

# TAX POLICY IN THE CONDITIONS OF CHANGING ECONOMY: NEW CHALLENGES AFTER CRISIS

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## Abstract

The aim of the research is to analyze the tax policy and its influencing factors in the changing conditions of the economic development, to estimate the influence of the tax policy of Latvia on the employment and the state budget revenues and to define and substantiate the necessity for further changes of taxes. The task of the research is: to investigate the influence of crisis on the socio economic environment in Latvia; to analyze the coherence between the tax reform and the influencing factors in the changing economic conditions; to estimate the influence of the tax changes on the employment and the state budget revenues as well as to give recommendations for the improvement of the tax policy in Latvia. In the research the following qualitative methods are used: studies of the scientific publications on tax policy issues, the method of analysis of special cases, as well as the methods of statistical analysis: dynamic row analysis, graphic depiction of data and its analysis. The conclusions, which were drawn as a result of the research and the proposed changes in the tax policy, will promote the stabilization of the socio economic situation..

**Key words:** tax policy, tax revenues, tax reforms

**JEL Code:** E6, H21, H3

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## Introduction

In the conditions of changing economic development during the last years the governments have faced new challenges of the stabilization of economic development and the increase of the welfare of inhabitants. The crisis has substantially changed the socio economic environment in many countries, especially in Latvia. Launching the international credit programme Latvia undertook the obligations to take measures to decrease the budget deficit. In 2008 the government started the budget consolidation. Totally, in the period from 2008 to 2011 the consolidation measures have been implemented with the fiscal influence of 16,6%

from GDP, from which the revenues make up about 6,6% from GDP but the expenditures make up about 10% from GDP. In 2009 the budget deficit was -9,1% from GDP, in 2010 - 8,1%, in 2011 -3,5%, in 2012 -1,4% and in 2013 -0,9% from GDP. As a result of these measures the income of the inhabitants considerably decreased, the unemployment increased, a widespread emigration began, the shadow economy expanded, the social inequality and the need for social benefits increased. In order to solve the above mentioned problems the government of Latvia has made several significant changes in the tax policy but the expected results have not been achieved. The necessity of improving the tax policy in Latvia and the topicality of this issue has determined the motive and choice for this research.

The tax policy is one of the most efficient instruments of the activities of the government, the use of which one way or another affect all the individuals of the society and all economic activities. The tax policy is often dealt with by the researchers and there are always new theoretical and practical conclusions about the efficiency of the application of the tax instruments and their influencing factors. Studying the tax policy of the EU memberstates during the crisis the author Hanna Lierse (Lierse, 2012) emphasises that the main changes have affected the tax base. In the research it is indicated that, in order to achieve a better result, it is also necessary to use the tax rate. In the tax policy, which is a part of the state strategy, the strategic goals of the taxation and the tasks to achieve them are usually defined along with definite instruments of the solution which can be changed according to the internal and external factors. In the tax policy the flexibility of the defined tasks and the application of instruments are especially important as well as the capability to respond to the external and internal changes of conditions.

The last years of the economic development are characterized by particular cyclic fluctuations as a result of which the economic and social consequences were caused and they make the governments think about new challenges of the tax policy in order to create the conditions for the economic regulation as well as for the ensurance of the state budget revenues and the decrease of the inequality of the income of inhabitants. In his research Paul ZAI has justly pointed out that each country started its fight against the economic crisis in its own way, some of them with discretionary measures to induce an increase of the public revenues and a decrease of public expenses, while others have chosen policies centered on fiscal consolidation (ZAI, 2012). The readjustment of the tax policy to the new changing economic conditions have also been studied by Ho, Alfred Tat-Kei; Niu, Meili (Ho Alfred & Meili, 2013). The problems of the tax administration and the influencing factors of the taxpayers behaviour have been studied by Keith Walsh (Walsh, 2012). In the research it is justifiably indicated that the taxpayers behaviour and the attitude towards taxes is largely influenced by

