The Latvian Economy

Tax reform in Latvia – a small but worthy step in the right direction

Tax reform package passed by the Parliament on July 27 involves changes to the labour, corporate, and excise taxes, as well as measures to combat shadow economy. Overall it is a move in the right direction, with more to be done. The reform will have a small but positive effect on the economic growth. A lot of the success will depend on the efficiency and responsiveness of tax authority and society’s willingness to cooperate.

Effect on households
- Net wage about 4-4.5 percentage points higher next year (especially for small and medium wage earners);
- Inflation 0.8 percentage points higher next year, significantly less than the net wage growth;
- Motivation to legalize envelope wages insufficient;
- Higher social security contributions for reduced income tax regime users (e.g., recipients of royalties and economic operators), stricter eligibility requirements for microenterprise tax regime in the short term increase tax burden, but is a needed step towards more sustainable pension system; more to be done.

Effect on businesses
- 0% corporate income tax rate for undistributed profit to push for more transparent corporate financial flows and improved investment activity in the medium term; together with a 20% (currently, 23.5%) tax on distributed profits to reduce the tax burden for most businesses, except a few large companies negatively affected by the discontinuation of most corporate income tax deductions (e.g. accelerated amortization)
- Minimum wage hike and higher social security contributions will increase labour costs, but pressure to increase gross wage likely to be a tad lower due to in general lower labour tax wedge;
- Labour tax wedge for sole earners still to remain the highest in the Baltics;
- Measures to combat grey economy, especially the extension of the reverse VAT charge, will make it harder to work in shadows.

Overall effect on the GDP growth and income inequality:
Higher consumption boosting economic growth in the short term, healthier business environment and increased investment activity; less income inequality within the working population.

Main risks:
Red tape, poor government communication leading to lack of cooperation from the society.
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Payroll tax reform

Competitiveness and income inequality at stake
Labour tax reform in Latvia is very much needed mainly for two reasons. One is to lower the tax wedge on labour towards that in Estonia and Lithuania – Latvia’s main competitors. Currently, Latvia has the highest tax wedge on labour (earners without dependents) among the Baltic countries, impeding new job creation and hurting competitiveness. The other is to reduce income inequality in Latvia – the fifth highest in the European Union (EU) in 2015.

Moving towards more progressivity
Starting next year, Latvia is moving to a more progressive personal income (PIT) tax system, where progressivity comes both from allowances and PIT rates. The reform stipulates that 20% rate will be applied to the first EUR 20 000 of annual gross labour income, 23% – to the next EUR 35 000 (income between EUR 20 000 and EUR 55 000), and 31.4% – to the remainder, i.e. annual income above EUR 55 000. It is important to note that the annual income exceeding EUR 55 000 will be taxed at a 23% rate at the pay-out time and 10.5 percentage points (pp) of the earners solidarity tax will be transferred to the PIT account, resulting in a total PIT rate of 31.4%. Hence, in this case introduction of a 31.4% PIT rate for large labour income will neither increase labour costs nor reduce net wage. In addition, capital gains will be taxed at a 20% flat rate as of next year (currently 0%, 10% and 15%), but no progressivity yet.

The social security contributions (SSC) will be raised by one percentage point (+0.5 pp for employers and +0.5 pp for employees) and amount to 35.09% as of next year. The SSC are currently paid on the first EUR 52 400 of annual taxable income. A solidarity tax of 34.09% is applied on the remaining part of labour income, and all the revenues are transferred to the basic budget. Starting next year, SSC
Next year non-taxable income threshold between EUR 0 and EUR 200, allowance for each dependent at EUR 200, minimum wage at EUR 430

Labour tax reform to boost the average net wage by about 4-4.5 pp next year

Net wage increases for monthly income up to EUR 4583; largest winners – small and medium wage earners

Labour tax cuts cannot help lowest wage earners; skills, jobs, labour mobility and local government support can

will be paid on the first EUR 55 000 of annual taxable income, and a solidarity tax of 35.09% (+0.5 pp for employers and +0.5 pp for employees compared to 2017) will be paid on the remainder. From next year on, the solidarity tax revenues will be earmarked. 10.5 pp of the tax will be transferred to the PIT account and 10 pp will be added to the person’s pension capital (second and/or third level).

The non-taxable income threshold will also become more progressive (between EUR 60 and EUR 115 in 2017) and vary between EUR 0 for monthly income above EUR 1000 (EUR 1100 in 2019, EUR 1200 in 2020) and EUR 200 (EUR 230 in 2019, EUR 250 in 2020) for monthly income up to EUR 440 next year. PIT allowance for each dependent will increase from EUR 175 to EUR 200 (EUR 230 in 2019, EUR 250 in 2020). The minimum wage will be raised to EUR 430 next year (currently, EUR 380).

