Reform of labour taxes in Latvia 2011-2013

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Abstract

The paper analyses the motives for and results of the labour tax reforms undertaken by the Latvian government in 2011-2013 with a special focus on the low-wage sector. The reforms were developed with the goal of overcoming negative effects on the labour market caused by the deep economic crisis in 2008-2010 as well as of coping with an increase in labour tax burdens during consolidation. In 2008-2010, Latvia was seriously affected by the global economic crisis and during these years real gross domestic product (GDP) declined by 21 percent. Labour market conditions became worse rapidly and at the beginning of 2010, the unemployment rate reached 21.5 per cent of the economically active population. For the period of 2011-2016, the reforms provide for a reduction in the rates of personal income tax (PIT) and social security contributions (SSC) as well as for an increase in PIT allowances. Taking into account the changes made in labour tax laws, we employed forecasts of average wages and applied the Eurostat methodology to calculate the tax wedge for different groups of employees depending on income level and on the number of their dependants. The results show that the impact of the reform varies greatly and it is more beneficial for employees with dependants and for low-wage earners. The findings of the paper contribute to policy discussions and decisions on the tax wedge, especially in the Euro area. In the period covered by the paper, about half of the Euro area member states (including Latvia) received a country-specific recommendation to address this issue in the context of the European Semester.[1]

Keywords: tax reform, personal income tax, social security contributions, tax wedge, tax allowance, Latvia

1 INTRODUCTION

Labour taxation (PIT and SSC) has been at the focus of Latvia's tax debate for many years for numerous reasons. Labour taxation plays a significant role in the cost of employment and its impact on competitiveness, especially within the Baltic region, which includes Latvia, Lithuania and Estonia. Labour taxes play also a significant role in ensuring revenues for national and local governments and social security budget transfers. At the same time, labour taxation is used as an instrument of redistribution, encouraging higher labour market participation and employment, reducing poverty and curbing the existing income inequality. Informal employment and labour tax evasion is another issue, in which an appropriate and fair tax regime could bring positive changes.

The aim of this paper is to analyse the reasons for and results of the labour tax reform undertaken by the Latvian government in 2011-2013 with a special focus on

[1] The implementation of the EU's economic rules is organised annually in a cycle, known as the European Semester. During each European Semester:
- the European Commission analyses the fiscal and structural reform policies of every member state, provides recommendations, and monitors their implementation;
- the member states implement the commonly agreed policies.

the low-wage sector of employment. The findings in the paper inform policymakers that the tax wedge on labour in the Euro area is among the highest in the world, negatively impacting economic growth, employment, and competitiveness. In 2013-2014, about half of the Euro area member states received a country-specific recommendation to address this issue in the context of the European Semester.

The research methodology is based on an analysis of *indicators characterising employment, wages, household incomes and the general government budget*, and on research into economic and scientific literature as well as reports of the government and international organizations. A big part of the study is a descriptive analysis of the tax reform with some speculations concerning what impact the reforms might have. We calculated *tax wedge indicators using mostly data available at the Central Statistical Bureau of Latvia,* Eurostat and the Ministry of Finance of Latvia. Our analysis of the impact of tax reforms shows a great variation among different groups of wage-earners. It will be more beneficial for those with dependants and for low-wage earners. However, the progressivity of labour taxes will remain low.

The remainder of the paper is structured as follows: section two analyses the impact of the economic crisis of 2008-2010 on the labour market, public finances and income distribution, identifying the challenges to be solved by means of forthcoming reforms. Section three shows theoretical interrelations between taxes and employment. Section four analyses initial results of implemented reforms, and section five contains conclusions on the achievements and drawbacks of the reforms, as well provides recommendation for further work.

2 THE ECONOMIC CRISIS IN LATVIA AND ITS IMPACT ON THE LABOUR MARKET AND ON THE WEALTH OF THE POPULATION

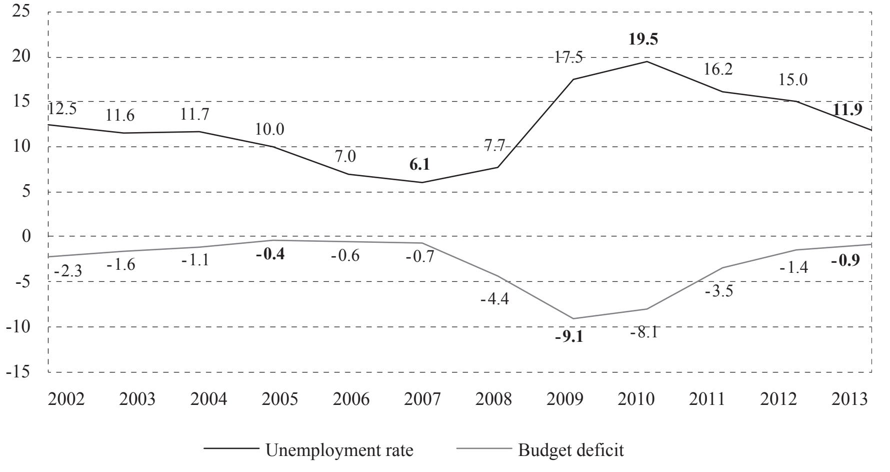
2.1 DEVELOPMENT OF GROSS DOMESTIC PRODUCT, EMPLOYMENT AND WAGES

In the years 2008-2010, Latvia suffered a serious economic downturn. The global liquidity and confidence crisis led to short-term liquidity problems and, consequently, to the takeover of one of the largest domestic banks of Latvia by the government in late 2008. This deepened the already growing problems faced by public sector finances. In addition, at that time Latvia faced both a cyclical and a structural crisis as during the preceding boom years the economy had accumulated imbalances in the real estate sector, as well as in the labour and financial markets and was growing way above its potential level in an unsustainable growth path (Kasjanovs and Kasjanova, 2011). During these three years real GDP in total declined by 21 percent.

