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Latvia Stumbling Towards Progressive Income Taxation: Episode II

In August 2017, the Latvian parliament adopted a major tax reform package that will come into force in January 2018. This reform was a long-awaited step from the Latvian authorities to make the personal income tax more progressive. Some of the elements of the adopted reform, e.g. the changes in the basic tax allowance are estimated to help reducing the tax wedge on low wages and help addressing the problem of high income inequality. At the same time, the way the newly introduced progressive tax rate is designed will effectively lead to a reduction in the tax burden on labor and will hardly introduce any progressivity to the system.

In recent years, reducing income inequality has become one of the top priorities of the Latvian government. Income inequality in Latvia is higher than in most other EU and OECD countries, and the need to address this issue has been repeatedly emphasized by the Latvian officials, the European Commission, the World Bank and OECD.

The main reason for high income-inequality is a low degree of income redistribution ensured by the tax-benefit system. The personal income tax (PIT) has been flat since the mid-nineties. While the non-taxable income allowance introduces some progressivity to the system, the Latvian tax system is characterized by a very high tax burden on low wages, compared to other EU and OECD countries.

Since the beginning of 2017, the government has worked on an extensive tax reform package that was passed in the parliament in August and will become effective as of January 2018.

Two years ago, we wrote about the tax reform of 2016. In this brief, we estimate the effect of the 2018 reform on the tax burden on labour and income inequality. We will only consider changes in direct taxes on personal income – the changes in enterprise income tax and excise tax are outside the scope of our analysis. Parts of our estimations are done using the tax-benefit microsimulation model EUROMOD (for more details about the EUROMOD modelling approach, see Sutherland and Figari, 2013) and EU-SILC 2015 data.

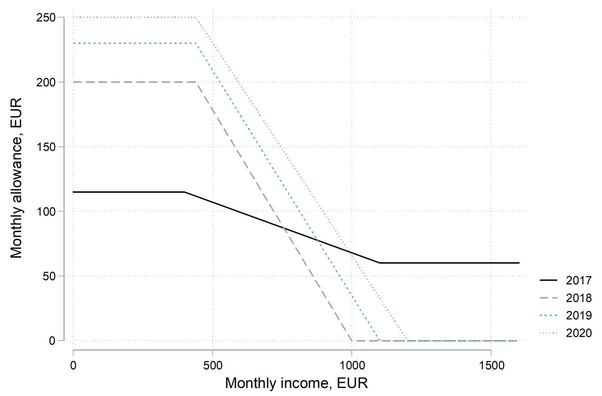
Tax reform 2018

We focus our analysis on four elements of the reform that are expected to affect income inequality and that are described below. In our simulations, however, we take into account all changes in the PIT rules.

First, the flat PIT rate of 23% will be replaced by a progressive rate with three brackets: 20% (applied to annual income not exceeding 20,000 EUR), 23% (for annual income above 20,000 EUR and below 55,000 EUR) and 31.4% (applied to income exceeding 55,000 EUR per year).

Second, the maximum possible PIT allowance will be increased and the structure of the PIT allowance will be made more progressive. Latvia has a differentiated allowance since 2016, which means that individuals with lower incomes are eligible for a higher tax allowance. Figure 1 shows the changes in the non-taxable allowance that will be introduced by the reform. Another important change is that the differentiated allowance will be applied to the taxable income in the course of the year. The current system foresees that, during a calendar year, all wages are taxed applying the lowest possible allowance (60 EUR per month in 2017), but workers eligible for a higher allowance have to claim the overpaid tax in the beginning of the next year.

Figure 1. Basic PIT allowance before (2017) and after (2018-2020) the reform, EUR



Source: compiled by the authors.

Third, the rate of social insurance contributions will be increased by 1 percentage point. Social insurance contributions are capped and the cap will be increased from 48,600 EUR per year to 55,000 EUR per year, i.e. to the same income threshold that divides the top PIT bracket.