Positive effect on consumption

According to our assessment, the payroll tax reform together with the minimum wage hike will add about 4-4.5 percentage points to the average net wage increase next year. The inflation effect from higher excise tax will eat up some of the wage increase, but not all, so that the reform’s net effect on the purchasing power will be positive. Consumption will speed up, boosting economic growth.

A higher non-taxable income threshold (for monthly income up to EUR 1000) and 20% PIT rate will translate into higher net wages for people earning up to EUR 4583 a month, with smaller wages seeing a steeper rise. Compared to this year, the net wage of people earning more will be a tad lower – dragged down by higher SSC and solidarity tax. For the latter group the introduction of a 31.4% PIT rate does not have any effect on the net wage as it is compensated by a corresponding reduction in the solidarity tax (after 10.5 pp are transferred to the PIT account). Moreover, if we take into account the modification of the solidarity tax, transferring 10 percentage points of the solidarity tax to the individual pension capital accounts, very large wage earners also benefit from the reform. The transferred amount, in fact, can be considered as a postponed wage, which if counted means that the very large wage earners gain as much as the small ones.

Wage earners with dependents will gain from a larger child allowance. However, very small wage earners, who already at the moment are not paying the PIT because the taxable amount after deducting the allowances exceeds the gross wage, will lose out. The net wage for this group will be smaller next year due to higher SSC. It is important to note, though, that tax changes per se cannot help these people. The solution lies in skill building, labour mobility measures, grey economy reduction, and local government support, such as, targeted real estate tax rebates, free school lunch programs for children, and funding of extra-curricular activities for children.
The net wage increase will take some of the pressure off employers to raise the gross wage

Competitiveness marginally improved

Higher SSC payments for the employer (up from 23.59% to 24.09%) will increase the labour cost. However, the increase in the net wage will most likely take some of the pressure (generated by tightening labour market) off the employers to raise gross wages as quickly as in the case with no reform. Hence, the labour cost increase next year will be a tad slower than it would have been without the tax reform, helping competitiveness.

The minimum wage hike has a twofold effect on business. On the one hand, higher minimum wage facilitates income legalization – smaller share of the wage is paid in an envelope. On the other hand, small businesses (especially in regions) often can only afford to pay a close to minimum wage including all the payroll taxes because that is the amount their employee earns for the company – this is how productive the worker is. These companies might not be able to cope with additional costs and could resort to sacking people, closing their business and/or sinking deeper into the tax evasion. Skill building and improving, export support measures, and labour mobility enhancing measures will be helpful in these cases.

The reform will succeed in reducing the tax wedge of annual gross wages up to EUR 55 000 (EUR 4583 per month) and slightly lowering the income inequality for the working population – the tax wedge curve is becoming steeper. The tax burden will decrease the most for workers with no dependents, i.e. young professionals. The graphs below show that as a result of the reform the tax wedge on labour in Latvia will become more similar to the situation in Estonia and Lithuania. Assuming that the neighbours do not change their tax policy, Latvia’s tax wedge looks very competitive for workers with one or two dependents, except for very high wages.

Proposed and already approved changes to the tax policy in Estonia and Lithuania (proposals intend more pronounced tax wedge reduction in LT but the probability that they will be approved is small) indicate that the neighbours are also pushing their tax wedge lower. Hence, the increase in Latvia’s competitiveness within the region will be marginal. Currently, it looks like we will still have the highest tax burden on workers without dependents. For workers with one or two dependents the tax wedge will be higher than in Estonia, but similar to or lower than in Lithuania.
Thinking about more sustainable pension system

According to the Ministry of Finance, about 200 thousand workers operate under reduced income tax regimes (e.g., recipients of royalties, economic operators (saimniecīšķās darbības veicēji), employees of microenterprises) and contribute very little to their pension. These people either operate under a tax regime that requires no mandatory SSC or the amount they pay is so small that it does not cover even for the minimum pension. Thus, the share of population depending on others to pay their pensions is too big, posing both political and fiscal risk.

The tax reform envisages that some of these groups will have to pay slightly more in SSC from next year on. In addition, the reform introduces changes to the microenterprise tax regime, narrowing the number of eligible businesses (maximum annual turnover limit will be decreased from EUR 100 000 this year to EUR 40 000 as of next year) and limiting the number of microenterprises a person can work for to one (as of 2019). As some of these companies and employees move to a tax regime with fully taxed labour income, the stress on the pension system slightly eases. No doubt, this will increase the tax burden for the businesses/people involved, but the move is absolutely necessary for ensuring adequate social security coverage.