The crisis had a significant impact on employment in Latvia. The labour market conditions deteriorated rapidly and at the beginning of 2010 the unemployment rate reached 21.3 per cent of the economically active population (on average 19.5 per cent in 2010, figure 1).

Figure 1

Unemployment rate and the state budget deficit in Latvia (% of GDP)



Source: Central Statistical Bureau of Latvia.

The crisis caused significant changes in the structure of economic sectors. For example, employment in the construction sector almost halved (table 1). In the first phase of the recovery, job matching (Beveridge curve) was indicative of the flexible and effective labour market in Latvia (Zasova, 2011). However, there is a substantial risk of an increase in structural unemployment because of a possible mismatch between employees' skills and the requirements of new job opportunities if the unemployment rate remains at a high level for a longer period of time. Long-term unemployment causes economic costs due to deterioration in the skills and employability of those people outside the workforce. An increase in discouraged jobseekers also stimulates outward migration, which according to estimates during 2009-2010 reached 70 thousand people for the three year period (Hazans, 2011). Considering the existing negative natural demographic growth in Latvia this potentially harms the long-term growth prospects of the country.

High unemployment and the policy of internal devaluation (e.g. cutting wages in the public sector) soon led to a decrease in labour income. In 2009, the average wage, compared to the previous year, decreased by 3.9 per cent, and in 2010 by another 3.5 per cent. Furthermore, the share of minimum wage earners increased substantially up to 30 per cent of total employment, but the share and number of those employees with income close to an average wage (an interval from 427 to 711 euro per month) decreased (see figure 2). The shadow economy in Latvia peaked in 2010 (Putniņš and Sauka, 2014). Therefore the share of minimum wage earners could be one of the indicators of increased underreporting, and it also undeniably shows a real increase in the share of low-wage workers in total employment.

Table 1

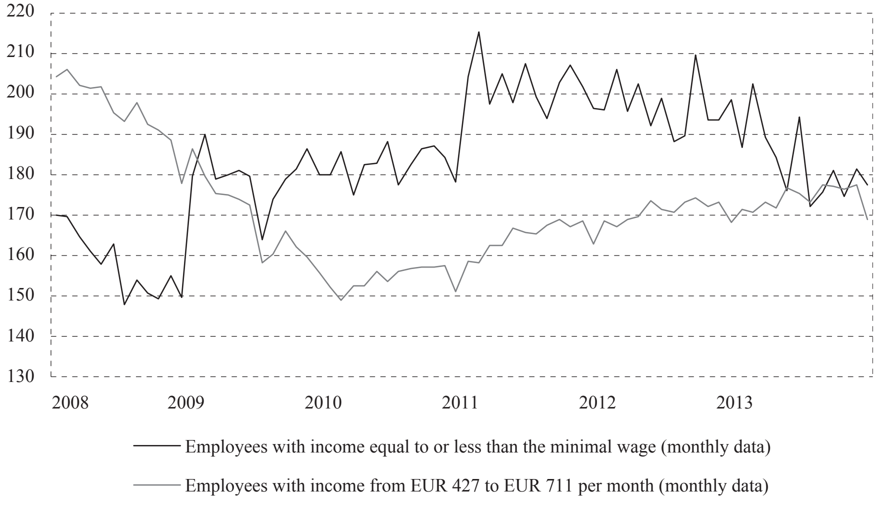
Employment by sectors

	Structure (%) 2010	Changes in the number of employees (%) 2010/2008
Primary sectors	9.8	0.0
Manufacturing	14.3	-21.6
Electricity, gas and water supplies	1.9	-16.1
Construction	7.0	-47.6
Trade, hotels and restaurants	19.3	-16.1
Transport and communications	9.9	-12.2
Public services	21.8	-11.5
Other activities	16.1	-5.3

Source: Ministry of Economics of Latvia, 2011.

Figure 2

Changes in the number of employees by level of income (in thousands)



Source: Central Statistical Bureau of Latvia.

Latvia responded to the crisis by maintaining its currency peg[2] and by an adjustment through internal devaluation and front-loaded consolidation, which included cutting public expenditures. The main rationale behind the choice of such a policy was that the country needed to address underlying structural inefficiencies in the economy. Internal devaluation is preferable to exchange rate devaluation, which offers only temporary relief from cost pressures while avoiding long overdue reforms (Åslund and Dombrovskis, 2011).

[2] Latvian government's exchange-rate policy of pegging Latvian lats rate of exchange to another country's currency.