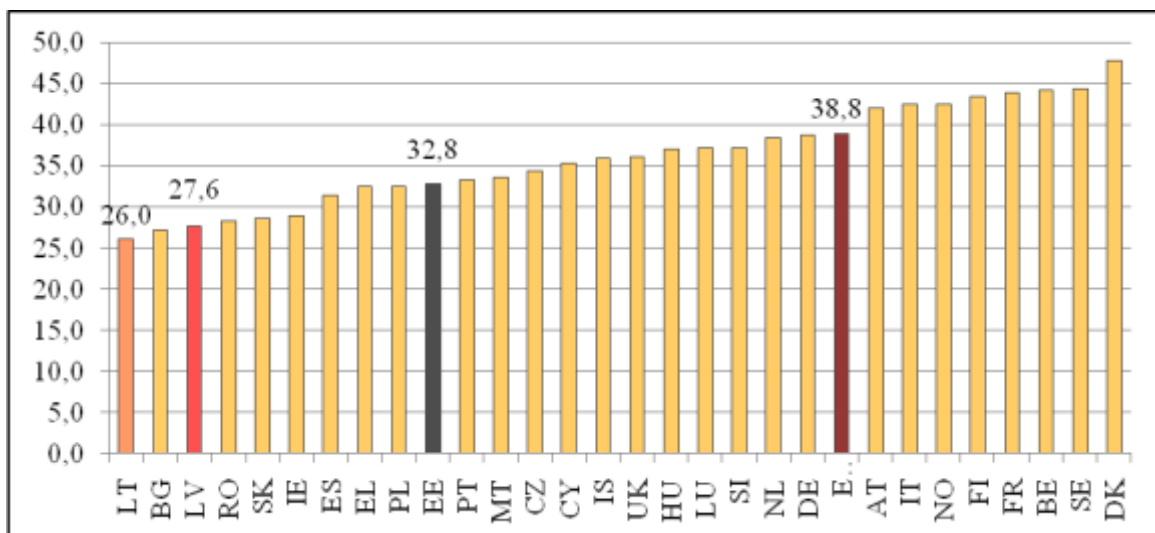
the state policy. There are also other studies in the international and national publications but along with the changes of the economic situation we must find new ways of the tax policy.

## 1 The socio economic environment in Latvia after crisis

Investigating the socio economic situation after crisis in Latvia we can define new tasks: to restrict emigration, to facilitate the formation of the budget revenues, to reduce the social inequality, to stimulate the reduction of shadow economy, to improve the tax administration.

If we analyze the taxes in Latvia according to the tax proportion of GDP, then we have an impression that the taxes are low and therefore, the problems do not exist. Among the memberstates of the EU the tax burden in Latvia is the third lowest and after the tax changes for the year 2014 there is a trend to become even lower.

**Fig. 1: Tax burden in the European countries in the year 2011, % from GDP**



Source: (Taxation trends in the European Union., 2013)

Despite the fact that the tax burden is low there is still the demand of the society for lower taxes. The author considers that a further reduction of taxes can lead to the deadlock: on the one hand there is a demand for lower taxes but on the other hand the society expects that the government will perform their functions and the financing in different areas will increase. One must not forget that an important argument for the historical roots of taxes was to create the funds in order to satisfy the common needs of the society, namely, the fiscal function of taxes. The government of Latvia has set the goal to retain the tax burden in the amount of one third from GDP and so the present situation can become a problem to ensure the budget revenues. Estimating the tax burden, it seems that we must speak about particular tax groups and the balance of them, as well as about the taxpayer groups. The question is whether the tax

burden is divided evenly among the taxpayer groups and also among direct and indirect taxes. Analyzing the situation in Latvia we can ascertain a clear predominance of the tax burden on labour over the common tax burden which accounts for 44% from the workforce costs and it is one of the highest indicators in EU. Totally, the taxes on labour (Personal Income Tax and Mandatory State Social Insurance Contributions) in 2013 accounted for 14.1% from the common tax burden (27.5%). This indicator demonstrates the main problem of the tax policy in Latvia, i.e. unproportional tax burden division among the taxes to be collected.

