The evolution of tax and benefit policy in Latvia: what has been the place of distributional considerations?

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Introduction

Latvia has one of the highest levels of income inequality and poverty in the EU. During the boom, income inequality was rising and in 2007 was the highest in the EU. During the 2008-2009 recession, when Latvia experienced the world's largest GDP contraction and a mass increase in unemployment, poverty, as measured by the at-risk-of poverty rate, declined as the incomes of the top quintiles fell more strongly than those of the relatively poor. The Latvian government has sometimes been applauded for this 'achievement' (e.g. Krastiņš, 2012). Yet the reduction in poverty is a result of the way in which this poverty indicator is measured: the at–risk-of-poverty rate shows the share of population receiving income below a certain proportion of the median income. Thus, the poverty rate can decline even with declining incomes if at the same time income distribution becomes more even, and vice versa – if incomes are growing unevenly, the poverty rate can increase. A more concrete indicator to assess the change in population welfare in the periods of rapidly changing average incomes is the share of population classified as severely materially deprived, which in Latvia declined from 38.9% in 2004 to 19.0% in 2007 and then increased to 30.9% in 2010[4] (compared to 18.5% in Lithuania, 8.7% in Estonia and 8.8% for the EU average in 2010).

In Latvia income inequality and poverty have become topics of active public debate after the publication of investigations undertaken by the Baltic Center for Investigative Journalism Re:Baltica –"The Hidden Side of Latvia's 'Success' Story" (Spriņģe, 2012) and "The Invisible Side of Latvia's 'Success' Story: Life with 'God's Mercy and the Goodness of Others'" (Rizga, 2012). As argued by Spriņģe (2012), not only is Latvia generally characterised by a high level of income inequality, but what should be a main virtue of the benefit system is distorted in Latvia. Thus, in contrast to other developed countries "where social security means assistance for people in difficult circumstances and support for the needy", the Latvian benefit system allows for large benefits to wealthy households but often provides only meagre benefits to those who are really in need. Spriņģe identifies cases where the size of monthly child-related benefits can be measured in thousands of euros – in one particular case exceeding 16 thsd EUR per month. Moreover, this benefit was paid out in 2011, when the government had already introduced a "sliding" ceiling on the size of benefits, which stipulated that above a certain threshold only 50% of the benefit, to which a person is notionally entitled, is paid out.

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[4] Severe material deprivation is defined as inability to afford at least four of the following items: to pay rent, mortgage or utility bills; to keep the home adequately warm; to face unexpected expenses; to eat meat or proteins regularly; to go on holiday; a television set; a washing machine; a car; a telephone (Eurostat, Glossary) http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Glossary:Material_deprivation_rate

The Baltic International Centre for Economic Policy Studies (BICEPS) participated in the Re:Baltica project by estimating the distributional impact of some of recent tax and benefit reforms. In what follows we provide some of the results of these calculations that were performed using the Latvian part of EUROMOD tax-benefit microsimulation model[5]. In addition, here we present the results of an estimate of the distributional impact of austerity measures that were implemented in 2008-2012 and show that the impact was progressive, in the sense that higher income groups contributed relatively more to budget consolidation. At the same time, we also show that the distributional impact of the most recent reforms in personal income tax, which were designed and implemented after the end of the programme with international lenders, is likely to be regressive, despite the fact that the government had earlier committed to different reforms which would have had a more progressive impact. We argue that distributional considerations, especially assistance for those really in need, have had a low priority in designing tax and benefit policy in Latvia.

Increase in income inequality during boom years

"Fairness in relation to taxation has a long history in the economics literature. One of the basic principles of taxation since the publication of Adam Smith's *Wealth of Nations* in 1776, has been the individual's ability to pay, i.e. taxes raised to finance state expenditures should be related to each individual's ability to pay. Taxation according to the ability to pay has since gained more or less unanimous acceptance as an equity norm for tax design. The concept is however too general for concrete policy purposes since application of the ability to pay principle requires, …, specifying exactly how much each individual should be asked to contribute." (Vanags, 2010).

