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Equity and Efficiency in the Latvian Tax-Benefit System

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There is a trade-off between two major objectives of a tax-benefit system: equity and efficiency. The tax-benefit systems that redistribute a lot of income tend to generate disincentives to work. The tax-benefit systems that create good incentives to work and earn, are less effective in mitigating poverty, social exclusion and deprivation. In this brief we argue that, when contrasted to other EU countries, the Latvian tax-benefit system is less effective in achieving either of the objectives.

Equity-Efficiency Trade-Off

There is a fundamental trade-off between the two principal objectives of a tax-benefit system - income redistribution and efficiency. On the one hand, income redistribution is desirable as it helps to mitigate socially undesirable market outcomes such as poverty and deprivation. On the other hand, more income redistribution is often associated with higher distortions to labour supply and work effort.

There is no universal prescription as to how much a government should redistribute. The answer to this question depends, among other factors, on the relative value that society (government) assigns to the welfare of different population groups, and on the individuals' labour supply elasticity.

However, a given degree of income redistribution can be achieved at a different cost of efficiency. In this brief, we analyse the degree of income redistribution generated by the tax-benefit system and work incentives in Latvia in the context of other EU countries. In our analysis, we use the European microsimulation tax-benefit model EUROMOD (Sutherland and Figari, 2013) version G2.0, EU-SILC data, and the analysis framework developed by Jara and Tumino (2013).

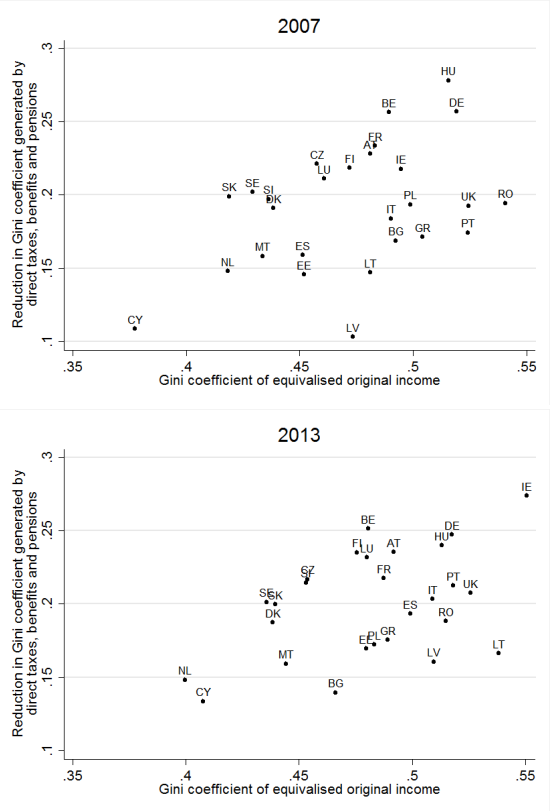
Income Redistribution in the EU

EU countries differ substantially in terms of inequality of original income and in terms of the degree of redistribution generated by the tax-benefit system (see Figure 1, data on 2007 and 2013). The Gini coefficient of equivalised household original income (which consists of income from employment and self-employment, property income, private pensions, private transfers and other relatively minor components) ranges from around 0.4 (Cyprus, Netherlands) to almost 0.55 (Romania in 2007, Ireland in 2013).

Inequality of original income in Latvia in 2007 was at the EU average level (Gini coefficient of 0.47), but the degree of income redistribution generated by direct taxes, benefits and pensions was the lowest in the EU. As a result, the inequality of disposable

income in Latvia in 2007 was the highest in the EU (Gini coefficient of 0.37). Part of the answer as to why the degree of income redistribution in Latvia is so low is a relatively small contribution of pensions to redistribution – it is almost half of that observed in the EU on average, despite the fact that the share of public pension recipients in the total Latvian population in 2007 was above the EU average. Another important factor was the very minor role of means-tested benefits: in the EU on average, means-tested benefits generate a reduction in Gini coefficient by about 0.02, while in Latvia the corresponding figure is just one tenth of this.

Figure 1. Gini coefficients of original equivalised household income and degree of redistribution generated by tax-benefit systems in the EU in 2007 and 2013



Source: EUROMOD statistics, authors' calculations

In the course of the crisis and the following recovery, the degree of redistribution in Latvia increased (see lower panel of Figure 1). An important factor behind the increase was growing number of pension recipients and an increase in the average size of pensions (both in absolute terms and relative to employment income). The increase in the number of pension recipients was not a result of changes in eligibility criteria, but was due to population ageing and the fact that more people applied for other types of pensions. The growth in the average size of pension was due to generous indexation of pensions in 2008 and compositional changes, as pensions of new pensioners until 2012 were larger than the average pension. Another reason for a growing degree of redistribution was an increase in the size and the number of recipients of means-tested benefits (mainly Guaranteed Minimum Income (GMI) benefit). This was a result of reforms in the provision of the means-tested benefits and of falling incomes from employment, which made more people eligible for the social assistance programmes. Nevertheless, despite the increase in recent years, the degree of income redistribution in Latvia remains one of the lowest in the EU.

