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Possible Improvements of Personal Income Tax in Latvia

Ivars Avotiņš
Docent Commerce department
Turiba University
Riga, Latvia
Ivarsaaa@gmail.com

Gita Avotiņa
Ph.D. student
Turiba University
Riga, Latvia
avotinag@gmail.com

Rosita Zvirgzdiņa
Head of Commerce department
Turiba University
Riga, Latvia
rosita@turiba.lv

In the European Union lot of taxes are as equal between the Member States as possible to the extent of interests of each Member State. At the same time there are some taxes that can make a big competition between countries. Personal Income Tax is the tax that affects competitiveness between the Member States, including between Latvia, Lithuania and Estonia. This was especially relevant in 2023 and is becoming more and more important in 2024, when many international companies are choosing a country to build their central office or manufacture in the Baltic region or make decision on continuation or extension of presence in the particular country. Thus, in addition to various other aspects, competition for workforce is impacted by tax rates applied to personal income having direct impact on each individual and interests. The balance between interests of the state and private individual is being managed via amendments in legislation which are also based on theories.

The methods applied in this study are literature review and regression analysis. They help to assess Latvian progress in comparison to Lithuania and Estonia via method of comparison analyses development and relationship among strategic indicators of Personal income Tax development in Latvia. Due to confirmation of authors analyses expertise assessment method is used.

The most popular theory on the issues is connected to "The Laffer Curve" and the two effects on revenues: the arithmetic effect and the economic effect. Thereby, the practical aspects of competition for higher salaries and number of residents needs to be highly evaluated by minimizing the risk of decrease of income and lack of expected result.

Keywords: Income Tax, Taxation systems, Tax in Latvia

I. INTRODUCTION

Since ancient times tax issues have faced conflicting opinions, conflicting interests and goals. Interests of private persons are usually strived to be balanced with the interests of the public sector, having regard of the vision of public development of the national economy, economic growth or the social and ecological aim in the specific territory.

At the same time the operation in particular geographical territory shall attract the private sector to conduct business, develop and maintain infrastructure, employ employees. These interests shall be balance with the necessity to provide the public sector with a certain amount of money and employees.

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More than thirty years have already passed since restoring of the independence the tax system has been maintained in the territory of the Republic of Latvia. There have been several reforms, usually with the aim of improving the system and obtaining a relatively logical balance between the development of the business environment, social policy, employment, the country's economic environment, infrastructure development and other factors. At the same time, in the case of Latvia, as an open economy which is also a member of the European Union, it is essential to be equal to an investment-attracting economy, especially compared to the neighboring countries.

Along with the other factors, Latvia's economy is not isolated from the rest of the world, which also means the impact of global events on the economy, as well as a certain set of actions in cases where global events or challenges occur.

If changes in global prices or other events can be considered as finite and long-term transitory challenges,

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where in some cases tax adjustments must be made for a certain period, then at the same time there is a global long-term vision (global direction) in the direction of sustainability. It is the vision of the United Nations to reduce the confounding issues of ecological and social problems to make the planet Earth suitable for habitation and living from the point of view of human existence[10].

Looking at taxes from the point of view of their optimal taxation, the foundations can be traced back to around 1970. [1]] In particular, you can look at the question - at what point should taxes be different depending on the applicable asset, and at what point should they be unified.[2] An important prism of taxation is from the question of whether taxes should be linear, or when they should aim to be non-linear - basically progressive. An important turning point in the review of these theories was the creation of A. Laffer's curve, which made it possible to look at the tax issue not only from the point of view of taxation and the theoretical approach of social justice - the largest beneficiaries pay more, but also from the point of view that higher taxes, expressed in percentage terms, do not always ensure higher budget income, which, as a result, can be used to achieve national goals more quickly or with better quality.