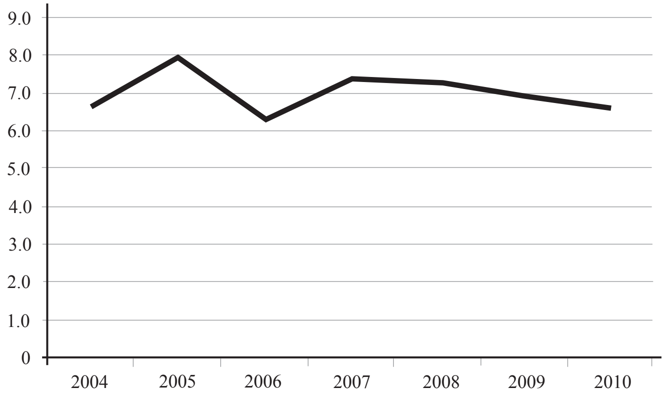
Both income inequality and poverty are influenced to a large extent by political decisions of the government mainly through treatment of tax policy using its redistributive function: countries with more progressive tax systems that redistribute more income have lower poverty rates (for example Denmark and Austria). Countries with lower redistribution have higher numbers of people within the low-income group (U.S., Latvia).

"Despite the accelerated public increase in public spending, prior to the crisis in 2007, Latvia had one of the lowest reductions in inequality due to government taxes and spending when compared to high-income OECD countries. The Gini coefficient for household income was 0.44 before and 0.35 after government taxes and transfers" (World Bank, 2010). In OECD on average the reduction in Gini is nearly 0.15 points. Therefore, disadvantages of highly redistributive tax-benefit systems (low work incentives, high administrative costs) are not likely to outweigh the potential gain from a reduction in inequality.

Income inequality in Latvia was increasing in the boom years. During that time, the top end of society and the middle class benefited more than the poor, as there are no statutory indexation rules for social transfers except for pensions and the growth of wages outpaced that of benefits. In 2007 inequality in Latvia was the highest among EU member states. The only year when income inequality slightly declined was 2006 (see Figure 1).

[5] EUROMOD is a tax-benefit microsimulation model for the European Union (EU) developed by the core developer team based mainly at ISER, University of Essex, and financially supported by the European Commission DG-EMPL. For more information on the EUROMOD, see: https://www.iser.essex.ac.uk/euromod

Figure 1. S80/S20 income quintile share ratio in Latvia in 2004-2010



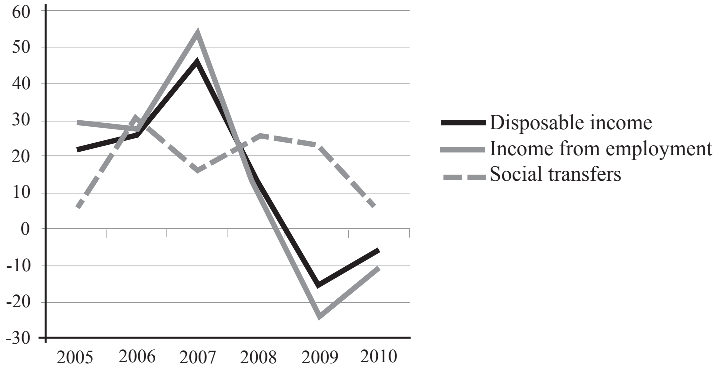
Source: Eurostat

Tax experts in Latvia have noted that the country has had very conservative tax policies and prior to 2010 the established system was beneficial for wealthy individuals and businesses but imposed a relatively large burden on employment income. Furthermore, Eurostat data show that the greatest share of Latvian government revenue was collected through indirect taxes, primarily sales taxes (value added tax (VAT)) that are added to the cost of food, clothing, or medicines – items people with low incomes spend most of their money on (Eurostat, 2012). In countries with more progressive tax systems, governments collect more from people with higher incomes through direct taxes on things like real estate, capital gains, dividends and interest income. In Latvia before the crisis, capital gains and other sources of capital income were not subject to personal income tax. Attempts to introduce a progressive tax system in Latvia have so far failed and suggestions to reduce the tax burden on labour and to increase the real estate tax that appeared as early as 2000 as well as proposals to tax dividends were ignored by politicians in the pre-crisis period.

The personal income tax rate in Latvia is flat and has remained unchanged at 25% for many years. Some progressivity of personal income tax is ensured by a non-taxable income allowance, which, however, is quite low: in 2007 it was 50 LVL (71 EUR) per month and the allowance for a dependent was 35 LVL (50 EUR) per month. Until 2010, dividends (as well as interest income and income from capital gains) were not taxed, which created strong incentives to receive compensation in the form of tax-free dividends rather than salary. For example, as shown by Spriņģe (2012), in the last ten years Latvian oligarch "Lembergs earned 14.8 million LVL from dividends and [interest on] bank deposits. If the dividend tax which was introduced during the crisis had been introduced ten years earlier, Lembergs would have had to pay nearly 1.5 million lats (2.1 million euros) in tax". It was also widespread to take advantage of the real estate business as the land tax was rather low and the law allowed ways of avoiding a range of other taxes (Spriņģe, 2012).

