through a team approach;
- Provide enhancements to defining, tracking, and controlling large taxpayers;
- Distinguish between limited-scope and full-scope audits (limited-scope refers to audits that only address specific items identified prior to starting the audit; full-scope refers to audits that look at all aspects of the declaration(s) being examined;
- Provide technology applications for auditor use.

3) Create a compliance management information system to provide information on audit effectiveness, enhance controls on audit inventories, and provide information for employee appraisals.

4) Create a National Audit Plan that allocates compliance resources to areas of high compliance risks, while striving for balanced coverage of targeted declaration filings. This will requires both "top down," headquarters-driven process and "bottom up," regional audit involvement. Finally, establish annual declaration closure accomplishments for targeted audit coverage.

5) Enhance position management practices for compliance personnel.

- Establish lower-grade positions for assignment of compliance check workload.
- Construct professional auditor positions on a tiered approach to allow for growth within the profession and competition for more complex workload.

6) Standardize audit processes throughout SRS regional offices. Invest in classroom training on audit approach, focusing first on:

- Team audit approach to large business
- Income Declaration auditing versus financial statement auditing
- Developing an auditor's tool kit, with technology applications Audits directed at limited issues

7) Implement an Information Reporting Program (IRP) to enhance voluntary compliance levels for various market segments.

- Submit legislative proposal for third party information declaration reporting on critical compliance items.
- Establish processes needed for recording, cross matching, and enforcement actions on IRP program documents.

5. Law on Taxes and Fees

The Latvian Law on Taxes and Fees is the equivalent of the International Best Practice Tax Administration Law. In general it is a good law, but certain best practice provisions or suggestions are not included in the Law. For example:

1) The Tax Administration shall have the right to issue a summons to the taxpayer and to any other person having relevant information concerning the taxpayer to give testimony, provide information or to produce documents or other books and records to facilitate the investigation of a taxpayer's tax obligation.

2) Provision for Third Party Information Declarations.

3) Secondary tax Liability, wherein third parties are considered jointly liable with the taxpayer, such as representatives, persons aiding in the avoidance of tax, Corporate Officers actions that are responsible for a Company's non payment of tax and a transferee of property at below value.

4) Third party transferee liability to assure payment of tax by transferor on transfer of property, if transferee knows the transferor has no intention of paying the tax.

5) Clear procedure for the assessment of tax and specific contents of a Notice to Pay.

6) Enforced collection procedure against security accounts and against claims and receivables due taxpayer from third parties.

7) In addition to installment agreements, provisions should be made for declaring a taxpayer insolvent, a tax arrear as un-collectible and offer and compromise for a lesser amount, with provisions for reinstating the liability should taxpayer's financial position change with the period of time for collection.

8) Clear, standardized rules of audit procedure, office and field, and conference procedure.

9) Clearly specify indirect methods of proof, manner and form of investigation.

10) Increase the number of violations resulting in interest and penalties and evaluate the current infractions to determine whether the amounts are a deterrent. For example: penalty for untimely legal person registration, not cooperating after issuance of summons, understatement of tax, failure to submit information declaration or withhold tax, and maintaining inadequate books and records, negligence penalty, civil fraud penalty, properer penalty, frivolous declaration.

11) The Statute of Limitation for assessment and collection should coincide with the period of time allowed for net operating loss carry forwards. In Latvia's Enterprise Income Tax Law, Section 14, the carry forward period is 5 years, but the Law on Taxes indicates a 3-year Statute of Limitation to collect taxes. This should be extended to no less then same 5 years, otherwise there would be no way of determining the validity of a loss carry forward originating in a period prior to three years. In the United States the Government has 3 years to discover and assess a tax liability and a 10-year statute of limitation to collect the tax.

12) An Article in the Law regarding tax related criminal offenses, each offense and penalty being clearly and separately defined which should be made a part of the criminal code. The current criminal code refers to tax evasion and failure to repeatedly file or provide information, but there are many more related offenses not listed. For example: non-payment of withholding taxes, producing counterfeit documents to the SRS, and endangering tax collection process, filing false declaration or statements, aiding and assisting tax fraud, obstructing investigation.

13) Liens imposed immediately after Notice of Demand for payment is unpaid.

14) Jeopardy assessment based on experience rather than waiting for taxpayer to start disposing or hiding assets.