Many authors have described the correlation between the tax burden and tax revenue in the budget since A. Laffer's research. A fairly common use is the “Laffer Curve,” named after an economist who visualized the idea that the amount of tax revenue may not coincide with a function of an increasing tax rate. According to Laffer, tax rates have two effects on tax revenue – the arithmetic effect and the economic effect. The essence of the arithmetic effect is that when the tax is increased, the income will increase proportionally, and when it is reduced, it will decrease proportionally. The economic impact has the opposite effect, because by reducing the tax, wages will increase, which will motivate even more to receive funds legally and, as a result, the amount of taxes will increase. Similarly, by increasing taxes, their payable amount will decrease.[3]

The purpose of the research is to develop proposals for the improvement of Latvian labour taxes from the perspective of small and medium-sized companies, recognizing the most important tax aspects of Lithuania and Estonia, which are strongly supported by the governments or in which Latvia has unused advantages.

This is especially relevant in 2024 and onwards, when many international companies are choosing a country to build their central office for the Baltic region and representative offices in other countries. The number of employees employed in representative offices is usually significantly smaller.

II. Materials and Methods

Measurement of Tax Systems and possible improvements in the systems are relevant in any country in the world. At the same time each of the neighbouring countries are the ones that are making their country as attractive as possible to international investors in comparison to other countries in the region.

As the cost of labour is one of issues that is analysed by the international companies, the need for tax analyses and the best possible tax system for being attractive to investors shall of importance.

The compilation of tax from year 2020 till 2024 was made to understand the current situation. At the same time in theory the effect of tax changes and the total government tax income changes are analysed by a lot of scientists, and each time in each specific situation different suggestions are made.

At first theoretical approaches are described by the analyses of theories. From that the authors made data analyses with comparison method. That lead to suggestions that needed appropriation from the experts of tax field as expert assessment method.

As there are a lot of issues to improve in the case of Latvia, to attract more educated human capital with bigger tax income at the later stage, authors made the best possible suggestions from the results that were approved by the majority of experts and in some cases even with improvements from expert comments and suggestions.

III. Results and Discussion

Application of Personal income tax in Latvia since 1994 up to now is governed in accordance with the law "On personal income tax" [6].

Table 1 Summary of personal income tax rates [8]

<table>
<tr><th>Country</th><th>Year</th><th>Minimal sallary, EUR</th><th>Till EUR 20004</th><th>From EUR 20004 till 78100</th><th>Above EUR 78100</th><th>Above EUR 101094 *[3]</th></tr>
<tr><td rowspan="5">Estonia</td><td>2020</td><td>584</td><td rowspan="5" colspan="4">20%</td></tr>
<tr><td>2021</td><td>584</td></tr>
<tr><td>2022</td><td>654</td></tr>
<tr><td>2023</td><td>724</td></tr>
<tr><td>2024</td><td>820</td></tr>
<tr><td rowspan="5">Latvia</td><td>2020</td><td>430</td><td rowspan="5">20%</td><td rowspan="5">23%</td><td colspan="2">31,4%</td></tr>
<tr><td>2021</td><td>500</td><td rowspan="4" colspan="2">31%</td></tr>
<tr><td>2022</td><td>500</td></tr>
<tr><td>2023</td><td>620</td></tr>
<tr><td>2024</td><td>700</td></tr>
<tr><td rowspan="5">Lithuania</td><td>2020</td><td>607</td><td rowspan="5" colspan="3">20%</td><td rowspan="5">32%</td></tr>
<tr><td>2021</td><td>642</td></tr>
<tr><td>2022</td><td>730</td></tr>
<tr><td>2023</td><td>840</td></tr>
<tr><td>2024</td><td>924</td></tr>
</table>

*Calculated as 60 average monthly salaries (in 2020 as 84 average monthly salaries), 2022 – 90,426 EUR; 2021 – 81,162 EUR; 2020 – EUR 104,277.60.

Despite continuingly having one law in Latvia, its application and the applicable rates have changed significantly over the time. In the case of Latvia, the last significant changes are related to the year 2018, when the progressive PIT rate has been introduced in opposite to the fixed rate of 23% applied until then.

The fact that the minimum wage differs among the three Baltic states and in the case of Latvia it is the lowest, creates significant differences between the countries. However, the lower minimum wage does not simultaneously mean the lowest tax application. Comparing the personal income tax rate of Latvia and Estonia, it is clear that the rate in Estonia is lower than in Latvia, while at the same time it is higher in Lithuania.