The pre-crisis period was characterized by an overheated labour market that stimulated strong growth of wages in both public and private sectors, while pensions and other benefits were growing more slowly. However, 2006 was a year of parliamentary elections which brought increases in social transfers (the main examples being introduction of additional payment to the childbirth allowance, permission for those in receipt of child-care benefit to work, a rise in the amount of the state social security benefit, which correspondingly increased the minimum guaranteed level of the old age pension) and as a result there was a slight reduction in inequality (see Figure 2).

Figure 2. Growth of household disposable income main components (per household member), % year-on-year



Source: Central Statistical Bureau

The increase in child related benefits was a major development in the field of family policy during the pre-crisis years. Until 2005 child-care benefit was independent of individual social security payments and was established at 90% of the minimum wage for persons with children below 1.5 years, and at 70% for those with children between 1.5 and 3 years.

As of 2005, this benefit was made earnings related: it was equal to 70% of the individual's average salary on which social insurance payments had been paid, but there were limits on the size of the benefit – it could not be less than 56 LVL and could not exceed 392 LVL (payable to either one of the parents). For socially uninsured persons child-related benefit amounted to 50 LVL per month. Initially child-care benefit was not compatible with employment, i.e., a person could only receive the benefit if s(he) was not working. From March, 2006, this restriction was removed. As of 2008, child care benefit for socially insured persons was replaced by an earnings-related parental benefit, which had a minimum level, but the ceiling on benefit size was removed. Thus, the benefit was very much larger for families with higher incomes than for poorer households.

Other child related benefits were also increased in the pre-crisis period: before 2006, parents received a one-off childbirth allowance of 296 LVL. Starting from 2006 additional payments of 100 LVL for the first child, 150 LVL for the second child and 200 LVL for the third and each additional child were introduced.

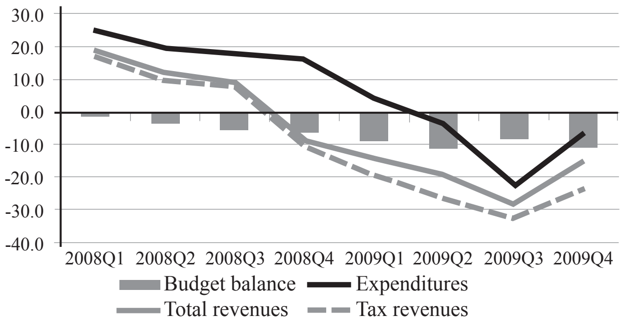
There is also a state family benefit which is not means tested: a flat monthly amount of 8 LVL is provided for the first child, and until the crisis the amounts for subsequent children were larger - 9.60 LVL for the second, 12.80 LVL for the third child, and 14.40 LVL for the fourth and each subsequent child.

As argued by Spriņģe (2012) "(t)he Latvian benefits system overall works largely in favor of the wealthy, allowing them to receive huge benefits, while people on small incomes receive the minimum benefit".

The crisis years: a reduction in inequality

Early in 2007, the government adopted an anti-inflation plan, which had as its main short-term goals: balancing fiscal policy, reducing speculative activities in real estate market and limiting expansion of consumer credit. Adoption of the plan and moderation of credit growth by the main banks triggered a gradual slowdown in the economy in 2007. By mid-2008, GDP year-on-year growth approached 0% (from growth in excess of 10% at the beginning of 2007), private consumption was down by 3.2%, imports plummeted by 7.9%. The fiscal balance quickly deteriorated as a result of modest tax revenues, and in the 3rd quarter of 2008 the situation was further exacerbated by the government's decision to nationalise the second largest commercial bank, Parex bank, which had faced a deposit run and had been unable to finance its syndicated loans. The deterioration in public finances is illustrated in Figure 3 where it can be seen that by mid-2008 revenue growth had declined to less than 10% (down from almost 30% a year earlier), while expenditure growth remained as high as 20%.