Understanding the fiscal meaning of the employment tax, the author considers that the policy of the employment tax must be changed very cautiously and it should be done in a complex way together with other reforms of the socio economic policy and the improvement of the tax administration.

One of the factors after crisis, which must be taken into account in order to make the tax policy, is a significant reduction of the number of employees. The reduction of the number of employees can be explained by several factors caused by the crisis: downsizing of the production during the crisis; the increase of the illegal employment due to the sharp cut of wages; the manpower drain to seek a better life, etc. We must lay a special emphasis on emigration because the emigrants are mostly young people of working age as a result of which the age structure of inhabitants in Latvia has dramatically changed. So, after crisis the number of taxpayers has significantly decreased but the social need for pensions and benefits has increased.

**Tab. 1: The dynamics of the number of emigrants and imigrants in Latvia in the period of 2006 till 2012**

Years	2006	2007	2008	2009	2010	2011	2012
Emigrants	17019	15463	27045	38208	39651	30311	25163
Imigrants	8212	7517	4678	3731	4011	10234	13303

Source: (Starptautiskā ilgtermiņa emigrācija samazinās, pieaug imigrācija, 2013)

The international migration of inhabitants, its pros and cons have already been extensively studied for many years and we know several theories of the world migration: Stalker P. (Stalker,P., 2008); Ravenstein E.G. (Ravenstein E.G.,1985); Lee S. (Lee,S.,1966); Hugo J. (Hugo,J., 1993). Studying the migration theories more extensively we can make a conclusion that the process taking place in Latvia which began during the crisis fully corresponds to the statements in the theories that one of the basic factors of emigration is an economic inequality. Besides, after joining the EU there are big possibilities for migration which is

connected with the freedom of movement. The research proves that the migration has positive and negative consequences as to the economy of the manpower „donor” countries as well as the economy of the manpower receiver countries. In the case of Latvia we can mostly speak about emigration because the data proves the predominance of the emigration over immigration. The negative influence of emigration on the economy and the society as a whole manifests itself in different ways:

1. the enterprises suffer losses because they do not make the planned profit due to the lack of workforce. Besides, the costs increase in connection with seeking new employees and their training because it becomes more difficult to find specialists in several areas;
2. there are the revenues not received in the budget which could be earned by the emigrants for the state economy. Firstly, they are the tax revenues not received in the state and local budgets, secondly, it is the decline of the domestic demand and thirdly, it is the downturn of production;
3. the cash flow which flows into the economy, sent to Latvia by most of the emigrants, promotes the increase of inflation because the demand increases which is not based on the increase of GDP;
4. among the emigrants there are predominantly young people at the child-bearing age which negatively influences the birth-rate and the natural population growth of Latvia. As a result of this, an unfavourable age proportion develops and the load of the social budget becomes greater. Therefore, the sustainability of the social security system can be endangered;
5. the government spends a lot of money on the training of specialists but as a part of them leaves the country, then we can speak about a ”brain drain”, the invested money does not give positive results for the economy, the investments do not pay off.

## **2 The tax revenues not received**

In this research the author is interested in the influence of emigration on taxes, therefore, on the basis of certain assumptions and the legislation of Latvia the calculations were made about the taxes not received from the wages due to emigration. The calculations were made using the data base of the Central Statistical Bureau (CSB) about the number of emigrants according to the age groups of 20-24, 25-44 and 45-64 in the period of 2008-2012 (the period of crisis). The assumptions were used for each age group: at the age of 20-24 the people work in Latvia, receive the minimum wage, they have no dependents; the people of the age 25-44 work in Latvia, receive the average wage, they have one dependent; the people of the age 45-64 receive an average wage, they have no dependents. In the calculations the following points

stated by the law were taken into account referring to the relevant age groups: the indicators of minimum and average wages, the rate of personal income tax and mandatory social insurance contributions, nontaxable income minimum and the tax relief for dependents. The results of the calculations are depicted in the following table.