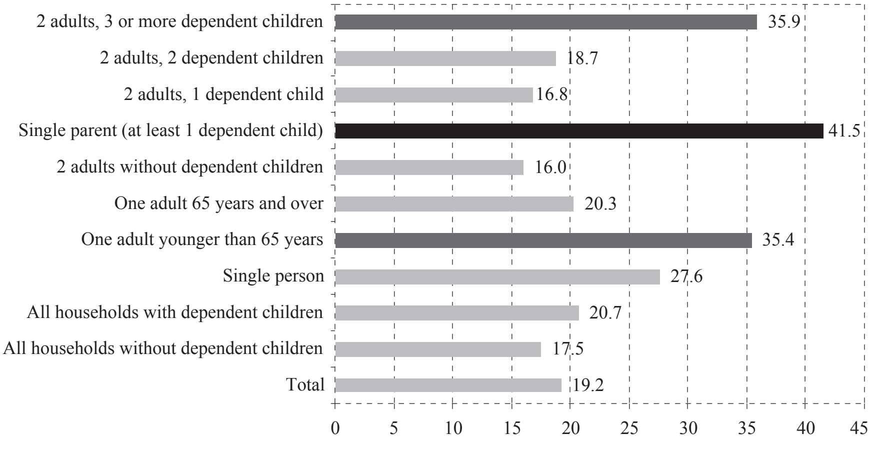
2.2 GROWTH OF INCOME INEQUALITY AND POVERTY TRAPS

In 2007, wages and salaries were the main way in which 76.6 per cent of Latvian households earned their living. This figure decreased to 64.4 per cent in 2010. At the same time the share of social transfers of the total income of households increased from 17.9 per cent in 2007 to 31.9 per cent in 2010 (Central Statistical Bureau of Latvia, 2010). If any weakness in the labour market lasts for a longer period of time, it will heighten concerns about long-term dependency on benefits and create the risk of poverty traps (World Bank, 2013).

In 2012, according to the data of the Central Statistical Bureau of Latvia (CSB), poverty rates by household type show that families with dependent children, especially with three and more, and single-parent families, are at the highest risk of poverty (see figure 3). Before 2008, the at-risk-of-poverty rate for people of retirement age was twice as high as for children. After the crisis, the at-risk-of-poverty rate for children was two and even three times higher than for people of retirement age. This was a result of increased unemployment and decreased labour income at the time when pensions were exempted from consolidation measures due to a decision of the Constitutional Court.

FIGURE 3

At-risk-of-poverty rate by household type in 2012 in per cent*



** The proportion of population (as percentage) whose equivalent disposable income is below 60% of gross national disposable income equivalent median.*

Source: Central Statistical Bureau of Latvia.

Income inequality is another concern that was revealed by the crisis. There are different theoretical views on this issue, but recent empirical evidence and works by development economists have created a broad international consensus that a more equal distribution of income strengthens aggregate demand, investment and growth. This, in turn, accelerates job creation, including high-productivity activities that offer better remuneration and social benefits, thereby further reducing inequality (UNCTAD, 2012). Tax and transfer systems reduce overall income inequality in all countries. On average across the OECD, three quarters of a reduction in equality is due to transfers, while the rest is due to direct household taxation (OECD, 2012).

In 2009, the Gini coefficient of equivalised disposable income amounting to 37.5 per cent in Latvia was the highest in the European Union (according to the Eurostat data in 2009 the EU-27 average was 30.5 percent), showing a necessity and possibilities for improving tax-benefit policies.

Labour market institutions such as taxes and benefit systems may cause additional problems to employment growth or provide disincentives especially for low-wage workers. One such indicator is the unemployment trap that measures the proportion of gross earning taxed away (by higher taxes and withdrawal of benefits) when shifting from unemployment to employment. Another measure is the low-wage trap that assesses the proportion of gross earnings taxed away (by higher taxes and withdrawal of benefits) when gross earnings increase (for the unemployment trap Eurostat uses earnings amounting to 67 per cent of an average wage, for the low-wage trap – a wage increase from 33 per cent to 67 per cent of an average wage).

In 2010, the unemployment trap in Latvia was 90.06, above the EU-27 average of 74.74, while the low-wage trap was 33.00 which is significantly lower than the EU-27 average of 47.46 (Eurostat data). This could be explained by the flat-rate personal income tax system with a low non-taxable threshold. It is noteworthy that since 1994 Latvia has had a flat income tax system, in which some progressivity has been achieved through the PIT basic allowance (non-taxable minimum) and the PIT allowance for dependants.

2.3 CHANGES IN LABOUR TAXES DURING THE BUDGET CONSOLIDATION PERIOD

The crisis had a significant impact on public finances. From 2004 to 2008, total tax revenues as a percentage of GDP increased from 27.8 per cent to 31.3 per cent due to high consumption-based economic growth. This upward trend was interrupted in 2009 due to rapid worsening of the economic situation. In 2010 the tax burden decreased to its lowest value since 1995, standing at 27.4 per cent of GDP, and total tax revenue in 2010 decreased by 2.2 billion euro from 2008, leading to unsustainable levels of budget deficit.

As a result of this loss in revenues, the government had to introduce major fiscal consolidation measures that amounted to a reduction in government expenditures totalling 16 per cent of GDP (as can be seen in table 2 below: 9.53 per cent in 2009, 3.97 per cent in 2010 and 2.26 per cent in 2011).

