INCENTIVES TO ENTER THE LABOUR MARKET IN LATVIA

Anna Pluta

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SUSTINNO

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The focus of the study

Personal Income Tax reforms: came into force since January 2016

- introduction of the regressive non-taxable minimum,
- increase in the amount of the allowance for dependents,
- solidarity tax charged on high salaries

The aim of this paper is to analyse a number of reforms of the labour tax system that came into force since January 2016 with respect to their effect on the changes in incentives to enter the labour market.

Financial incentive to work

Incentives to start working paid job is measured by **PTRs** – the proportion of total gross earnings that would be taxed away because of taxes, SIC and benefit withdrawal when a person enters employment.

Calculation of PTRs

- 2 approaches:
  - calculated only for those who are already in work and have income
  - to predict the hypothetical wage rates for those actually not working on the basis of the observed workers' wage rates.
- taking into account all the interdependencies between incomes of all members of the household
- computed dividing all the population by deciles of the equivalised disposable income distribution

Methodology: what is Euromod?

- EUROMOD is a static microsimulation tax-benefit model
  - Deal with income
  - Re-calculate income components (taxes and benefits) under different assumptions (policy reforms, macroeconomic changes)
- EU-27 countries are covered
- A unique model – EUROMOD is built for all EU countries using unified methodology, which allows for cross country comparison of the model output (financed by DG-EMPL)
- Based on micro level representative national data (EU-SILC for Latvia)

Discussion of the Results

Prediction of the hypothetical wage rates

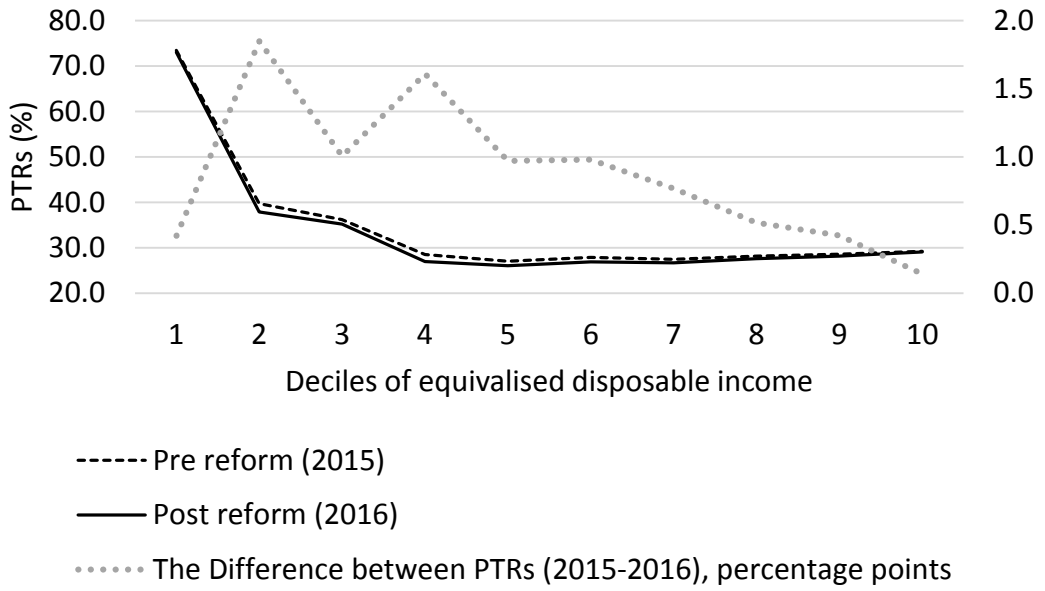
Table 0.1.

Potential Wage for the Unemployed computed via Heckman Two Step Wage Regression

Source: Author's computations using EU-SILC 2012 data (2011 income)