As we welcome these policy changes and believe this is a step in the right direction, the approved changes are still insufficient to guarantee the sustainability of the social security and in particular pension system given the shrinking and ageing population. Moreover, while the approved changes to the microenterprise tax regime reduce the number of qualifying businesses, they do not prevent the regime to be used solely for tax optimization purposes. It is crucial to keep the number of these enterprises as low as possible so that only those for whom the tax regime is actually designed (for starting new businesses) can use it because the social security contributions paid for the employees are too small.

Corporate income tax reform

Profit underreporting hurts business environment and investment

The deepness of the last crisis was approximately the same in Latvia and Estonia, but the share of overdue loans (slightly above 20% in Latvia vs. only about 8% in Estonia) was much greater in the former largely because of different corporate cultures. Profit hiding, scheme building and tax avoidance, whether illegal or legal-ish, is more pronounced in Latvia. SSE Riga Shadow Economy Index suggests that about 80% of businesses underreport their true profit. Such companies have less skin in the game and are less motivated to save their business during a crisis. They walk out on their suppliers, which then walk out on their business partners, making the whole business environment distrustful and unhealthy. Poor equity makes it hard to finance investment and expand.

Essence of tax changes

The corporate income tax will be increased from 15% to 20%, with 0% rate applied to undistributed profit. Most of the corporate income tax (CIT) deductions (e.g. accelerated depreciation) will be removed. With the new regime the tax advance payments will be discontinued.

Positive effect on business environment in the medium term

Tax burden for small and medium sized enterprises will be lower. Currently, the distributed profit is taxed twice – 15% CIT on profit and 10% on dividends, resulting in an overall 23.5% rate. However, the tax burden will go up for businesses, mainly large companies, which have been able to pay less in taxes due to application of different tax breaks. In addition, the discontinuation of advance payments will increase the funds at the disposal of businesses, potentially leading to higher investment activity.

It is futile to expect that the corporate income tax reform will bear fruit quickly and provide a massive boost to investment immediately. However, in the medium term the financial flows of businesses could become more transparent, leading to healthier business environment, larger investment activity and consequently economic growth. The government has provided a carrot to the small and medium sized businesses, but no major change will happen without a thorough work of the State Revenue Service in eradicating illegal business practices.
Excise duties

In search of the lost budget revenues

Excise duties have been increasing over time and were set to rise in 2018 as well, even without the tax reform in place. Excise duties serve as a way to discourage consumption of the levied products and ensure budget revenues. However, the tax reform envisages steeper excise duty hikes than planned before. Apart from the two main goals mentioned above, the tax reform foresees steeper excise duty hikes as a way to compensate for lost government revenues stemming from labour and corporate income tax reform. The Ministry of Finance estimates that excise tax duty hikes will bring in additional EUR 57 million each year.

In 2018, the sharpest rise in excise duties will be for alcohol. The excise duty for beer will increase by half and by close to one-fifth for wine and hard liquor. Over 2019-2020 excise duties for alcohol products will increase by around 10% each year. Thus, by 2020 the excise duty for beer will have almost doubled from EUR 4.5 per 100 litres in 2017 to EUR 8.1 per 100 litres in 2020, while for wine and hard liquor they will have increased by half compared to the current rates. Excise duty for cigarettes will have increased by around one-fifth between 2017 and 2020, with two hikes planned – one in 2018 and one in 2019. Excise duties for fuel will also be hiked twice over the tax reform horizon. Excise duty for both unleaded petrol and diesel will grow by 9% in 2018 with the following hike intended in 2020.

Among the Baltics, excise duties in Latvia are moderate

Currently excise duties are mostly the highest in Estonia. Higher duties can be explained by Estonia’s proximity to wealthier Finland. Due to ease of travelling some Finns buy excise products in Estonia, where they are cheaper. Contrary to Estonia, excise duty rates in Lithuania are mostly the lowest. Thus, in most of the cases Latvia’s excise duty rates are in between those in Estonia and Lithuania.

The available information for 2018-2020 shows that Estonia will continue to have the highest excise duty rates in most products. Uncertainty persists with respect to excise duty rates in Lithuania. While duties for cigarettes and fuel are likely to stay lower in Lithuania, duties on alcohol will most likely rise above those in Latvia. To limit alcohol consumption, Lithuanian government has increased the legal age for buying alcohol from 18 to 20, placed a full ban on alcohol advertising and further limited hours of selling alcohol. These changes will come

1 In further analysis excise duties on beer, wine, hard liquor, cigarettes, unleaded petrol and diesel are considered.
into effect on January 1, 2018. Efforts to curb consumption most likely will be accompanied with excise duty hikes.