Table 2
Consolidation measures in 2009-2011[a]

Consolidation measures	2009		2010		2011	
	Mn. euro	% of GDP	Mn. euro	% of GDP	Mn. euro	% of GDP
Revenue, of which:	529.2	2.85	374.4	2.06	322.0	1.59
Value added tax	411.2	2.21	–	–	120.2	0.59
Personal income tax	-124.2	-0.67	219.4	1.21	-78.3	-0.39
Social security contributions[b]	49.8	0.27	52.2	0.29	175.2	0.86
Excise duties	155.5	0.84	17.2	0.09	29.9	0.15
Real estate tax	–	–	43.0	0.24	8.6	0.04
Corporate income tax	-8.3	-0.04	–	–	1.6	0.01
Other taxes	–	–	0.1	0.00	27.0	0.13
Non-tax revenue	45.2	0.24	42.5	0.23	37.7	0.19
Expenditure, of which:	1,243.3	6.69	348.0	1.91	136.4	0.67
Current expenditure (remuneration, goods and services)	566.1	3.04	204.2	1.10	43.6	0.23
Interest payments	43.4	0.23	-0.3	0.00	0.2	0.00
Subsidies, grants and social support	549.8	2.96	76.2	0.41	89.6	0.48
International collaboration	1.2	0.01	0.4	0.00	–	–
Payments to the EU budget	8.5	0.05	–	–	–	–
Capital expenditure	74.3	0.40	67.5	0.36	3.0	0.02
Total	1,772.5	9.53	722.4	3.97	458.4	2.26

[a] *The numbers in the table show the size of consolidation measures. Due to the crisis government adopted many budgetary decisions such as tax rates increase, tax base broadening, as well as expenditures cuts.*
[b] *Excluding contributions to the state funded pension scheme.*
Source: Ministry of Finance of Latvia.

Main consolidation measures took place on the expenditure side, but changes in taxation were also significant as tax rates and bases were increased in almost all tax categories (see table 3). Although the largest increase in taxes was attributed to consumption and property taxation, labour taxation was increased as well.

Before 2008, the Latvian government had the goal of reducing the tax burden on labour for low-income households through an increase of PIT allowances. The first consolidation package adopted at the end of 2008 also provided for cutting the PIT rate by 2 percentage points to 23 percent.

As the crisis and shortage of tax revenues proved to be much more severe than had been initially anticipated, this policy was soon reversed and the PIT rate was increased to 26 per cent in 2010. Moreover, the basic allowance that had been increased to 128 euros per month at the beginning of 2009 was significantly reduced to 50 euros per month in the second half of 2009 (note that in 2009 the average monthly gross salary in Latvia amounted to 655 euros). At the same time, the allowance for dependants was not changed and remained 90 euros per month.

Table 3

Major changes in tax rates during the consolidation period

	2008	2009	2010	2011
Value added tax general rate, %	18	21	22	22
Reduced rate	5	10	10	12
Personal income tax general rate, %	25	23	26	25
Tax rate for economic activities	15	15	26	25
Tax rate on income from capital (such as dividends and interests)	–	–	10	10
Tax rate on capital gain	–	–	15	15
Basic allowance, euro per month	114	From Jan. 128 From Jul. 50	50	64
Allowance for dependants, euro per month	80	90	90	100
Social security contributions rate (%), of which:	33.09	33.09	33.09	35.09
Employer rate	24.09	24.09	24.09	24.09
Employee rate	9	9	9	11
Real estate tax rate (land and commercial buildings), %	1	1	1.5	1.5
Rates for residential housing (depending on cadastral value), %				
less than 56,915 euro	–	–	0.1	0.2
56,915 – 106,715 euro			0.2	0.4
exceeding 106,715 euro			0.3	0.6

Source: Ministry of Finance of Latvia.

In a comparison of labour taxation in the Baltic region, where all countries use flat income tax rates, Latvia showed the highest PIT burden at the end of the crisis. This is especially true for below-average wages and is a result of the higher PIT rate and lower basic allowance. While in Latvia the PIT rate and the basic allowance changed almost each year during the period of 2009-2011 (see table 3), in Estonia the PIT rate and allowances were changed only once, in 2008, and thereafter stayed at the same level (the PIT rate was decreased from 22 per cent in 2007 to 21 per cent in 2008 and the basic allowance increased from 128 euros per month in 2007 to 144 euros per month in 2008 (the child allowance is applied in the same amount as the basic allowance, only starting from the second child). The same is true for Lithuania where the PIT rate and basic allowances have remained stable since 2009. The labour tax system in Lithuania was reformed in 2009, when the PIT rate was reduced from 24 per cent in 2008 to 15 per cent in 2009, the basic allowance was increased from 93 euros per month in 2008 to 136 euros per month in 2009 (in Lithuania the basic allowance is applied according to income levels), the allowance for child was increased to 29 euros per month for the first child and 58 euros per month for second and subsequent children (previously at 14 euros per month for each child) and a health insurance contribution rate was introduced at the level of 9 per cent.