Figure 3. Year-on-year growth of general government budget total revenues, tax revenues and expenditures, %; seasonally adjusted budget balance, % of GDP

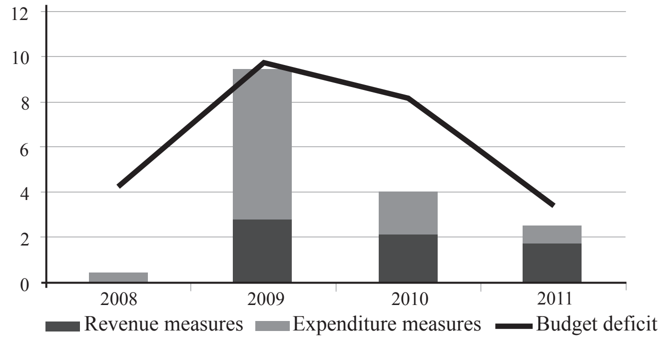


Source: Eurostat, authors' calculations

Faced with a rapidly deteriorating fiscal position and the situation in the global financial markets, the Latvian government sought financial assistance from international lenders. After negotiations in the autumn of 2008 Latvia was provided a 7.5 billion euro (about 1/3 of GDP) bailout facility from the IMF, the European Commission, the World Bank and the Nordic countries. The Latvian authorities took a firm position to proceed with the adjustment under a fixed exchange rate, despite estimates by lenders which suggested that this might result in a more protracted recession than in a scenario of widening exchange rate bands to the 15% range permitted by ERM2 (IMF, 2009a). As a consequence, the government had to accept especially strict and wide-ranging budget consolidation measures.

The total size of consolidation implemented during the programme was impressive: according to the Ministry of Finance (Ministry of Finance, 2012) the total size of budget consolidation measures implemented in 2008-2011 amounted to 16.6% of GDP, of which most (10% of GDP) consisted of expenditure cuts (see Figure 4). Under pressure from international lenders, consolidation was front-loaded, in 2009 reaching almost 10% of GDP. Although lenders were closely involved in controlling the structural reforms implemented, the exact mix of measures was proposed by the Latvian authorities.

Figure 4: Size of implemented consolidation measures and budget deficit outturn, % of GDP



Source: Ministry of Finance, Eurostat

The 2009 consolidation mainly consisted of expenditure measures, of which a major share consisted of cuts in the government wage bill, including both a reduction in the number of civil servants and wage cuts. On the revenue side, the government stuck to the goal of shifting the tax burden from labour to consumption, thus a major measure was an increase in the VAT rate, while at the same time the personal income tax rate for employees was reduced from 25% to 23% (for the self-employed it remained unchanged at 15%) and the non-taxable minimum and exemptions for dependents were raised. Another revenue-side measure introduced in 2009 was removal of ceilings on social security contributions. This measure was aimed at easing pressure on the social budget. However, it opened possibilities for abuse of contributory benefits, and, as shown by Spriņģe (2012) these possibilities were indeed exploited to obtain very high benefits.

However, when designing the 2009 supplementary budget, it became obvious that the economic forecasts underlying the 2009 budget were overly optimistic (GDP growth forecast 2.0%, unemployment 7.7% (Ministry of Finance (2008)), while in practice in the second quarter of 2009 GDP was down 17.9% year-on-year and the LFS-based unemployment rate reached 16.7%, with the implication that the reduction in labour taxes could not be sustained. As a result, the non-taxable allowance was more than halved (from 90LVL to 35LVL per month). As an additional measure to reduce budget outlays, the government attempted to cut pension expenditures and in June 2009 passed amendments to the Law on State Pensions, which stipulated that old-age pensions should be cut by 10% and pensions to working pensioners by 70%. This decision was strongly opposed by the public and on December 21, 2009, the Constitutional Court ruled that the government's decision was unconstitutional arguing that the state must guarantee peoples' right to social security. Moreover, from July 2009 and to the end of 2013, old-age pensions are not to be indexed.