Finally, the reform will modify the solidarity tax – a tax, which was introduced in Latvia in 2016 and which is paid by top income earners. When this tax was initially introduced, one of its objectives was to eliminate the regressivity from the tax system caused by the cap on social insurance contributions. Hence, the rate of the solidarity tax was set at the same level as the rate of social insurance contributions and was effectively replacing social insurance contributions above the cap. The reform foresees that part of the revenues from the solidarity tax (10.5 percentage points) will be used to finance the top PIT rate. This element of the reform implies that after January 2018 those falling into the top PIT bracket will, in fact, not face a higher PIT rate than those falling into the second income bracket – the introduction of the top rate will be offset by the restructuring of the solidarity tax.

Results

There are four main findings. First, the reform will reduce the tax wedge on labor income, whereas the tax wedge on low wages will remain high by international standards. Second, most of the PIT taxable income earners (93.5%) will fall into the bottom income bracket. Hence the reform will effectively reduce the tax burden, while the effect on progressivity is very limited. Third, the (small) increase in tax progressivity is ensured mainly by changes in the tax allowance, while the effect of changes in the tax rate on progressivity is negligible: Even those few PIT payers that fall into the top tax bracket will not experience any increase in the tax burden due to a compensating change in the solidarity tax. Finally, it is mainly the households in the middle of the income distribution that will gain from the reform.

Effect on tax wedge

We start with a simple comparison of the average labor tax wedge in Latvia and other OECD countries for different wage levels before and after the reform. The tax wedge measures the share of total labor costs that is taxed away in the form of taxes or social contributions payable on employees' income.

Table 1. Average tax wedge for single wage earners without dependents in Latvia and other OECD countries, before and after the reform

	67% of average worker's wage	100% of average worker's wage	167% of average worker's wage
OECD average in 2016, % [(a)]	32.3	36.0	40.4
Latvia 2016, % [(a)]	41.8	42.6	43.3
Latvia's rank in 2016* [(a)]	6	11	16
Latvia 2018, % [(b)]	39.4	42.3	42.6
Latvia 2019, % [(b)]	39.1	42.1	42.6
Latvia 2020, % [(b)]	39.0	41.9	42.8

Source: (a) OECD and (b) authors' calculations. *Note*: * Ranking across 35 OECD countries. Higher ranking implies higher tax wedge relative to other countries.

Table 1 shows that the tax wedge on low wages (67% of an average worker's wage) in Latvia is pretty high. In 2016, it was the 6th highest across OECD countries, while the tax wedge on high incomes (167% of the wage) is much closer to the OECD average.

While the reform will slightly reduce the tax wedge for low wage earners (from 41.8% to 39.0% in 2020), it will still remain high by OECD standards. Despite an increase in PIT rate for high-income earners, the reform will also lower the tax wedge for those who earn 167% of the average wage. Why? The explanation comes from the income thresholds for the tax brackets. The income of those earning 167% of the average wage is estimated to fully fall into the first tax bracket in 2018–2019 and only slightly exceed the income bracket for the second PIT rate by 2020. This means that most of the incomes of people earning 167% of the average wage will be taxed at the rate of 20%, which is lower than the current flat rate of 23%. Moreover, in 2020, only a small share of their income will be taxed at 23% – the same rate that these individuals would have had faced in the absence of the reform. Hence, we observe a reduction in the tax wedge for high-income earners.

Generally, only a very small share of taxpayers will fall into the middle and the top income brackets. According to our estimations, as many as 93.5% of all PIT taxable income earners will fall into the lowest income bracket, and only about 6.5% will fall into the second income bracket and about 0.5% will face the top PIT rate.

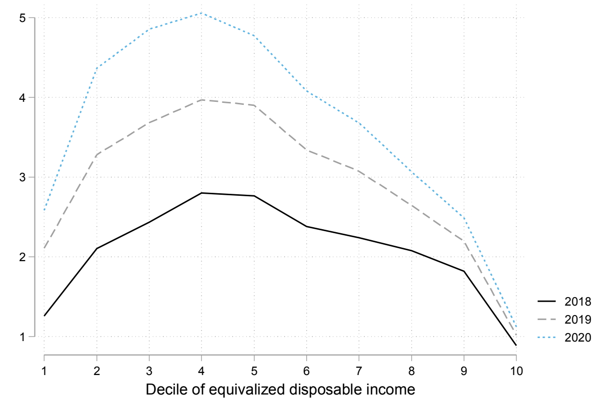
Apart from the progressive PIT schedule, the reform envisages important changes in the solidarity tax. As explained above, part of the revenues from the solidarity tax will be used to finance the top PIT rate. Therefore, even those (very few) taxpayers whose income will exceed the threshold for the top PIT rate, will not experience any increase in the tax burden because of the compensating change in the solidarity tax. Therefore, the reform will effectively reduce the tax burden on labour with very little effect on progressivity.