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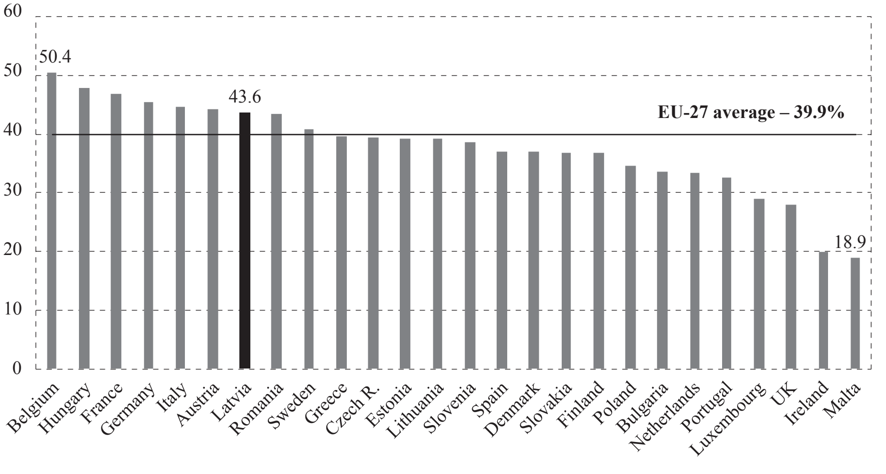
Labour costs are influenced not only by PIT, but also by social security contributions. The highest SSC rate among Baltic States in 2010 was observable in Lithuania with 40.7 per cent (of which the employer rate was 31.7% and the employee rate was 9%), while in Latvia it was the lowest with 33.09 per cent (of which the employer rate was 24.09% and the employee rate was 9%). In Estonia the total SSC rate in 2010 was 38.0 per cent (of which the employer rate was 34.4% and the employee rate was 2.8%, the lowest among the Baltic States).

As result of changes in PIT, the tax wedge for low-wage earners increased in Latvia and in 2012 was one of the highest in the EU as well as higher than in the other Baltic States, Lithuania and Estonia (see figure 4).

The tax wedge is an important issue for the whole of the EU and euro area given that the tax burden on labour in the euro area member states is among the highest in the world, negatively affecting both growth and employment (Dolenc and Laporšek, 2010). Within the euro area, 11 countries face a particular challenge with regard to the high tax burden on labour. As reflected in the country specific recommendations (CSRs), these countries are: Austria, Belgium, Estonia, France, Germany, Italy, Latvia, Luxembourg, the Netherlands, Portugal and Spain (European Union Economic Policy Committee, 2014).

FIGURE 4
Tax wedge in the EU in 2012 (%)*



**Tax wedges for a single worker with 67% of average earnings, no dependants.*
Source: Eurostat.

The differences in the tax burden on labour in neighbouring countries with otherwise quite similar economic conditions gave reasons to worry about the cost competitiveness of Latvian companies and the possibilities of increasing investments in high labour intensity projects.

2.4 A RATIONALE OF THE LABOUR TAXES REFORM

The following list summarizes the issues arising as consequences of the 2008-2010 crisis on the labour market and on the tax policy.

Weaknesses of the labour market:

- high unemployment, especially long-term unemployment, with all the associated economic and social costs;
- emigration of discouraged jobseekers;
- decreased participation rates.

Labour market institutions:

- high unemployment trap;
- increased dependency on benefits;
- high tax wedge for low-wage earners.

Barriers to economic development and growth:

- role of taxes in regional cost competitiveness and job creation;
- income inequality and a risk of poverty.

Labour taxes may affect all these issues, however, in different intensities. Nevertheless, their role as a source of revenue for the budget financing should also be taken into account.

3 THEORETICAL CONSIDERATIONS ON THE IMPACT OF LABOUR TAXES ON EMPLOYMENT

Taxation of labour income can influence the employment level in an economy due to its effect on both unemployment level and the size of the labour force. Labour taxation drives a wedge between the total labour costs faced by employers and the real consumption wage received by employees. This will generally affect both labour demand and labour supply decisions (OECD, 2011).

In a perfectly competitive labour market, taxation would have no impact on unemployment as the real wage would adjust so that market would clear (OECD, 2011). Higher taxation would reduce the voluntary supply of labour if net wages were below the level acceptable to some individuals (thus increasing inactive population, but not affecting unemployment). In practice, however, taxation affects unemployment levels indirectly by alleviating or exacerbating non-tax distortions created by other labour market institutions – specifically by out-of-work benefits and wage setting institutions (OECD, 2011).

The effect of taxation on labour supply varies among different population groups. Individuals respond differently to changes in the real consumption wage depending on their individual preferences and family characteristics. Taxes affect decisions on participation, numbers of hours worked, but also on the amount of an effort an individual is willing to put into their work, including long-term decisions concerning occupation and education. Taxes also influence a decision to engage in tax avoidance or evasion (including working in the informal sector) (OECD, 2011).

The demand for labour is affected by the ratio of the tax wedge that is passed on to an employer.

The tax wedge is a difference between what employees take home in earnings (or net pay) and what it costs to employ them. Employer social security contributions and – in some countries – payroll taxes are added to gross wage earnings of employees in order to determine the measure of total labour costs (OECD, 2008).

The more elastic the labour supply (and/or demand) curve is, the more harmful the tax wedge for employment becomes. In case of standard, convex, aggregate labour supply (and demand) curves, a high tax wedge particularly affects earners of relatively low wages. Since one of the main factors explaining real wage differentials is skill level, one can argue that the negative impact on employment caused by the tax wedge is most severe for low-skilled workers (World Bank, 2005). The situation in the low-wage segment of employment is made even more complex by other labour market institutions – such as minimum wage and social benefits creating, for example unemployment, inactivity and low-wage traps.

Empirical evidence suggests that low-income workers, single parents, second earners and older workers are relatively responsive to changes in taxation of labour income, particularly at the participation margin (OECD, 2011). In addition, taxable income elasticities suggest that higher-income individuals are more responsive to tax changes than middle-income and lower-income workers (OECD, 2011).