In the 2010 budget, the personal income tax rate reduction was reversed and the rate was raised even above the pre-crisis level (to 26% for both employees and the self-employed, while for the latter the rate was previously 15%). Other major revenue measures included broadening the personal income tax base to include capital gains, dividends and interest and an increase in both the rate and the tax base of real estate tax. Although these reforms had been called for much earlier by international organisations (IMF, 2006) they had not been implemented by the government until pushed by severe revenue shortfalls. On the expenditure side, major cuts in the public wage bill continued. In addition, a number of benefit restrictions were introduced in 2010. First, a "sliding" ceiling was applied to a number of contributory benefits, including unemployment benefit, parental, maternity and paternity and sickness benefits. The ceiling stipulated that above a threshold of 11.51LVL per day, only 50% of the benefit, which a person is notionally entitled to, would be paid out. Yet, combined with abolition of the ceiling on social security contributions implemented earlier, this still permitted very large benefits for high earners. Another measure with respect to parental benefit was that working parents were no longer able to receive benefit. Second, supplementary payments to state family benefit and child birth benefit were abolished. Third, the amounts of maternity and paternity benefits were cut from 100% to 80% of the average contribution wage.

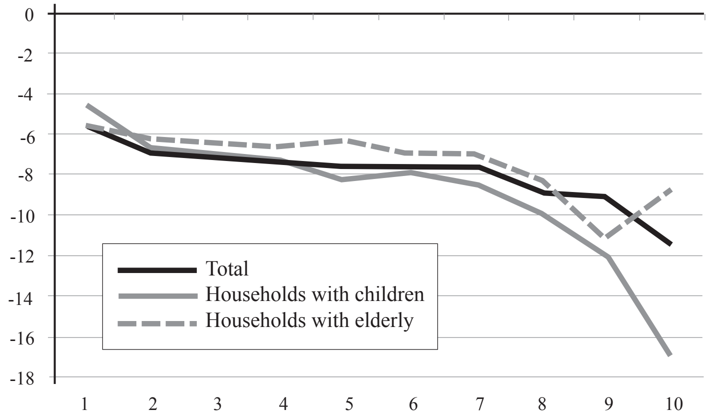
Finally, the 2011 consolidation mainly comprised revenue measures, the most important of which was a further increase in the VAT rate and an increase in employee social security contributions from 9% to 11%.

In what follows we present estimates of the distributional impact of selected budget austerity measures as described above. The estimates for Latvia along with other 8 EU member states have been done using the EUROMOD micro-simulation tax-benefit model (Avram et al, 2013). The measures that are taken into account in the estimation include the old-age pension freeze, the increase in social security contributions and personal income tax rate, broadening of the personal income tax base and removal of ceilings on social security contributions, the reduction in tax exemptions, the cuts and ceilings on child-related benefits, the removal of eligibility for employed parents for parental benefits, and public pay cuts. The distributional impact is estimated by comparing two scenarios: (i) the baseline scenario - simulation of the 2012 tax-benefit policy system (with austerity measures implemented), and (ii) the counterfactual scenario – simulation of the tax-benefit policy system that would have emerged in 2012 in the absence of austerity measures.

There are some limitations to the analysis. First, the EUROMOD input data used in this estimation exercise is based on European Union Statistics on Income and Living Conditions 2008 (with income data referring to 2007). The data are adjusted up to 2012 using updating factors based on the aggregate evolution of respective income categories according to national statistics. Second, only the direct impact of the measures is modelled, not taking into account possible secondary effects such as the behavioural response of people to reforms implemented. Figure 5 shows the estimated impact on household income by household type and by decile group.

The results suggest that the impact of the austerity measures was progressive in the sense that relatively well-off households experienced a proportionately larger reduction of household income. It should be kept in mind though that the input data come from household survey data which do not normally fully capture individuals who are at the extreme tails of income distribution. The progressivity of the impact is likely to be a consequence of ceilings introduced on contributory benefits and cuts in public wages. The effect of cuts in contributory child-related benefits is also reflected in the fact that for households with children the progressivity of the impact is stronger than on average for the whole population.

Figure 5: Estimated impact of austerity measures on household income by household type and by decile group, %

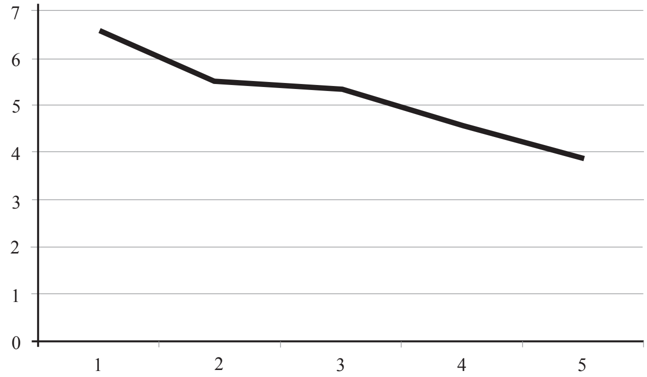


Source: Avram et al (2013)