Recommended inclusions directly related to fighting corruption include:

1) Power to issue a summons. Applied against uncooperative public official, taxpayer, who hides assets and information or transfers assets to a third party. The summons is a tool to detect hidden assets and information and cash flow from third party sources, both in the present and in the future within the 5 year statute of limitation to collect taxes. This increased measure to the investigative process is a deterrent to corruption, since the probability of detection is enhanced.

2) Third party information declarations to detect income sources and property transaction of public officials, spouse and dependents. Determines legal from illegal income, since illegal income is not supported by third part declaration, as a result, illicit enrichment through net worth method is more readily proven.

3) The secondary tax liability shall refer to the following:

- Persons who contribute to or assist in avoiding the payment of taxes of the another person;
- Person who has received monetary assets, property or rights from a taxpayer by transaction without compensation or with compensation below market value, within three years prior to the due date of an unpaid tax liability.
- Person who has received monetary assets from a legal entity in the form of a dividend or bonus, which distribution resulted in the legal entity having insufficient funds in which to pay its taxes.

Purpose: Limits corruption and transfer of assets for non-payment of tax. Establishment of Code of Ethics within the private sector through penalizing tax evasion and corruption.

4) Third Party Liability-A person who purchases or receives property of another person shall be liable for the tax obligations of the transferring person if the person receiving the property knew or had reason to know that the person transferring the property had done so for the purpose of avoiding the payment of a tax obligation. Purpose: Penalizes a third party who conspires to commit a corrupt act or aids another in tax evasion. Addresses both active and passive corruption.

5) Tax audits shall be undertaken on the basis of an annual plan adopted by the Tax Administration, which is primarily based on the evaluation of tax significance and tax risk of taxpayers to include a random audit plan. Purpose: Deterrent to corruption and evasion, since no taxpayer would feel safe that it would not be audited.

6) Including as a criminal tax offense illicit enrichment, since the Criminal Code does not include it, the law on Taxes should declare illicit enrichment to be a criminal tax offense.

7) Specifically state in the Law on Tax and Fines that indirect methods and the forms thereof serve as evidentiary proof of both civil and criminal tax violations.

8) Specifically state in the Law on Taxes that the Director, deputy directors, heads of regional offices and management personnel of the SRS are prohibited from being officers of political parties, members of a Republic legislative body, or make contributions in money, property or services to political bodies.

9) Impose a lien immediately after failure to pay Notice of Demand for Payment to prevent transfer of assets.

10) Allow jeopardy assessments upon inclination and experience, rather than waiting until taxpayer to initially perform an action leading to transfer.

CHAPTER VIII: Personal and Enterprise Income Tax laws

A. Introduction

The transparency of tax decisions and allowances, the rate of tax, rebates, credits and exclusions all affect the income control of individuals and corruption probability, either directly through the Personal Income Tax or indirectly through the Enterprise Income Tax.

B. Discussion

The discussion of these two Direct Tax Laws is not intended to be an analysis of the Laws. Instead, the discussion serves merely as an indication of the provisions that may directly or indirectly affect income control and corruption.

C. Personal Income Tax Law

The current taxable rate is a flat 25%, which is much higher than the rates existing in most developing countries. As a rule of best practice, the Personal Income and Enterprise tax rates should be related. Since the flat rate of the Enterprise tax is 15%, it is recommended that the Personal rate also be 15% or a progressive tax rate with a maximum rate of 15%. The purpose for lowering the rate is to combat those taxpayers unwilling to comply with the Personal Income Tax Law due to the high rate of tax. A fair tax rate stimulates compliance.

It was indicated in a meeting with the Secretary of State, Minister of Finance that Latvia intends to reduce the personal income tax rate to 22% in 2007, 17% in 2008 and 15% in 2009.

Pursuant to Section 9 (19) income from selling one's property is exempted from the inclusion in the computation of taxable. Specifically, sub-section c, which exempts from tax the selling of immovable property, which has been in the possession of a person more than 12 months. I would assume that this provision is intended to relate to principal residence, but it does not specifically state principal residence. The SRS interprets this provision as applying to personal residences. Regardless, taxpayers are claiming all immovable property owned is their personal residences. There is needed a regulation clarifying this position. A person, as in the United States may have more than one home, but only one can be the primary personal residence to which tax on income is excluded. The affect that this provision may have on corruption is the conversion of illegal income into a legal ownership of property not subject to taxation, and, therefore, not subject to audit. In addition, a one year ownership provision, with no distinction of property held for the production of income does not curtail a natural person in the business of building homes for resale after one year. This is a substantial revenue drain.