TABLE 2 PERSONAL INCOME TAXES AS A % OF GDP[9]

Year	*2018*	*2019*	*2020*	*2021*	*2022*
Estonia	5.442	5.516	6.016	6.825	6.3
Latvia	5.974	6.448	5.951	5.981	5.794
Lithuania	4.248	7.215	7.281	7.506	7.643

Looking at the amount of income tax and social contributions as a percentage of GDP, it is clear that regardless of the period, in the case of Latvia, it is lower than the indicators of Lithuania and Estonia. This confirms that the tax reform of 2018 has had a relatively small effect in the short term, when in 2019 the amounts are relatively close, but in 2021 there is a significant gap in terms of revenues for Estonia and Lithuania.

Swedbank expert Evija Kropa has calculated the total impact: "If it is assumed that an employee earns 1,500 euros per month before paying taxes without registered dependents, you can count on 1,097 euros "on hand" in Latvia. In Lithuania, such an employee would receive 120 euros less salary, or 977 euros, and in Estonia - 147 euros more, or 1244 euros." In addition, the total payment must be taken into account: "if the salary "on paper" is 1,500 euros, the employer pays another 507 euros in taxes in Estonia, 354 euros in Latvia and 27 euros in Lithuania. In the case of middle incomes, the highest total tax burden still remains in Latvia (41%), followed by Estonia (38%) and then Lithuania (36%).[4]

TABLE 3 EMPLOYER COSTS VERSUS EMPLOYEE INCOME [7]

	Neto income	*Employer costs*	*Bruto income*	*Income vs payment*
Estonia	1’500	2’007	1’244	62%
Latvia	1’500	1’854	1’097	59%
Lithuania	1’500	1’527	977	64%

To have an understanding of the opinions of specialists, interviews with scientists and focus groups, experts and certified tax specialists have taken place and answers received from:

Dr. oec. Anatolijs Prohorovs – author of the monograph "Corporate income tax in Latvia and Estonia (2017)";

Andris Jaunzemis – certified tax consultant, partner of SIA TaxLink Baltics;

Jānis Zelmenis – managing partner of BDO Latvija, author of the publications "If we don't think in the long term, only bad news awaits us with the decreasing number of taxpayers (Delfi, 19.07.2021)" and "Global CIT reform and Latvian interests (Dienas Bizness, 12.07.2021)";

Marina Bičkovska – certified tax consultant.

The opinion of experts was:

Anatoly Prohorovs: "Introduce a fixed PIT rate and by setting the fixed rate at 20%. By excluding the progressive rate and introducing linear. In the event that the introduction of a fixed rate of 20% is not possible, then introduce a regulation that is no more unfavourable than in Estonia and Lithuania, i.e. raise the thresholds from which the increased rate is applied."

Jānis Zelmenis: "Until 2018, there was a fixed PIT rate in Latvia, but from January 1st, 2018, a progressive PIT rate system was introduced in Latvia. The goal of the reform was to reduce the labour tax burden, especially for low-income workers, to increase the income of the working population and to reduce income inequality. Therefore, in our opinion, there is no need or justification to return to the fixed PIT rate.

Our proposal is, however, to continue the progressive system of PIT rates, but to divide the income thresholds according to a principle that takes into account, for example, the amount of the minimum wage, the amount of the average wage in the country, wages above the average level, high wages."

Andris Jaunzemis: "Personally, I do not think that the progressive system is demotivating for high salaries. Any employer will take into account the impact of PIT on the net salary when determining a higher salary. Accordingly, the employee will hardly feel it. Here we should look at what kind of system is offered by the countries with which we compete - Estonia and Lithuania. If they do not provide for the progressive system, then we should at least adapt our system to the systems of other countries so that we are competitive. If it is foreseen, then it should be evaluated so that we are not the most expensive in the Baltics, because the opportunities to attract the workforce and the costs of companies greatly affect it."

Marina Bičkovska: "I believe that in the case of Latvia, the progressive tax rates are applied to too low income threshold, thus encouraging the choice of highly qualified professionals to move to countries with lower taxes, which generally has a negative impact on the economy in Latvia.