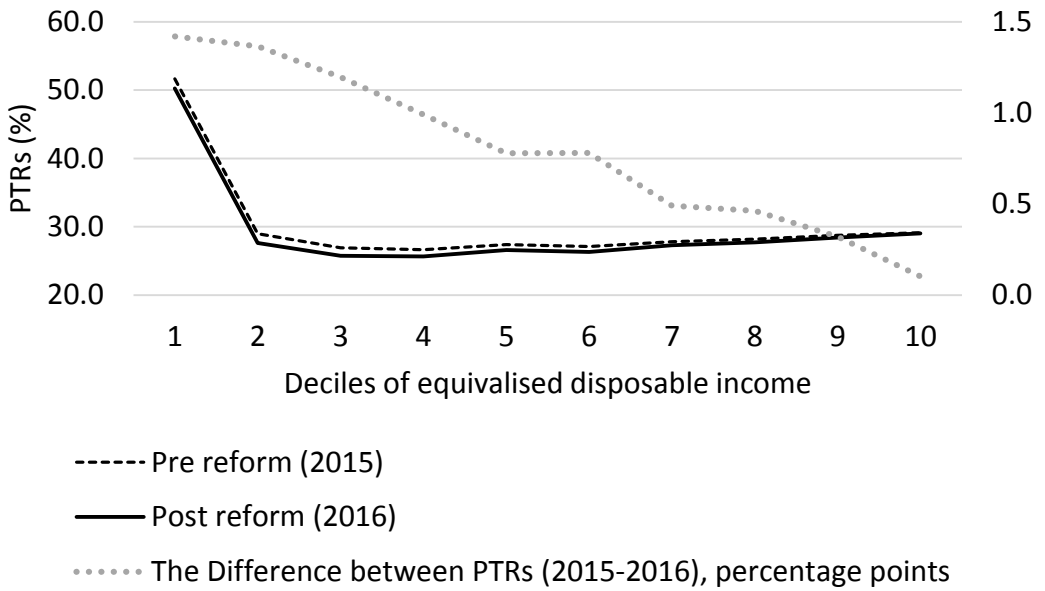
	Coeff.	p-value
Employment income (ln)		
Primary Education (ref. Tertiary Education)	-0.9471	0.000
Secondary Education (ref. Tertiary Education)	-0.6154	0.000
Male (ref. Female)	0.1264	0.000
Age	0.0889	0.000
Age^2	-0.0025	0.000
Age^3	0.0000	0.000
Constant	5.6708	0.000
Employment status		
Male (ref. Female)	0.1500	0.000
Region: Degree of urbanisation – cities (ref. Thinly populated area)	0.1723	0.000
Married (ref. Single, Divorced, Widowed)	0.0749	0.000
Number of children below age of 2	-0.0689	0.084
Age	0.2714	0.000
Age^2	-0.0046	0.000
Age^3	0.0000	0.000
Secondary Education (ref. Primary Education)	0.9725	0.000
Tertiary Education (ref. Primary Education)	1.3897	0.000
Other income in a household	0.0001	0.000
Constant	-5.1553	0.000
Lambda	-1.3808	
Number of obs.	15165	
Censored obs.	8486	
Uncensored obs.	6679	
Wald chi2 (6)	673.42	
Prob>chi2	0.0000	

Has the tax reform implemented since January 2016 affected the work incentives?



Source: author's calculations based on EU-SILC 2012 using EUROMOD-LV

Fig. 1. **Pre and Post reform distribution of PTRs in Latvia by deciles of equivalised disposable income in 2015 and 2016, computed only for those in work**



Source: author's calculations based on EU-SILC 2012 using EUROMOD-LV
Note: The hypothetical wage rates for those actually not working are predicted using Heckman two stage estimation method.

Fig. 2. **Participation tax rates in Latvia by deciles of equivalised disposable income in 2015 and 2016 computed taking into consideration both employed and unemployed**

Has the tax reform implemented since January 2016 affected the work incentives? [cont.]

	No. of observations	Mean	Std.Dev.	Min	Max
Observed employment income (ln)	6679	5.423	1.228	3.337	9.199
Predicted employment income (ln)	6679	5.361	0.398	3.518	6.303

Heckman post estimation

Source: Author's computations using EU-SILC 2012 data (2011 income)

An approach of calculation of PTRs	PTRs are computed only for those in work		Employed and unemployed or inactive are taken into consideration	
	2015	2016	2015	2016
Mean	31.98	31.14	29.19	28.46
Median	28.69	28.23	28.53	28.07
p25	25.16	23.76	25.69	24.45
p75	31.08	31.08	29.87	29.81

Table 0.2.

PTRs in Latvia in baseline 2015 system and change due to reform in 2016 - mean, median, p25 and p75, %

Source: Author's computations using EU-SILC 2012 data (2011 income)

Has the tax reform implemented since January 2016 affected the work incentives? [cont.]

