Frankenstein Tax: the evolution of the solidarity tax in Latvia

ESPN Flash Report 2019/47

Olga Rajevska – European Social Policy Network July 2019

The solidarity tax introduced in Latvia in 2016, levied on earnings above the social contributions cap, was aimed at reducing taxation regressivity for high-earning workers. The original law has been amended, modifying the tax distribution scheme and strongly undermining the initial solidarity basis of the tax.

Description

In Latvia, the personal income on which social contributions are paid is capped. The cap is slightly less than 5 times the average wage. Due to the flat (23%) personal income tax (PIT), this system resulted in fairly regressive labour taxation: in 2015, the total tax burden (PIT plus social contributions) for an employee on the minimum wage (€360/month) was 40.4%, for someone on the average wage (€818/month) it was 42.5%, but with a €10,000/month wage it was only 32.5%. To counter this situation, the so-called *solidarity tax* was introduced in 2016, levied on the income above the cap applied for social contributions. As stipulated in the Solidarity Tax Law, the new tax was aimed at reducing taxation regressivity and mobilising resources to improve social protection and reduce inequality.

The social contribution rate is 35.09% of the gross wage (34.09% before 2018 [the additional percentage point was for healthcare insurance]), of which 24.09% is paid by employers and 11% by employees; reduced rates exist for certain groups including working pensioners, the disabled and the self-employed. The solidarity tax rate was set at the level of the applicable social contribution rate. The tax was collected by the State Social Insurance Agency and then transferred to the general budget (not earmarked). In this form, the law was in effect in 2016 and 2017.

Shortly after the law came into force in 2016, two lawsuits were filed in the Constitutional Court by the payers of the new tax. The plaintiffs claimed that the tax contravened the principle of equal treatment. They also claimed that it was not a tax but rather a social contribution - and thus that it contravened the individual principles of social insurance, as the increased contributions did not create rights to increased social benefits. In autumn 2017, the Court decided that the only discrepancy with the Constitution was the presence of different tax rates, and ruled that the Parliament must adopt a new tax rate regulation from 2019.

Meanwhile, the progressive three-level PIT was introduced in 2018 and social contributions were increased to 35.09%. The distribution of the solidarity tax was reshaped and the tax purposes set in the law were widened to include the financing of healthcare and pensions, and support to private pension funds. As a result of these legal amendments, from 2018 the tax became less progressive, and much more complicated for the State Social Insurance Agency to administer: 1) 10.5 percentage points (p.p.) of the 35.09% were recorded as PIT (i.e. the solidarity tax functions as an auxiliary instrument for collecting the PIT); 2) 1 p.p. was directed to healthcare financing; 3) 10 p.p. were forwarded to *individual* taxpayers' accounts in private pension funds (statutory funded pension schemes and voluntary schemes); and 4) the remaining share (typically 13.59 p.p.) was directed to the *non-individualised* pay-as-you-go (PAYG) pension budget.

In 2019, the solidarity tax rate was reduced to 25.5%: 10.5 p.p. are registered as PIT, 1 p.p. goes to the healthcare budget, and 14 p.p. are allocated to *individual* pension accounts in the PAYG scheme. The tax is paid fully by the employee alone.

The total number of solidarity tax payers is around 6,000 (less than 0.7% of all employees), and according to the Ministry of Finance, these people mainly work in financial intermediation, IT and legal services.

The government is considering a third reform of the tax system, which will be based on an assessment of the reforms that entered into force in 2018 and 2019.

Outlook and commentary

While the goal of reducing tax regressivity was successfully achieved in 2016 and 2017, the initial law did not provide a mechanism ensuring that the tax collected would be spent on the stated objectives of social protection and reduction of inequality. The money was spent on defence, privileged state pensions for the military, diplomats, judges, etc., and on teachers' wages (Judgment of the Constitutional Court of 19/10/2017).

In 2018, the tax in fact turned into quite a complex tool for 1) applying the new PIT scale; 2) forcing the taxpayers to increase their individual pension savings in private funds; and 3) financing healthcare. At the same time, the part of the tax that went to the PAYG pension budget did indeed enhance solidarity. The logic behind the changes in the Solidarity Tax Law shows that not only the plaintiffs, but also the government and the parliament perceive the tax as a social contribution, whatever the Constitutional Court has decided.

As different tax rates were ruled out by the Court from 2019, the government had planned to opt for the highest rate (35.09%), leaving the tax distribution unchanged. The Parliamentary Budget and Finance Committee rejected the draft and proposed to set the rate at the lowest limit (25.5%), excluding private pension funds from the tax beneficiaries. The members of Parliament criticised the tax vocally (calling it a "non-viable construct", a "Frankenstein's monster", a "patchwork", and "trash") and attacked the government for submitting the bill more than a year after the court verdict, when no time was left for discussion. At the same time, they agreed to examine the bill as a matter of urgency within one day. All the proposed amendments were consistently rejected, except for one very important proposal: adding the words "registered on individual accounts" after the words "pension budget", in practice eliminating all solidarity from the solidarity tax.

In Latvia, pension contributions make up 24.5%: 20 p.p. are registered on individual accounts, while the remaining 4.5 p.p. go to a non-personalised common pool; this is a very important mechanism for balancing the assets and liabilities in the highly-individualised pension system. Using the pool, pensions below the statutory minimum are pulled up to the minimum; more generous indexation rules apply to some of the most vulnerable groups, etc. If the share of the solidarity tax going to the PAYG pension budget had been directed to the common pool (as it was in 2018), it would have provided funding to improve the situation of the poorest pensioners. Instead, all solidarity from the tax was lost: although the pension budget now receives more money, this money cannot be used to increase the lowest benefits, but is reserved for future pensions of the most prosperous taxpayers. Given the longer life expectancy of high-income individuals, such a law has an opposite effect - in the long run, it redistributes money from poorer contributors to richer people within the pension system. So, in the end, who stands in solidarity with whom?

Hopefully, the tax reform which the government is considering will allow correcting the negative impact of the previous reforms.

Further reading

Latvijas Republikas 13. Saeimas rudens sesijas devītās sēdes stenogramma, 20/12/2018 [Transcript of the 9th meeting of the 13th Saeima of the Republic of Latvia autumn session], https://saeima.lv/lv/transcripts/view/511

Satversmes tiesas 19.10.2017. spriedums "Par Solidaritātes nodokļa likuma 3., 5., 6., 7. un 9. panta atbilstību LR Satversmes 91. panta pirmajam teikumam un 109. pantam" [Judgment of the Constitutional Court of 19/10/2017 "On the conformity of articles 3, 5, 6, 7 and 9 of the Solidarity Tax Law with the first sentence of Section 91 and Section 109 of the Constitution of the Republic of Latvia"], https://www.vestnesis.lv/op/2017/209.4

Author

Olga Rajevska (Scientific Institute of Economics and Management, Faculty of Business, Management and Economics, University of Latvia)

Quoting this report: Olga Rajevska (2019). Frankenstein Tax: the evolution of the solidarity tax in Latvia, ESPN Flash Report 2019/47, European Social Policy Network (ESPN), Brussels: European Commission.