

# Latvia Stumbling Towards Progressive Income Taxation

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*The 2016 budget includes measures aimed at increasing the progressivity of the Latvian income tax system. In this brief we report some exercise on the impact of these measures using the Latvian EUROMOD tax-benefit microsimulation model. We show that by their design, the reforms are aimed at a reduction in income inequality and an increase in the progressivity of the tax system. However, there are risks that the behavioural response of the tax payers will subvert the intended impact of the reforms.*

Ever since it was introduced in 1994 the Latvian personal income tax has been applied at a flat rate, albeit varying over time, mitigated only by a small untaxed personal allowance. Partly as a result of this, the Latvian tax-benefit system redistributes less original income than most other EU countries. Is this all about to change? The 2016 budget currently being debated in the Parliament contains two proposals aimed at introducing more progressivity in the personal income tax. These are the introduction of a “solidarity tax” aimed at high earners and the introduction of an earnings differentiated non-taxable allowance. The stated aims of these measures are to reduce inequality and help low wage-earners.

## Description of the Reforms

### Solidarity Tax

The solidarity tax foresees that income above 48,600 EUR per year will be taxed at a rate of 10.5% (employee’s part), plus 23.59% (employer’s part). The new tax will affect a very small share of wage earners. According to

Finance ministry’s estimate, this tax will affect 4.7 thousand persons, whose income in 2015 exceeded this threshold, or 0.59% of all employed individuals (Finance Ministry, 2015).

### Differentiated Non-Taxable Personal Allowance

The differentiated non-taxable personal allowance will be introduced gradually between 2016 and 2020. The basic idea is to make the allowance dependent on income: individuals receiving income below a certain threshold are eligible for the maximum possible allowance, then the allowance gradually declines with income until it is zero. The system will be introduced gradually in the sense that the minimum allowance will not reach zero until 2020 – it will be gradually reduced from 85 EUR in 2016 to 0 EUR in 2020.

The way the system will be implemented foresees that during a fiscal year, all individuals will be taxed applying the minimum non-taxable allowance (e.g., 85 EUR in 2016). At the beginning of the next year, people eligible for a higher tax allowance

will have the opportunity to apply for a tax refund, by making an income declaration, and to get the overpaid tax back.

## Simulations of Reforms: Inequality

Below we present simulation results from EUROMOD, which is an EU-wide tax-benefit microsimulation model (for more details see Jara and Leventi, 2014). The results show the first-round effect of the simulated policies, i.e., they show the pure effect of the proposed reforms abstracting from any behavioural responses that these reforms might induce. We simulate the effect of five reform scenarios: two scenarios of differentiated non-taxable allowance (one scenario reflects the system that is planned to be introduced in 2016, the second scenario represents the system that is planned to be introduced in 2020), one scenario that simulates introduction of the solidarity tax, and two scenarios that combine the solidarity tax with the new non-taxable allowances. We compare these reforms with the baseline system, which describes the tax-benefit rules that are in place in 2015.

It is important to note that we assume in the simulations that everyone who is eligible for a tax refund under the new non-taxable allowance rules does in fact apply for the refund, which means that we estimate the maximum possible effect from the introduction of the higher tax allowances.

Table 1 summarizes the effect of the proposed reforms on income inequality as measured by the Gini coefficient. All the proposed reforms reduce income inequality, but the solidarity tax achieves higher equality by reducing incomes in the top decile. The non-taxable allowance mainly affects people in the middle of the income distribution, as the bottom deciles contain proportionally fewer employed individuals, while in the top deciles the allowance, which is set in absolute terms,

makes a smaller share of the income – hence, a weaker effect. Pensioners, who mainly belong to the lower deciles of the income distribution, do not gain from a higher allowance, because of a special taxation regime for pensions that already provides for a higher personal allowance. All major benefits (unemployment benefit, social assistance, child-related benefits) are not subject to personal income tax, hence benefit recipients also do not gain from the proposed changes (see Figure 1).