The results presented above do not include the effect of the increase in VAT rates implemented as part of the crisis measures. This reform is likely to have an opposite distributional impact, i.e., poorer population groups, who spend a relatively large share of their income on consumption, are expected to be more sensitive to these changes. The effect of a change in VAT is hard to estimate, firstly because it requires information about the pass-through of a VAT change into prices. What we present below is an estimation assuming a 100% pass-through, which might be a reasonable assumption given that the change in VAT in Latvia was broad-based, in which case the pass-through tends to be higher (Institute for Fiscal Studies et al, 2011). Moreover, since our main purpose is to evaluate the distributional impact of the reform, the exact extent of the pass-through is not crucial: what is important is that the degree of the pass-through is equal across different groups of goods and services. We base our calculations on data about composition and structure of consumption expenditure by quintile from CSB published aggregate statistics from Household Budget Survey. We compare two VAT regimes – the 2011 rate and the 2008 rate, thus our estimation covers two VAT increases and we assume an unchanged consumption structure. We do not model the impact of the reduction in the VAT rate implemented in mid-2012 since we are looking only at budget consolidation measures implemented in response to the crisis. Figure 6 illustrates the calculated increase in the share of disposable income spent on VAT by income quintiles.

Our results suggest that the impact of the rise in VAT was, as might be expected, regressive: the share of income spent on VAT in lower quintiles increased more strongly than in the higher quintiles, thus increasing income inequality.

Figure 6: Estimated increase in the share of disposable income spent on VAT due to an increase in VAT rates in 2011 vs. 2008 by income quintiles, percentage points



Source: authors' calculations

The dynamics of the S80/S20 income quintile ratio suggests that overall income inequality in Latvia declined in the crisis years. According to Eurostat data, the S80/S20 income quintile ratio declined from 7.3 in 2007 (the highest ratio in the EU at that time) to 6.6 in 2010. In part, the reduction was due to the overall impact of the crisis. As shown by Bičevska (2012), higher wages fell more strongly than lower wages. Additionally, the employed population was more affected than pensioners as a result of the fall in wages (while old-age pensions were frozen) and of the increase in unemployment. However, the poverty rate in absolute terms, as measured by the share of severely materially deprived households, remains among the highest in Europe and increased strongly during the crisis from 19.0% in 2007 to 30.9% in 2010 (compared with 18.5% in Lithuania, 8.7% in Estonia and 8.8% in the EU on average in 2010). The mix of austerity measures implemented in response to the crisis was designed under considerable scrutiny and was generally supported by the international lenders. However, today some of the most recent reforms implemented by the government are leading in quite the opposite direction from the path supported by the lenders.

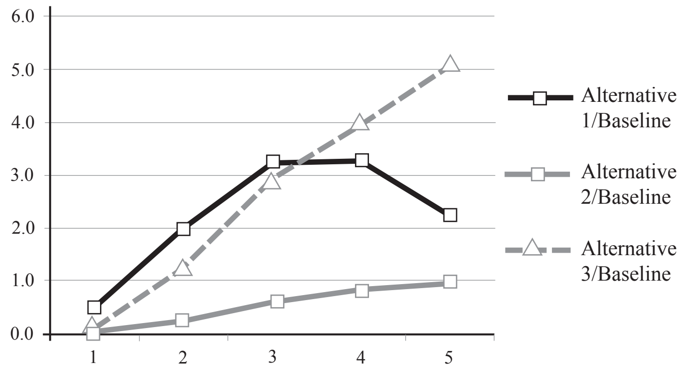
End of the programme with international lenders: distributional impact of newly proposed reforms

In December 2011, Latvia completed the programme with the international lenders, but continues a close policy dialogue with the IMF under post-programme monitoring. While positively assessing the progress achieved by Latvia in recent years and the return to economic growth, the IMF emphasizes that "(t)he 2012 budget, which aims for a deficit below 2.5 percent of GDP, demonstrates the authorities' commitment to fiscal discipline and to meeting the Maastricht criteria. However, alternative measures such as higher real estate tax, progressive personal income tax, and improved targeting of social benefits, might have proved less distortionary and facilitated a more sustainable adjustment. Continued high unemployment and poverty rates make it important to maintain a strong social safety net." (IMF, 2011).