Consequently, there is a need to design a tax policy targeting individual employment groups at different income levels and family characteristics in order to address the most pressing issues efficiently with minimum fiscal costs.

A high tax burden on labour runs counter to the objective of boosting economic activity and increasing employment. In particular the interaction between a high tax burden on labour and a benefit system may create unemployment or inactivity traps for groups with high responsiveness to the wage level, such as low skilled and low-income earners. However, note that the tax wedge is not the only factor explaining the level of unemployment. In many EU member states there is a need for further structural reforms in order to ensure proper functioning of the labour markets, which should accompany measures to address the tax wedge in order to increase their employment effect (European Union, Economic Policy Committee, 2014).

4 THE LABOUR TAX REFORMS

4.1 CHRONOLOGY AND GOALS OF REFORMS

Latvia's economy returned to growth at the end of 2010 (in the third quarter of 2010, the GDP growth rate was positive for the first time in nine consecutive quarters with 2.9 percent). However budget consolidation continued in 2011, as there was a necessity to decrease the budget deficit further and improve the sustainability of public finances. With regard to labour taxes, the government decided to adopt the following tax changes for 2011:

- to reduce the PIT rate from 26 per cent to 25 per cent,
- to increase the basic allowance of PIT from 50 euros to 64 euros per month,
- to increase the allowance for dependants of PIT from 90 euros to 100 euros per month,
- to increase the SSC rate from 33.09 per cent to 35.09 per cent (an increase was fully implemented through the increased employee rate – from 9 per cent to 11 percent).

The goal of the government reform was to increase revenue of the state with focus on the social security budget, but at the same time to provide relief for low-wage earners as the tax burden increased only for those whose earnings were close to or above the average wage.

This reform helped to increase revenue and to improve the sustainability of the social security system, but the tax wedge for low-wage earners was not affected.

The next post-crisis labour tax reform was adopted in 2012 and included:

- a decrease in the PIT rate from 25 per cent to 24 per cent in 2013 and further decrease in the rate to 22 per cent in 2014 and to 20 per cent in 2015,
- increase in the allowance for dependants of PIT from the mid of 2013 from 100 to 114 euros per month.

This reform focused primarily on decreasing the labour costs of Latvian enterprises as well as on increasing their competitiveness in the region and thereby stimulating increase in overall economic activity and employment growth (Ministry of Finance of Latvia, 2012). This time, the labour tax reform did not provide any special measures for low-skilled jobseekers.

The decrease in the PIT rate started in 2013, but taking into account the fiscal costs for further steps of the adopted reform and the reform's impact on other labour market and growth problems such as unemployment traps or income inequality, the Minister of Finance and the Minister of Welfare initiated discussions on changes in the adopted reform.

Taking into account Latvia's flat income tax, the main instruments to influence low-wage workers are the basic allowance and an allowance for each dependant. A decrease in the tax rate is more beneficial to better paid workers. It would be possible to reduce the tax wedge compared to the EU average solely through the basic allowance if it were increased approximately to 140 euros per month (Šņucins, 2012).

In 2013, the EC, through its country-specific recommendations, indicated the need for appropriate calibration of the tax policy in order to stimulate employment for low-skilled people in Latvia (European Commission, 2013). In addition, the IMF pointed out that while some reduction in the tax wedge on labour would be desirable, untargeted cuts in the statutory PIT rate are not the first-best solution from an efficiency or equity perspective (IMF, 2013).

Taking into account these views as well as the debates between the government and its social partners (employers' organisations and trade unions), an agreement was reached that a reduction of income inequality and the support of employees with children (dependants) should be equally important goals of the labour tax reform in conjunction with a reduction of labour costs.

Thus, the reform was significantly adjusted. In 2014, the SSC rate was reduced by one percentage point and the PIT basic allowance and allowance for dependants were increased. In addition, the government plans a decrease of the PIT rate from 24% to 23% in 2015 and to 22% in 2016 (see table 4).

TABLE 4
Tax reform in Latvia in 2014-2016

	2013	2014	2015	2016
PIT rate, %	24	24	23	22
Basic allowance, euro per month	64	75	75	75
Allowance for dependants, euro per month	114[a]	165[b]	165	165
SSC rate, %, of which:	35.09	34.09	34.09	34.09
Employer rate	24.09	23.59	23.59	23.59
Employee rate	11.00	10.50	10.50	10.50

[a] *As from 1 July 2013.*
[b] *As families with children are most at risk of poverty in Latvia (see figure 3), the income tax system is used as an instrument to support families with children. The main reason for that is the relatively small direct benefit – e.g. family benefit comprised 11 euro per month for each child in 2014.*

Source: Ministry of Finance of Latvia.