**Faster wage growth will outweigh higher inflation**

Excise duty hikes increase prices of levied products and prices of goods and services that use levied products immediately both for businesses and households. Companies that are involved in alcohol and tobacco production and fuel selling business are most affected by excise duty hikes. Additionally, such industries as transportation, logistics and transit to which fuel, a levied product, is a significant cost component can also be quite extensively affected. Higher costs push firms to raise prices, which pose risks to cost competitiveness, especially for exporters, but current economic situation is favourable for moderate price increases. Higher costs also boost inflation. Faster inflation reduces consumer purchasing power and slows consumption growth.

Excise duty hikes pose a risk to drive away consumption of levied products to neighbouring countries where duties are lower, thus reducing firm and government revenues. Because of this risk it is important not to overlook plans in the neighbouring countries, especially the two Baltic States. Harmonising rates with Russia and Belarus is challenging as the EU rather strictly defines the application and rates of excise duties. Besides, Russia and Belarus have visa travel regime and different currencies which further complicate official trade. Smuggling is and will remain an issue to some extent.

**Shadow economy**

**Fighting shadow economy in the spotlight**

Shadow economy continues to be one of the most pressing issues in Latvia, losing government millions of euros in budget revenues, impeding growth and worsening income inequality. SSE Riga Shadow Economy Index estimates show that shadow economy mounted to 20.3% of GDP in Latvia in 2016. The incidence of shadow economy is decreasing, but it still remains higher than in Estonia and Lithuania (15.4% and 16.5%, respectively). Among the biggest sources of shadow economy in Latvia are firms hiding revenues in order to avoid corporate income tax and firms paying envelope wages in order to avoid labour taxes and social security contributions. Among industries, the biggest share of shadow economy remains in construction sector.

Apart from that, in 2018 the reform envisages several complementary measures for fighting grey economy which according to the Ministry of Finance estimates will bring additional EUR 159.5 million in budget revenues. The reform widens the spectrum of industries to which reverse value added tax (VAT) charge is applicable. A reverse VAT charge has proven to be an effective way in dealing with VAT fraud. Up to now, it has been applied to business-to-business service transactions in six industries, including several construction services and mobile phone deliveries. As of 2018, reverse VAT charge will be applied to household equipment, game console, construction material and metal product deliveries as well as all construction services. The reverse VAT charge will account for a bit more than a third of the additional revenues.

Success of several other measures greatly depends on the State Revenue Service’s ability to strengthen institution’s capacity to collect taxes. For instance, the threshold for mandatory information declassification in VAT declarations between registered VAT payers is lowered from EUR 1430 to EUR 150. Similarly, in order to tackle envelope wages, banks will be obliged to hand information to the State Revenue Service about individuals who turn over more than EUR 15 000 in their bank accounts in a year. Both measures provide the State Revenue Service with potentially valuable information on possible tax fraud and avoidance, but they require massive data processing and ability to go after and penalize the ill-doers. Moreover, the latter measure might not have the desired effect as envelope wages and
illegal transactions rarely go through bank accounts. In that case it has a potential to increase red tape to banks and state institutions without real effect on shadow economy.

**Summary**

The tax reform is a move in the right direction with a slight but positive impact on the economic growth. The largest part of the working population will benefit from the net wage increases, especially the small and medium wage earners. The reform’s contribution to the average net wage growth is about 4-4.5 pp next year. Higher excise taxes will result in about 0.8-0.9 pp higher inflation in 2018, taking away some of the wage growth effect, but overall the purchasing power will improve, supporting consumption. The labour tax wedge will decline as a result of the labour tax reform but will still remain above those in Estonia and Lithuania given their recent plans on tax cuts (especially for sole earners, much less for cases with dependents). Minimum wage hike and higher social security contributions will lift labour costs, but the pressure to increase gross wages will slightly fall, helping competitiveness. Although at some short term cost, businesses will gain from the measures targeting shadow economy. At the same time the motivation to legalize envelope wages and to come out of the shadows might be insufficient. The 0% rate for reinvested earnings is expected to make corporate financial flows more transparent in the medium term, propelling investment activity. However, the tax burden for companies actively using tax breaks will likely increase.

Main risks to the reform are increase in the red tape, potentially undermining efficiency of the tax authority, and poor communication of the reform measures and objectives by the authorities, leading to lack of cooperation from the society.

Although the tax system clearly matters for the economic growth, it is not the only part of the equation. In order to achieve higher growth, economy needs efficient high-quality education and health system, regional development, efficient judicial system, eradication of grey economy and corruption.

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