In 2009, the IMF expressed concerns about the reduction implemented in the non-taxable income allowance, arguing that the impact of this reform is regressive (IMF, 2009b). The IMF generally supports "the goal of cutting labour taxes to stimulate employment but, given high marginal tax rates for low-income workers and to promote inclusion, its long-standing recommendations include: (i) raising the tax-free threshold rather than cutting the headline rate; (ii) introducing a progressive personal income tax; and (iii) introducing tax credits for net new hires, especially the long-term unemployed" (IMF, 2012). The tax rate for low wage earners in Latvia is one of the highest in the EU: the tax wedge for a single worker at two-thirds of average earnings in Latvia in 2010 was 41.5%, vs. 36.0% on average in the EU-27, 38.6% in Estonia and 38.9% in Lithuania (Eurostat, 2012). Nevertheless, in May 2012 the parliament urgently passed amendments to the law on personal income tax, which foresee that the personal income tax rate will be reduced by 1 percentage point as of 2013 and then gradually reduced to 20% by 2015. The tax allowance for dependents will be raised from the current level of 70 LVL per month to 80LVL per month as of July 2013. While the reduction in the tax rate as such is welcome, it has precluded the government from raising the non-taxable minimum and from introducing a more generous increase in allowances for dependents, despite the previous intention to raise the non-taxable allowance from the current 45LVL to 90LVL and to raise the allowance for dependents to 100LVL.

Figure 7 illustrates the estimated distributional impact of the currently implemented decrease in the personal income tax rate vs. the previously considered plans to raise the non-taxable minimum to 90LVL and to raise the allowance for dependents to 100LVL. The results suggest that the latter reform would have had a much more progressive impact.

Figure 7: 2012 personal income tax reforms - impact on average household net income vs. baseline by quintiles, %



Alternative 1: Increase in non-taxable minimum and allowances for dependents
Alternative 2: Reduction in personal income tax rate from 25% to 24% (effective Jan 1, 2013)
Alternative 3: Reduction in personal income tax rate to 20% (effective Jan 1, 2015)
Source: authors' calculations using EUROMOD

Another major reform which will come into force in 2013 and which raises concerns about the impact on socially least protected groups in Latvia are changes in the amount of, and the provisions for, the Guaranteed Minimum Income (GMI). GMI is the basic social assistance benefit and the reform will reduce the minimum level of GMI that local governments have to provide from 45LVL a month to 35LVL. The government argues that this will increase the incentive for job search. Given the already tiny level of guaranteed minimum income an improvement in work incentives through cuts in the tax burden for low paid workers or via provision of tax credits for new hires would be a more desirable option from the point of view of protecting the poorest population groups. Moreover, the other feature of the reform – the transfer of funding of GMI benefit from central government to the municipalities – is likely to cause "perverse incentives at the local level, and disparities in provision of these mandatory benefits across wealthy and poor municipalities. For this reason few EU and OECD countries retain decentralised financing of mandatory targeted benefits" (World Bank, 2010)[6].

Concluding remarks

Despite a period of reduction in the crisis years, income inequality in Latvia remains one of the highest in the EU. The poverty rate as measured by the share of severely materially deprived persons has increased strongly and is currently the second highest in the EU, much above the level observed in Estonia and Lithuania. This suggests that policies aimed at protecting the most vulnerable population groups and reintegrating them into the labour market should remain a genuine priority.

The reforms implemented during the recession did result in higher income households contributing more to budget consolidation. However, many of the reforms implemented in response to the crisis had been proposed much earlier (e.g., making capital gains subject to income tax, an increase in the rate and the tax base of real estate tax, avoiding too rapid wage bill growth in the public sector), thus in a way these anti-crisis measures were simply correcting previous policy failures.

Although not directly involved in designing the exact mix of anti-crisis policies, the international lenders played a major role in defining the direction of the reforms and ensuring protection of the poorest population groups. In some cases their role was decisive: for example, one of the reforms proposed by the government in 2009 but rejected by the lenders was to cut the non-taxable income allowance to 0 LVL (Eglītis, 2012). Some major reforms implemented by the government since completion of the programme with international lenders will have a regressive impact, despite earlier government commitments and lenders' recommendations. To conclude, we argue that there is a general lack of concern about income distribution in designing tax and benefit policy in Latvia and that protection of those in need has a low priority.

[6] World Bank (2010), "Latvia: From Exuberance to Prudence. A Public Expenditure Review of Government Administration and the Social Sectors," September 27, 2010.

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