Latvia is struggling to reduce the tax wedge for low income earners and to reduce the tax burden on labour

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For several years already, the EU, the World Bank and the OECD have emphasised the necessity for Latvia to reduce taxation on low-income earners by shifting it to other sources that are less detrimental to growth, and by improving tax compliance. The tax policy reform approved by the government in May 2017 goes in this direction. However, at the same time, the government has raised the compulsory state social insurance contribution rate to seek additional funding for healthcare, increasing thereby the tax burden on labour.

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Description

In comparison with other EU Member States, Latvia has high labour taxes and very low capital taxes. Effective tax rates on labour are high. The tax wedge on "low-wage earners" (defined as workers earning less than two thirds of the average wage) remains high at 41.9% in 2015, one of the highest rates in the EU (EU average: 37%) (Source: Eurostat). This weighs on economic activity and employment. At the same time, the aggregate burden of capital taxes in Latvia is low. Taxes on capital in 2015 reached 3.4% of GDP (the second lowest rate in the EU-28) while the EU-28 average rate was 8.4% of GDP (Source: European Commission, data on taxation). Latvia has the scope to reduce the taxation of low-income earners, a move which could be offset by increasing tax revenue from property and capital taxes. The EU (through its Country-Specific Recommendations), the World Bank and the OECD have stressed the need for Latvia to reform its taxation on labour by shifting taxes away from low-income earners, in order not only to boost employment and GDP growth, but also to improve income equality and contribute to tax compliance. Measures implemented so far (such as the reduction of the compulsory state social insurance contribution rate by 1 percentage point, raising the non-taxable monthly income minimum from €64.03 to €75.00, raising the personal income tax relief for dependents from €113.83 to €165.00 per month, the reduction of the personal income tax rate from 24% to 23% as of 1 January 2015) have had a limited effect on reducing the tax wedge on labour.

In May 2017, after more than a year of discussions with a number of policy stakeholders, the government approved proposals to reform the Latvian taxation system ("Basic Guidelines of the State Tax Policy for 2018-2021"). As indicated in this document, the reform proposals are based on an analysis of the proposals received from the social partners as well as the European Commission, the World Bank and the OECD. All these policy stakeholders highlighted the heavy tax burden on labour in Latvia, in particular for low-wage earners, as one of the key problems that should be addressed.

The approved lines of action to reduce the tax burden on labour include the introduction of a maximum differentiated personal income tax rate (20%, 23% and 31% depending on the size of one's income), raising the personal income tax rate on capital growth, raising the maximum differentiated non-taxable minimum and increasing personal income tax relief for dependents. These proposals are in line with the EU recommendation concerning the reduction of the tax ratio in labour costs for low-income earners.

Alongside with the development of the package of tax reform laws, the government is committed to developing

a new procedure for the funding of healthcare, establishing a link between the accessibility of healthcare services and the payment of state social insurance contributions. The draft law is to be formulated by the end of August, scheduling the introduction of the new procedure for healthcare funding as of 2018.

On 28 July 2017, the Saeima (parliament) approved the package of tax reform laws – a total of 11 draft laws scheduled to be implemented as of 1 January 2018.

Outlook & commentary

In June 2017, after lengthy and difficult discussions, the governing coalition decided to seek additional funding for healthcare by increasing the compulsory state social insurance contribution rate by 1 percentage point (increasing the employers' rate and the employees' rate by 0.5 percentage point each). This decision is in total contradiction with the government's aim to reduce the tax burden on labour and the related proposals it approved in May 2017. Information provided by the mass media reveals a lack of clarity even concerning the definition of the basic principles for the funding of healthcare; it also highlights contradictions with the initial declarations of the government and a possible shift in the planned time schedule. The most serious failing of the planned funding procedure is that even raising the state social insurance contribution rate (increasing thereby the tax burden) will not guarantee accessibility of healthcare services as attention is largely focused on the need to raise salaries for medical workers. Subsequently it can reduce the motivation to pay additional taxes.

The decision to raise the compulsory state social insurance contribution rate has resulted in a situation where incomes of households with two or more children and one income earner will not increase, but will instead decrease even if their earnings fluctuate around the average wage rate in the country. According to the estimates of the calculator developed by the Financial Institute of the Swedbank in cooperation with the Ministry of Finance, in 2018 the income of households with three children and one income earner will decrease in comparison with the current situation if the gross salary is less than €700 per month, while the actual income of a family with 4 children and one income earner will be lower if the salary does not exceed €885 per month. By comparison households without children or households with one child and one income earner will be in a better situation. Thus one of the aims of the approved taxation reform will not be met.

Further reading

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