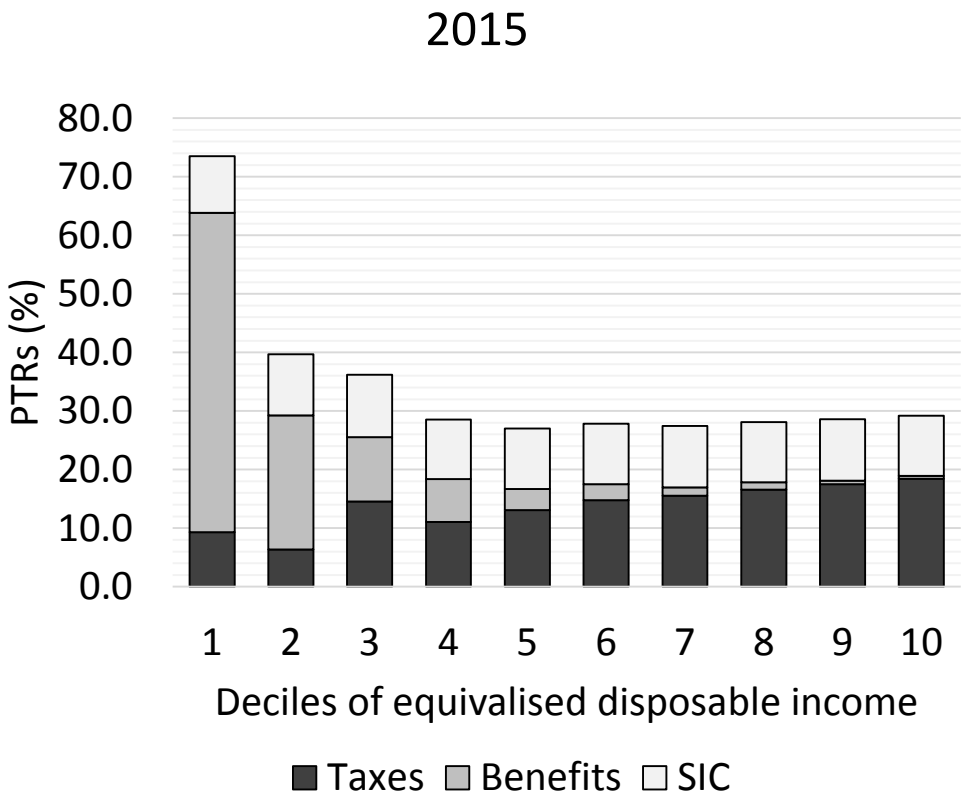
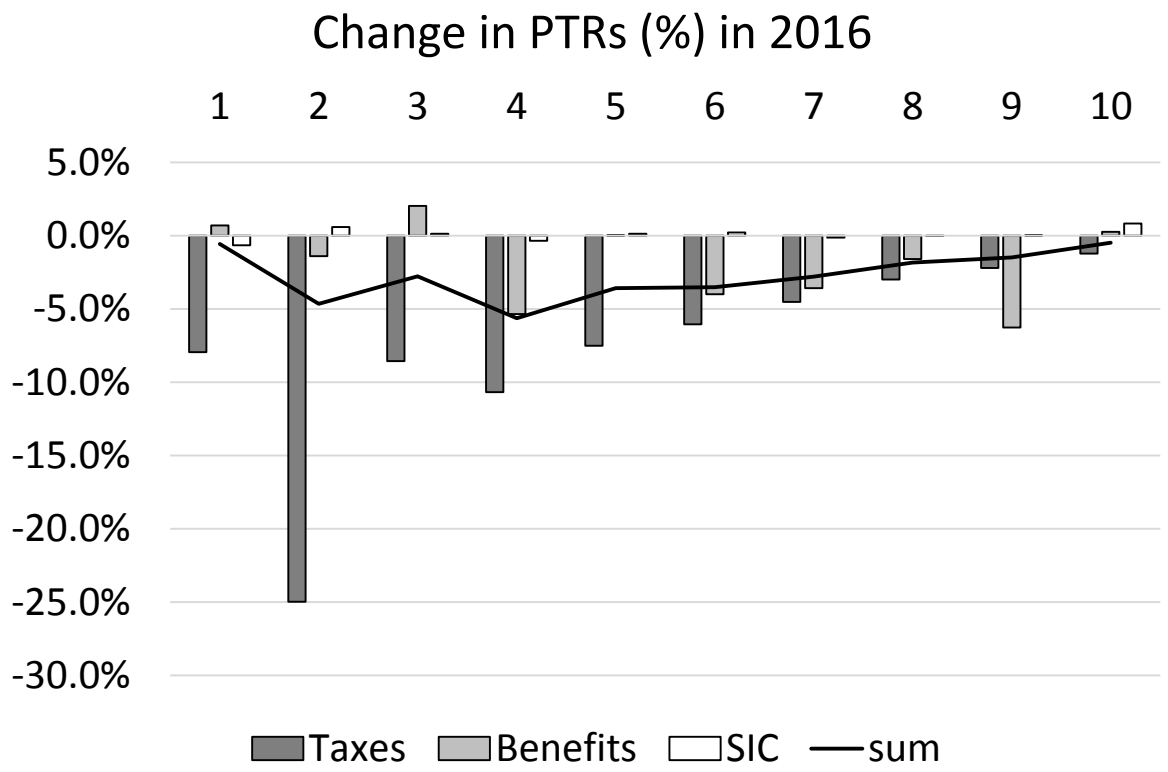