Thus, a possible solution would be the introduction of a fixed rate to simplify accounting and ensure Latvia's competitiveness with other countries within the scope of PIT rates.

As an alternative, the thresholds of the progressive rate can be reviewed, however, in this case it should be taken into account that after the times of COVID, the rhythm of work in many industries switched to the remote work mode and there is a tendency for citizens to change their place of residence, having also evaluated the impact of taxes before that. "

The opinion of the authors in this case corresponds with the opinion of Andris Jaunzemis and Marina Bičkovska from the point of view that in the case of

Latvia higher tax than in neighbouring countries should not be introduced, thus decreasing the position of competitiveness. Although compared to Lithuania and Estonia the volumes are similar compared - in the conditions of regional competition, from total numbers it can be seen that an international investor will choose to hire employees in Estonia or Lithuania, rather than in Latvia, because of the lower PIT rate and, as a result, lower overall labour costs. The opinion of Jānis Zelmenis is supported in the event that the progressive application of PIT is maintained, because in this case it is important that as the economy and the total GDP grow, the PIT thresholds should also be proportionally increased. The options proposed by Jānis Zelmenis are also grounded PIT rate is linked with4 determined number of minimum wages or average wages. The average salary does not include the income of the shadow economy and thereby the actual numbers of average salary doe not correspond to real situation in market, while minimum salary is a constant unit. By applying the average salary, on the one hand it motivates to pay a larger amount of salary, but on the other hand it also demotivates certain part of taxpayers to pay more because of the statistic data of the shadow economy.

TABLE 4 CALCULATION OF MARGINAL VALUES AFTER MINIMUM WAGE AND INFLATION [5];[6]

Year	*Min. wage EUR*	*Marginal value by minimum wage EUR*		*Marginal value by inflation EUR*	
		Lower	*Higher*	*Lower*	*Higher*
2018	430	20004	55000	20004	55000
2019	430	20004	55000	20524.1	56430
2020	430	20004	55000	20984.2	57695
2021	500	23260.47	63953.49	20884.18	57420
2022	500	23260.47	63953.49	22524.5	61930
2023	620	28842.98	79302.33	27225.44	74855
2024	700	32564.65	89534.88	27385.48	75295

From the calculation, it can be seen that the upper limit value is similar, regardless of the methodology. At the same time, the lower limit value has not changed since the beginning of 2018.

IV. CONCLUSIONS

Results:

1) Until 2017 (including), the PIT rate was fixed at 23% in Latvia. Since 2018, there is an existing system with a progressive PIT rate in Latvia.

2) Estonia has a fixed PIT rate of 20%, and if the rate is higher in the case of Latvia, the motivation will remain not to employ Latvian residents in Latvia, but to employ Estonian residents in Estonia.

3) As a result, since 2018, PIT revenues in Latvia compared to GDP are lower than in Lithuania and Estonia (before the reform they were higher than in Lithuania and Estonia).

4) Looking at the tax thresholds, if the highest threshold has been revised twice and is proportionally equivalent to changes in the minimum wage or inflation, then the lower threshold has not been revised and increased since its introduction.

Suggestions:

1) By cancelling the application of progressive PIT and returning to a fixed PIT rate, taxpayers who receive income in the amount subject to application of the highest PIT rate (including wages), would be less motivated to optimize costs and consider distribution of income in alternative ways. Although the authors initially proposed to introduce a fixed 23% PIT rate, after receiving expert opinions and arguing (Latvian taxes cannot be viewed separately from Estonian and Lithuanian taxes) that any rate higher than 20% gives Estonia an advantage over Latvia, the authors propose to introduce a fixed 20% PIT rate, similar to Estonia;

2) In the event that a fixed PIT rate is not introduced, and Latvia continues to be in a worse position than Estonia, the thresholds should be adjusted according to inflation. Inflation from January 2018 to March 2023 is 38.6%, but the amounts of income to which the progressive PIT rate of 23% is applicable have not changed. The rate is 31% from January 2022 - inflation 23.1%:

o 20,004 * 1.386 = 27,725, rounded to EUR 30,000;

o 78 100 * 1.231 = 96 141, rounded to 100 000 EUR.

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