**Tab. 2: The results of the calculation about the employment taxes not received due to the emigration from 2008 until 2012, mlj LVL**

Years	2008	2009	2010	2011	2012
The employment tax revenues not received	51.2	67.1	72.3	61.7	54.0

Source: authors calculations

Totally, in the given period the budget did not receive approximately 306.3 mlj LVL or about 2% to 4% from actually collected labour taxes which is a big amount for the budget of Latvia. Although the obtained results are approximate because of the assumptions, they clearly demonstrate the existing problem. Besides, we must point out that the emigration continues, therefore the government of Latvia must work hard on the solution of this problem. The author agrees with the opinion expressed in the research by the economist M.Hazans (Hazans M., 2011) that the majority of emigrants will not return to Latvia, that is why the government must change the highlights of the state policy which up to now were focused on the return of emigrants to Latvia by means of different benefits. Presumably, the attention must be focused on the tax and benefit reforms with the aim to create a socio economic environment in the country in order to attract the attention of investors, to develop the entrepreneurship and to stop further emigration.

Substantial losses of tax revenues are also due to the shadow economy. During the crisis the average wage sharply decreased along with a proportional increase of the employment tax burden. The employers often draw up the job agreements for the minimum wage stated by the law (in the year 2014 it is 320 euro per month) but the other part of the wage is paid in the envelope not paying taxes. According to the information of the Ministry of Welfare, at present 39% of the employees pay taxes from the minimum wage. Besides, there is also an illegal employment when the labour relations are not regularized.

Based on the data of the State Labour Inspectorate about the facts of the disclosed illegal employment and using the previous methodology of calculation the author found the fiscal

effect of the disclosed illegal employment on the budget, i.e. the tax revenues not received in the budget.

**Tab. 3: The results of the calculations by the author about the tax revenues not received as a result of illegal employment in the years 2007-2012**

Years	The number of enterprises surveyed	The number of the disclosed illegally employed people	The tax revenues not received calculated by the author mlj.LVL
2007	4000	2846	6.86
2008	4500	1623	4.55
2009	5000	1211	3.20
2010	3100	1823	4.97
2011	3100	2958	8.42
2012	3000	3002	8.90

Source: authors calculations

The situation can be estimated as alarming because it is a big amount for the Latvian budget, the lack of which is mostly felt by the local governments. Besides, this is only a part of revenues not received, the calculation of which is only a small part of the enterprises surveyed. As the capacity of the tax administrators is apparently not enough to improve the situation, the government must take measures, as a result of which the employers are willing to come out of the shadow economy and the employees do not agree with unregistered labour relations. The government has considered the option to increase the minimum wage and since 2014 it has already slightly increased (tab.4). On the employees` part it is a positive act because this way the people with low wages are protected. However, we must emphasise that the minimum wage is taxed by the employment taxes and so the neto wage is one third lower and it does not cover the basic needs of the inhabitants. The minimum wage must be increased but at present it must be done very slowly and cautiously, because for the employers it means the increase of taxes without tax reforms, as the taxable base would increase.

### **3 The improvement of the tax policy**

The author suggests to use other tax policy instruments to solve the problem, i.e. the nontaxable income minimum and the tax relief. The author considers that these tax policy instruments have not been appreciated in Latvia for long years and, besides, during the crisis

there were socially and economically unjustifiable changes made in these indicators that can be demonstratively seen in the table.

**Tab. 4: The nontaxable minimum of the personal income tax, tax relief for dependents and minimum wage per month in Latvia from 2008 - 2014, LVL**

Years	2008	2009	2010	2011	2012	2013	2014
Nontax.inc.min.	80	90	35	45	45	45	52
Relief for depend.	56	63	63	70	70	70	116
Min. wage per month	160	180	180	200	200	200	230

Source: (Likums par iedzīvotāju ienākuma nodokli, 1993)

Although the government decisions under the crisis were connected with the requirements of creditors referring to the budget consolidation, they are not justifiable because the biggest load was imposed on the inhabitants.