While lowering the tax burden is generally welcome, the motivation for applying the top rate to such a small group of taxpayers is not clear. For example, in their recent in-depth analysis of the Latvian tax system, the World Bank (World Bank, 2016) came up with a tax reform proposal that envisaged a considerably lower threshold for the top PIT rate, which, according to our estimations, would cover about 12% of the taxpayers. Given the limited budget resources and an especially high tax wedge on low wages, a more targeted reduction in the tax burden would be preferable. Similar concerns about insufficient reduction in the tax burden on low-income earners are expressed in the latest OECD economic survey of Latvia (OECD, 2017).

Effect on income distribution

Below we present the results from the tax-benefit microsimulation model EUROMOD. Figure 2 shows the simulated change in equivalized disposable income by income deciles compared to the baseline "no-reform" scenario in 2018-2020.

Figure 2. Change in equivalized disposable income by income deciles caused by the reform compared to "no-reform" scenario, %



Source: authors' calculations using EUROMOD-LV model

The first thing to note is that these are mainly households in the middle of the income distribution who will gain from the reform – their income will increase due to both the increase in non-taxable allowance and the introduction of the progressive rate.

The gain in the bottom of the income distribution is smaller for several reasons. First, the proportion of non-employed individuals (unemployed and non-active) is larger in the bottom deciles. Second, individuals with low wages are less likely to gain from the reduction in the tax rate and the increase in the basic allowance, since they might already have most of their income untaxed due to the currently effective basic allowance. The same applies to pensioners who have a higher basic allowance than the employed individuals and who are mainly concentrated in the bottom of income distribution.

Our results suggest that the wealthiest households will also see their incomes grow as a result of the reform (by about 1% in 10th decile). The growth is ensured by the fact that annual income below 20,000 EUR will be taxed at a reduced rate of 20%, and, taking into account that even in the top decile only about half of the individuals get income from employment that exceeds 20,000 EUR per year, the gain from the tax reduction is considerable even in the top decile. A reduction in the tax allowance for high-income earners will have a negative effect on wealthy individuals' income, but this will be more than compensated by the above positive effect of the change in the tax rate. Hence, the net effect on the incomes in the top deciles is estimated to be positive.

Finally, Table 2 summarizes the effect of the reform on the income distribution, measured by the Gini coefficient on equivalized disposable income. On the whole, the reform is estimated to slightly reduce income inequality – in 2020, the Gini coefficient is expected to be 0.6 points lower than it would have been in the absence of the reform. This reduction is mainly driven by the changes in the non-taxable allowance, while the three PIT rates are estimated to have an increasing impact on income inequality.

Table 2. Gini coefficient on equivalized disposable income in the reform and "no-reform" scenario

	2018	2019	2020
"No-reform" scenario	35.2	35.4	35.7
Reform scenario	35.0	35.0	35.1

Source: authors' calculations using EUROMOD-LV model

Conclusion

The 2018 tax reform was a long-awaited step from the Latvian authorities on the way to a more progressive tax system. The planned changes in the basic tax allowance are estimated to help reducing the tax wedge on low wages and help addressing the problem of high income-inequality.

At the same time, the second major aspect of the reform, the introduction of a progressive PIT rate, raises more questions than answers. The progressive rate, the way it is designed, will effectively lead to an across-the-board reduction of the tax burden on labor and will hardly help to reach the proclaimed objective of taxing incomes progressively. Given the limited budgetary resources and given that taxes on low wages will remain high compared to other countries even after the reform, a more targeted reduction of the taxes on low-income earners would have been a more preferred option.

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