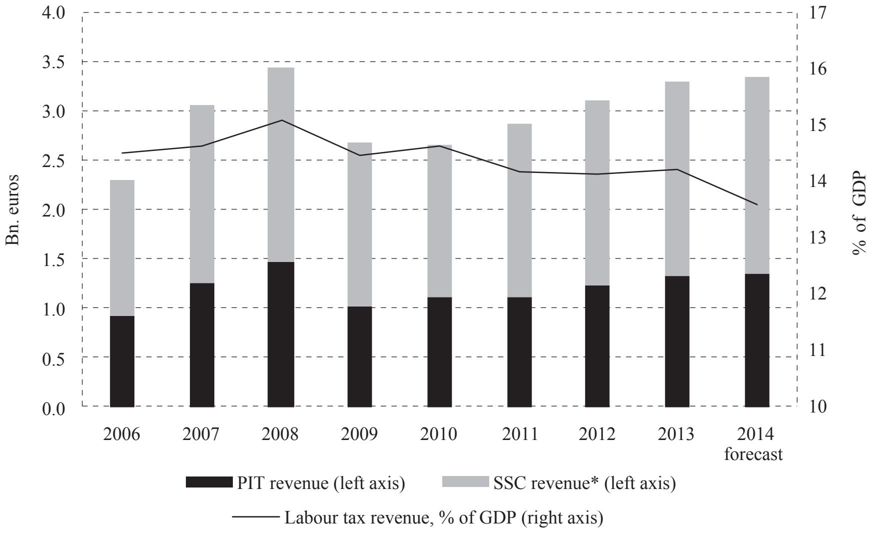
4.2 EVALUATION OF THE REFORMS

Since 2010, the economic situation in Latvia has markedly improved, showing a stable GDP growth above 4 per cent per year, a decrease in the unemployment rate and average wage increases along with increased productivity. However, it is too early to estimate the macroeconomic impact of the tax reforms as it takes time to influence the behaviour of economic agents.

Revenues from PIT and SSC have increased along with employment and wage increases (see figure 5). With decrease of the tax burden, the share of labour taxes as percentage of GDP becomes stable as employment and wages were increased and reporting was improved. This indicates that a comparatively large amount of tax revenue (approximately two per cent of GDP) was lost by the government in favour of households and businesses.

Figure 5

PIT and SSC revenue in 2008-2014, billion euros and % of GDP



** Without contributions to funded pension scheme.*

Source: Ministry of Finance of Latvia.

Our analysis of the tax reforms impact shows a great variation among different groups of wage-earners. In summary, the tax reforms were generally more beneficial to families with children and for low-income earners.

For example, due to the reform in 2014 an employee with two dependants earning a gross wage of 450 euros per month will take home a net wage that is approximately 7.6 per cent higher in 2014 than in 2013. At the same time, an employee with two dependants and a gross wage of 1,500 euros per month will take home approximately three per cent more in 2014 than in 2013 (see table 5).

However, as can be seen from the shaded area in table 4, in some cases, when an employee has a low wage and two or more dependants, the expected benefit is lower than for an employee with the same gross wage, but with one dependant or without dependants. This is explained by the fact that the total amount of available tax allowance for an employee with a low wage and two or more dependants is higher than his gross wage. For example, for an employee with a gross wage of

350 euros per month and three children, the total calculated allowance will amount to 570 euros per month (the basic allowance of 75 euros per month + the allowance for dependants of 165 euros per month, multiplied by 3).

Table 5

Increase of employees' income in 2014, % in comparison with the previous year, %

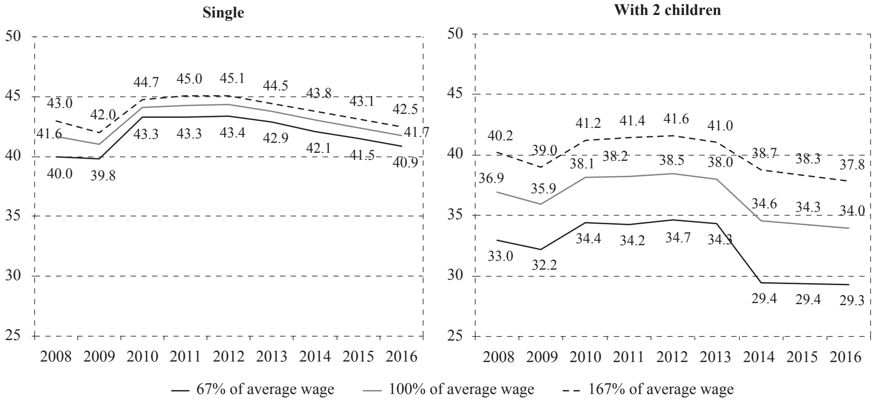
Gross wage, euro per month	Number of dependants					
	0	1	2	3	4	5
320	1.7	6.2	0.6	0.6	0.6	0.6
350	1.6	5.8	2.1	0.6	0.6	0.6
400	1.5	5.2	5.1	0.6	0.6	0.6
450	1.4	4.8	7.6	0.6	0.6	0.6
500	1.3	4.4	7.1	2.8	0.6	0.6
550	1.2	4.1	6.6	4.9	0.6	0.6
600	1.2	3.8	6.2	6.7	1.2	0.6
650	1.1	3.6	5.8	7.8	3.1	0.6
700	1.1	3.4	5.5	7.4	4.7	0.6
750	1.0	3.2	5.2	7.0	6.2	1.8
800	1.0	3.1	4.9	6.7	7.5	3.3
850	1.0	2.9	4.7	6.4	7.9	4.7
900	1.0	2.8	4.5	6.1	7.5	5.9
950	0.9	2.7	4.3	5.8	7.2	7.0
1,000	0.9	2.6	4.2	5.6	6.9	8.0
1,100	0.9	2.4	3.9	5.2	6.4	7.6
1,200	0.9	2.3	3.6	4.8	6.0	7.1
1,300	0.8	2.2	3.4	4.5	5.6	6.7
1,400	0.8	2.0	3.2	4.3	5.3	6.3
1,500	0.8	1.9	3.0	4.1	5.0	6.0
2,000	0.7	1.6	2.4	3.2	4.0	4.8

Source: Authors' calculation, based on implemented changes in taxes.