Work Incentives

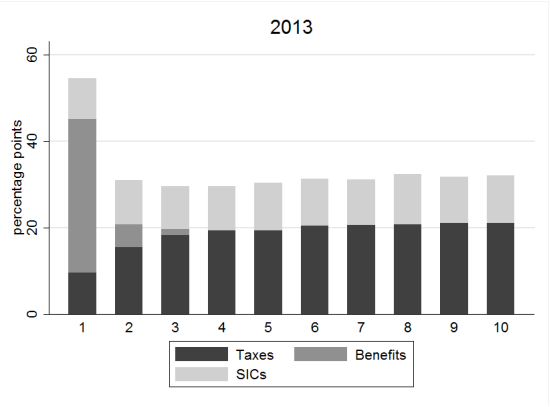
The existence of a trade-off between income redistribution and better work incentives suggests that tax-benefit systems that ensure less income redistribution are likely to generate better work incentives. Jara and Tumino (2013) have demonstrated the existence of this trade-off in the EU countries in 2007-2010 by identifying a negative and statistically significant correlation between Gini coefficients and Marginal Effective Tax Rates (METR). The METR is a measure that is commonly used to quantify work incentives at the intensive margin. It shows what proportion of a small increase in earnings (which results from e.g. an increase in the supplied hours of work) is lost as a result of extra tax payments or foregone benefits that the person is no longer eligible for after the increase in earnings. The negative correlation identified in Jara and Tumino (2013) suggests that countries with less income redistribution (i.e., higher Gini coefficients) tend to have better work incentives (lower METRs).

In Latvia, the mean METR in 2013 was 32.2%, only slightly below the EU average (34.5%), and much higher than the average in Estonia (22.8%) and Lithuania (27.4%), despite a lower degree of income redistribution (EUROMOD statistics). Another feature of the Latvian tax-benefit system is that it is characterised by especially high METRs for poor individuals. Thus, in 2013, 94% of individuals who faced METRs in excess of 50% belonged to the two bottom deciles of distribution of equivalised disposable income. This is different from many other European countries, where distribution of high METRs is either more even across deciles or rising towards the top end of income distribution (Jara and Tumino (2013), data for 2007).

The main reason for high METRs faced by the poorest population groups in Latvia is the design of means-tested benefits (GMI and housing benefits), which generates 100% METRs for the recipients of these benefits. Namely, for each additional euro earned, the amount of benefit is reduced by one euro, which leaves the net income unchanged. This adversely affects employment incentives for the poorest individuals and increases the poverty risk.

Figure 2 illustrates mean METRs by deciles of equivalised disposable income in Latvia and shows the contribution of taxes, benefits and social insurance contributions (SICs) to the mean METRs. It clearly demonstrates that high METRs in the bottom deciles result mainly from the contribution of benefits, which disappears in the fourth decile. The contribution of SICs is slightly smaller in the bottom decile, which is due to the fact that the proportion of employed individuals is smaller in the bottom decile. For the same reason, and also because of basic tax allowances, the contribution of direct taxes is smaller in the bottom deciles, but then the contribution of taxes levels off, reflecting the Latvian flat tax rate.

Figure 2. The contribution of direct taxes, benefits and social insurance contributions (SIC) to METRs in Latvia by deciles of equivalised disposable income in 2013



Source: authors' calculations using EUROMOD-LV

In their study on the incentive structure created by the tax and benefit system in Latvia, the World Bank (2013) pointed out the problem of bad work incentives generated by Latvian means-tested benefits. Our results, which are based on a population-representative database of incomes, also identify means-tested benefits as the major contributor to high METRs in the lowest deciles of the income distribution. Another concern expressed by the World Bank (2013) was that the problem of informal employment (either in the form of undeclared wages or work without a contract) can be exacerbated by high participation tax rates and METRs.

Conclusion

The Latvian tax-benefit system is characterized both by a relatively low degree of income redistribution and relatively weak work incentives, as measured by METRs. Recipients of means-tested benefits (GMI and housing benefits) are faced with 100% METRs, as benefits are withdrawn at the same rate as household income rises. This creates disincentives to increase labour supply for low-paid/low-skilled individuals, and hence creates a risk of poverty traps. Evidence from the literature suggests that the labour supply of low paid workers is particularly sensitive to

the incentives generated by the tax-benefit system, hence reforms that would bring down METRs in the bottom deciles could yield positive results in terms of employment of low paid/low skilled workers.

A potential reform is to introduce either a gradual phasing out of the means-tested benefits, or to exclude a certain amount of employment income from the income test for the means-tested benefits. Such reforms would be targeted at the bottom end of the income distribution, help combat poverty, improve the incentive structure of the Latvian tax-benefit system, and positively affect the labour supply of low-skilled/low-paid workers.

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