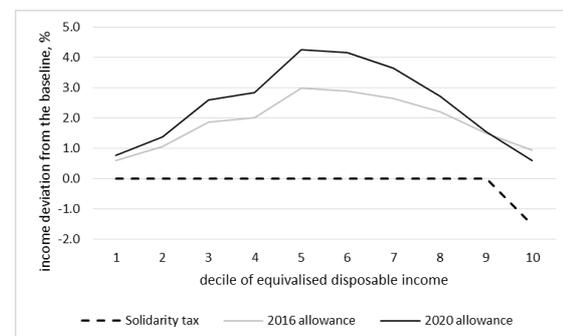
**Table 1. Gini Coefficient Associated with the Reforms**

	Baseline	ST*	2016 allowance	2020 allowance	ST + 2016 allowance	ST + 2020 allowance
Gini	0.361	0.358	0.360	0.357	0.357	0.355

Source: authors' calculations using EUROMOD

Note: ST – solidarity tax

**Figure 1. Deviation of Equivalised Disposable Income from the Baseline Scenario, %**



Source: authors' calculations using EUROMOD

Figure 1 also shows that the losers from the solidarity tax are in the highest decile, though it should be borne in mind that enterprises are also losers because they now have to pay part of the solidarity tax. The solidarity tax generates no direct gainers.

## Impact on Progressivity

The progressivity of a tax or system is typically measured by the Kakwani index. The Kakwani index (Kakwani, 1977) can vary between  $-1$  and  $1$  and the larger the index, the more progressive is the tax. A positive index indicates that the tax is progressive and a negative index indicates it is regressive. Table 2 shows the calculated Kakwani index for all major direct taxes (which include personal income tax, social contributions and the newly introduced solidarity tax) and separately for personal income tax (PIT) for each of the postulated scenarios. The results suggest that all of the proposed reforms increase the progressivity of the tax system.

*Table 2. The Kakwani Index for the Six Scenarios*

	Baseline	ST*	2016 allowance	2020 allowance	ST + 2016 allowance	ST + 2020 allowance
All income taxes*	0.034	0.040	0.048	0.058	0.054	0.064
PIT	0.07	0.07	0.10	0.12	0.10	0.12

*Source:* authors' calculations using EUROMOD

*Note:* ST – solidarity tax; income taxes include personal income tax, social contributions and the newly introduced solidarity tax

## Qualifications and Risks

The above results capture the so-called first round impact of the tax changes. In practice people will react to the changed incentives by changing behaviour and thereby changing the impacts. For example, the higher net reward for working in low wage jobs may increase the supply of workers willing to work in such jobs thereby possibly having a bigger positive effect on the incomes of low income households than implied by the simulations.

Perhaps more significant is the potential effect of the solidarity tax on the behaviour of high

earners and of the enterprises that employ them. This effect is captured by the concept of the elasticity of taxable income – defined as the change in taxable income in response to a change in the marginal tax rate. The taxable income elasticity concept takes into account all the behavioural aspects of the taxpayer in response to a change in the tax rate. As well as labour supply responses it includes other responses e.g. switching the form in which income is received as well as simple tax evasion (Saez et al., 2012). It is the switching of the form in which income is received, away from wage income towards other less-taxed forms of income that can be expected here. Thus according to an internal Latvian Employers Confederation employer survey, if the solidarity tax is implemented one third of employers will consider using legal tax optimization tools such as dividends or the microenterprise tax to avoid paying the tax. Here, employers are important as well as employees, because employers will pay the larger share of the tax. If this happens on a significant scale (high elasticity of taxable income) then the intention of the solidarity tax will be subverted.

There are also risks with the differentiated personal allowance. If the burden of annual reporting of income is too high then many may simply not do it and suffer the loss of income or find a way of recouping through shadow earnings.

## Concluding Remarks

The Latvian authorities should be applauded for grasping the nettle of progressive taxation but perhaps only with one hand for the way they have chosen to do it. Thus, the solidarity tax creates an incentive for both employers and employees to find ways of avoiding it and find they surely will. A tax accountant once said of the 80% supertax applied to high earnings in pre-Thatcher UK that it was a

‘voluntary tax’. This is also the likely fate of Latvia’s solidarity tax.

The differentiated personal allowance will clearly benefit low earners, if they claim it. In fact it will also benefit people earning well over the average wage. But will the low earners claim? Very few people in Latvia have ever filed an income declaration and we fear that many low earners will not do so now.

Thus at the top end progressivity is likely to be largely avoided and at the bottom end may not be fully claimed.

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