As can be observed in figure 6, the implemented and adopted tax changes will reduce the tax wedge in 2016 for all wage categories, especially for employees with children. However, they will not increase the existing small progressivity of labour taxation for single persons in Latvia. This means that the impact of reforms on another of the reform goals, the reduction of income inequality, is negligible.

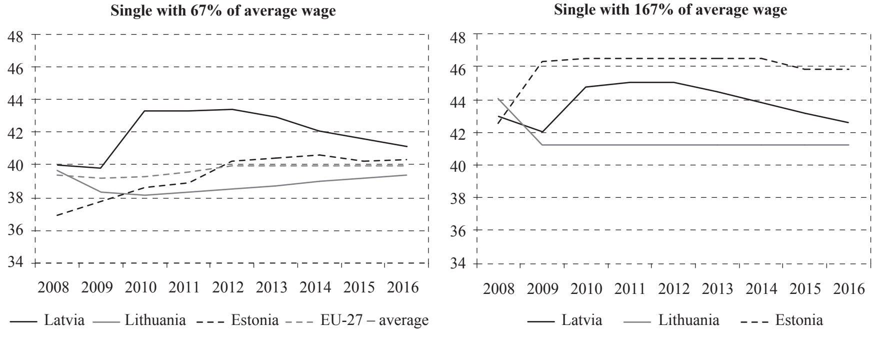
Due to changes that will be adopted in 2016, the tax wedge in Latvia for low-wage earners will be near to that of other Baltic States and to the EU-27 average, reaching one of the goals of the reform (see figure 7).

Figure 6
The tax wedge in Latvia



Source: Authors' calculation, based on forecasts and applying the Eurostat methodology.

Figure 7
*The tax wedge in the Baltic States and the EU-27, %**



** The EU-27 average tax wedges for a single worker with 67% of an average wage (EU-27 average tax wedge for a single worker with 67% of the average wage in 2012 is used for the period of 2013-2016).*

Source: Authors' calculation, based on forecasts and applying the Eurostat methodology.

5 SUMMARY AND CONCLUSIONS

In the years 2008-2010, Latvia was seriously affected by an economic downturn and real GDP declined by 21 percent. Labour market conditions became worse rapidly and, at the beginning of 2010, the unemployment rate reached 21.5 per cent of the economically active population.

High unemployment and the policy of internal devaluation soon led to a decrease of labour income. In 2009, the average wage, compared to the previous year, decreased by 3.9 per cent and in 2010 by 3.5 per cent. In 2007, wages and salaries were main way in which 68.3 per cent of households earned their living. This share decreased to 53.2 per cent in 2010.

As result of increased unemployment and decreased labour income, families with dependent children, especially with three and more, and single-parent families, were at the highest risk of poverty.

Income inequality is another issue that was revealed by the crisis. In 2009, the Gini coefficient of equivalised disposable income in Latvia was the highest in the EU, showing a necessity and possibilities for improving tax-benefit policies.

As a result of the loss in budget revenues, the government had to introduce major fiscal consolidation measures that in total amounted to 16 per cent of GDP. The main consolidation measures took place on the expenditure side, but changes in taxation were also significant because tax rates and bases were increased in almost all tax categories including labour taxes.

As result of such changes in labour taxes, the tax wedge in Latvia for low-wage earners in 2012 was 43.6 per cent, one of the highest in the EU (the EU-27 average was 39.9 per cent) and higher than in the other Baltic States (Lithuania: 39.2 per cent and Estonia: 39.2 per cent).

In 2011, the Latvian government started the labour tax reform by reducing the PIT rate by one percentage point, increasing the basic allowance as well as the allowance for dependants, but at the same time employee SSC rate was increased by two percentage points. The goal of this reform was to increase revenue of the state special social security budget while at the same time providing relief for low-wage earners as a tax burden was increased only for those whose earnings were near to or above an average wage.

The next post-crisis labour tax reform was adopted in 2012. It provided for a further reduction in the PIT rate and the allowance for dependants increased by mid-2013. A reduction of the PIT rate was introduced in 2013. However, taking into account the fiscal costs for further steps of the adopted reform and the reform's disregard of other labour market and growth problems such as unemployment traps or income inequality, at the end of 2013 the government decided to leave the PIT rate unchanged in 2014 and to reduce the rate from 24 per cent to 23 per cent in 2015 and to 22 per cent in 2016. Also starting in 2014, the allowance for dependants and the basic allowance were increased and the SSC rate was reduced by one percentage point (sharing 0.5 percentage points for employers and 0.5 percentage points for employees).

Our analysis of the impact of the tax reforms shows a great variation among different groups of wage-earners. It is more beneficial for those with dependants and for low-wage earners. We forecasted that in 2016, the tax wedge in Latvia for low-wage earners will be close to the other Baltic States and to the EU-27 average. However, the progressivity of labour taxes will remain low.

In order to achieve all the outlined goals of the reform, it is necessary to widen the scope of the reform, using more targeted tax allowances and providing more coordination with non-tax instruments.

The main labour tax changes were implemented recently, and the reforms are not yet completely finished. This makes evaluation of the results less efficient and suggests the need for further research in the future especially on the impact on various groups of wage-earners.

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