Section 10 (1) (3) allows a personal deduction for donations and contributions to certain public benefit organizations to which political parties under the public benefit organization law are excluded.
Section 11(3) allows a deduction for economic activity expenses related to acquiring income. This Section does not specifically disallow business expenses for entertainment and advertisement expenses affiliated with

political parties. There should be a specific statement in the law that no expense related to political parties will be allowed.

D. Enterprise Income Tax Law

International best practice does not support tax incentives through rebates, credits etc. Incentives are a guaranteed drain on revenue flow and have been economically proven to not have a guaranteed positive influence on the expansion of an economy or attract foreign direct investment. Rather than incentives aimed at reduced taxes through rebates or exclusions, favorable depreciation rates may be imposed to stimulate certain needed development.

To the credit of Latvia, provisions in the Enterprise Income Tax Laws granting rebates and in some cases allowing rebates after certain Governmental submissions and meetings, Sections 17 through 20, have been revoked.

Section 5 disallows expenses not directly related to Economic Activity. There is no specific provision in the Law disallowing expenses related to political organizations or expenses related to bribes or any form of political influence.

E. Both the Personal Income Tax and Enterprise Income Tax

The European Union, OECD and the UN have long recognized the dangers of the underground, shadow market, the drain on tax revenue and the resultant effect on the economic growth of a country. Latvia had also recognized this issue.

Section 17 of the Enterprise Income Tax Law permitted a 20% per cent rebate of taxes for certain small enterprises having balance sheet assets less than 70,000LV ($150,000) , gross income less than 200,000 LV ($400,000), and average number of employees not exceeding 25. This section, however, is revoked.

Section 11(1) and 11(2) of the Personal Income Tax, while permitting individual merchants having gross income less than 45,000LV($90,000) simpler accounting, does not afford a rebate.

Since Section 17 has been revoked, it is recommended that Latvia consider incorporating the Micro Enterprises-EU Commission Recommendation on Micro Enterprises, OECD, 2000 Economic Survey of Balkans, and UN Development Agency recommendations. These recommendations are designed to limit the shadow economy by encouraging small businesses to register and perform activities in a legal manner. The recommendations are not intended for use by legal persons to reduce their tax liability.

Micro-Enterprise status applies to economic activities of individuals and small legal persons. A Micro Enterprise is an economic activity having:

1. Gross receipts less than 45,000LV, this is an arbitrary number specifically chosen to affect the greatest volume of small businesses.
2. Nine (9) or less employees. This prohibits legal persons from doing split offs or split ups to qualify for Micro enterprise status.
3. Two (2) or less stockholders, all stockholders must be individuals. Aain to prohibit legal persons from qualifying as shareholders.
4. The business activity includes all activity except banking, financial services and insurance.
5. Simplified cash method of accounting to encourage registration. In some countries, only gross receipts must be recorded. However, to encourage maintaining records in the event the enterprise does not qualify at year end as a micro-enterprise, the cash method of accounting for income and expenses is encouraged.
6. No more than 80% of a micro enterprise’s gross receipts can come from one source. This eliminates an employer’s opportunity to fire an employee and retain the same person as an independent to avoid paying withholding tax and social contributions.
7. Tax rate can be either a flat percentage of gross receipts or less than half of the personal income tax rate. For example, in Latvia’s case the percentage of gross receipts could be in the range of 3% to 4%. The taxpayer registers at the beginning of a year and declares micro-enterprise status, the gross receipts are estimated based upon the prior year, and a calculation is presented for monthly prorating of the tax. The person also receive a certificate that must be visibly displayed so all customers and STS investigators may instantly see the certificate, failure to have or display a certificate warrants closing the business until the business complies.

Alternatively, the micro-enterprise pays a tax of 6% or 7 % (one half the flat rate) of taxable income computed according to the simplified cash method of accounting. It is not recommended that the one-half rate wait until the Latvia Personal Income Tax rates are proportionally reduced to eventually arrive at 15%. The incentive to reduce the shadow economy should be immediate.

The Micro Enterprise reduced tax rates do not decrease the tax revenue flow of a country. On the contrary, studies by the European Commission, OECD and UN indicate revenue flow is increased as more small merchants, which were never taxpayers, elect to transact business in a legal manner.