Before the crisis the government began to work on the family protection policy and the increase of the relief for dependents was also initiated but during the crisis the positive dynamics stopped and until 2014 there was no tangible progress. We must positively assess the decision about the sharp increase of the amount of money for the relief starting from 2014 but at the same time the author considers that it has been done too late because the initial negative effect has already set in. So, the government tax policy has not been well-considered and flexible. Although the amount of the tax relief is the amount of tax revenues not received in the budget, in general it has a positive effect on the development of the society: the social justice is promoted, birth-rate increases, the shadow economy is reduced, the confidence in the government policy increases. However, we must point out that the tax relief is envisaged only for the families with dependents, they are not available for the whole society.

The nontaxable income minimum is considered to be a more important instrument of the tax policy and it has a greater influence on the socio economic development because unlike the tax relief, the nontaxable minimum refers to all the working people. With the increase of the part of the nontaxable minimum the net income of the inhabitants increase, the purchasing power and the overall standard of living go up. It is important to emphasise that as a whole the nontaxable minimum decreases the burden of the employment taxes for the employers and stimulates them to come out of the „shadow”, i.e. the amount of envelope wages is reduced. As a result, the budget is also a winner. With the increase of the nontaxable minimum it is possible to substantially improve the financial situation for the part of the society with low



income. As to the nontaxable minimum in the given period, the data prove that the government has acted in total contrast to the above mentioned explanation. The nontaxable minimum has experienced a dramatic fall and nothing has changed up to now. The author considers that it is a big mistake in the tax policy which, together with the decisions about the tax relief, has caused several above mentioned consequences for the development of the society in the period after crisis – social inequality, shadow economy, and it has also increased the lack of confidence to the government, etc. The nontaxable income minimum in Latvia has a symbolic meaning but not a real social meaning, so, we can say that, in fact, the government does not use this instrument, which is not right. The data in the table show the comparison with other countries.

**Tab. 5: The nontaxable income minimum in the European countries in 2010, euro**

Country	Nontaxable minimum per year	Country	Nontaxable minimum per year
Austria	11000	Italy	0-1840
Belgium	6430-6690	Lithuania	0-1637
Bulgaria	-	Luxemburg	11265
Cyprus	19500	<b>Latvia 2014</b>	<b>900</b>
The Czech Republic	983	Malta	8500
Germany	8004	The Netherlands	1987
Denmark	5756	Norway	5363
Estonia	1725	Poland	778
Greece	12000	Portugal	2970
Spain	5151	Romania	0-700
Finland	0-650-3570	Sweden	1389-3634
France	5875	Slovenia	3100-6120
Hungary	0-665	Slovakia	0-3556
Ireland	1830-3666	Great Britain	7619

Source: (LR FM informatīvais ziņojums - iedzīvotāju ienākuma nodokļa atvieglojumi., 2011)

The data vividly show a drastic difference of the situation of Latvia from the most part of the countries even taking into account that from the year 2014 this amount has been increased.

The author recommends that during 2-3 years the nontaxable minimum should be nearer to the minimum wage. The differentiation of the nontaxable minimum is also possible depending on the level of income which could increase the progressivity of taxes and the social justice. Increasing the nontaxable minimum the state and local government revenues could slightly decrease but in the average term the social inequality will be reduced because

the real income of inhabitants will increase, the shadow economy will be restricted because the costs of the workforce will decrease and as a result of the increasing demand there will be the increase in employment and the economic activity. Eventually, the amount of the tax revenues in the budget will increase.

## Conclusion

The author hopes that the proposed changes will decrease the burden of the labour tax for the employees and also for employers which is an important aim of the tax policy in the conditions after crisis. In the research the necessity for a sharp increase of the nontaxable amount of the personal income tax has been substantiated, but it is advisable to refrain from essential changes in the tax rate. The author considers that in such a way the social justice towards the people with low wages will be respected and the budget revenues will cause no negative fiscal effect. This approach is also advantageous to the employers because the taxable base is decreased which will stimulate the development of the entrepreneurship.

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