Fig. 3.a. **Pre reform contribution of taxes, benefits and social insurance contributions to PTRs in Latvia by deciles of equivalised income, 2015 computed only for those in work**



Change in PTRs (%) due to reforms of labour taxes in 2016, comparing with the baseline 2015 system

Source: author's calculations using EUROMOD-LV and EU-SILC 2012 data (2011 income)

Has the tax reform implemented since January 2016 affected the work incentives? [cont.]

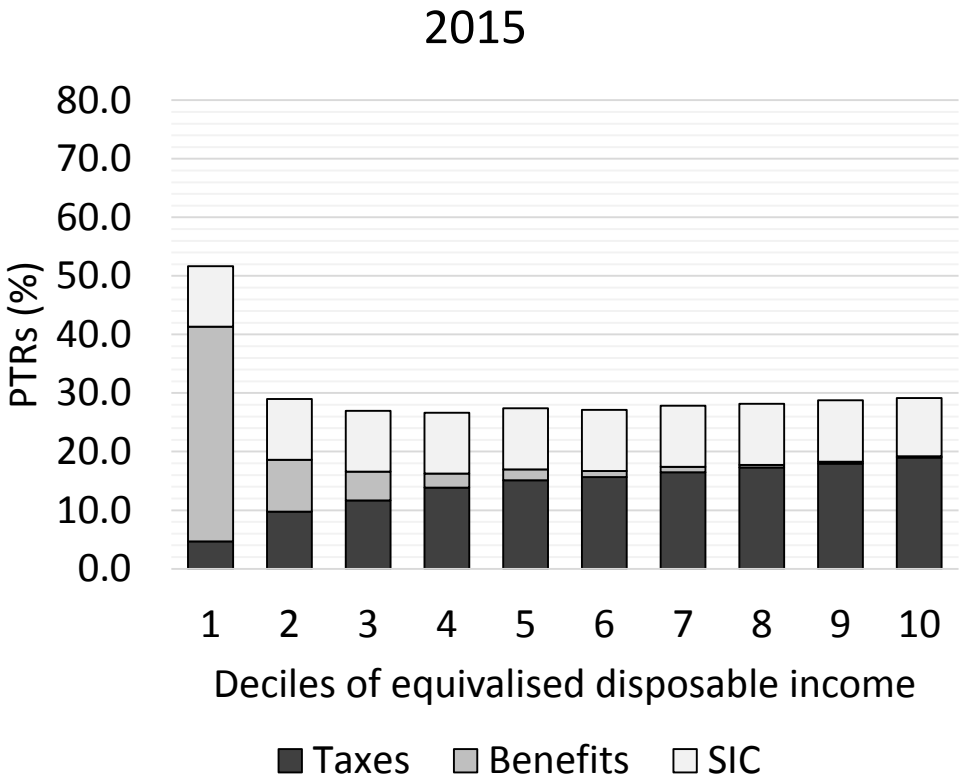
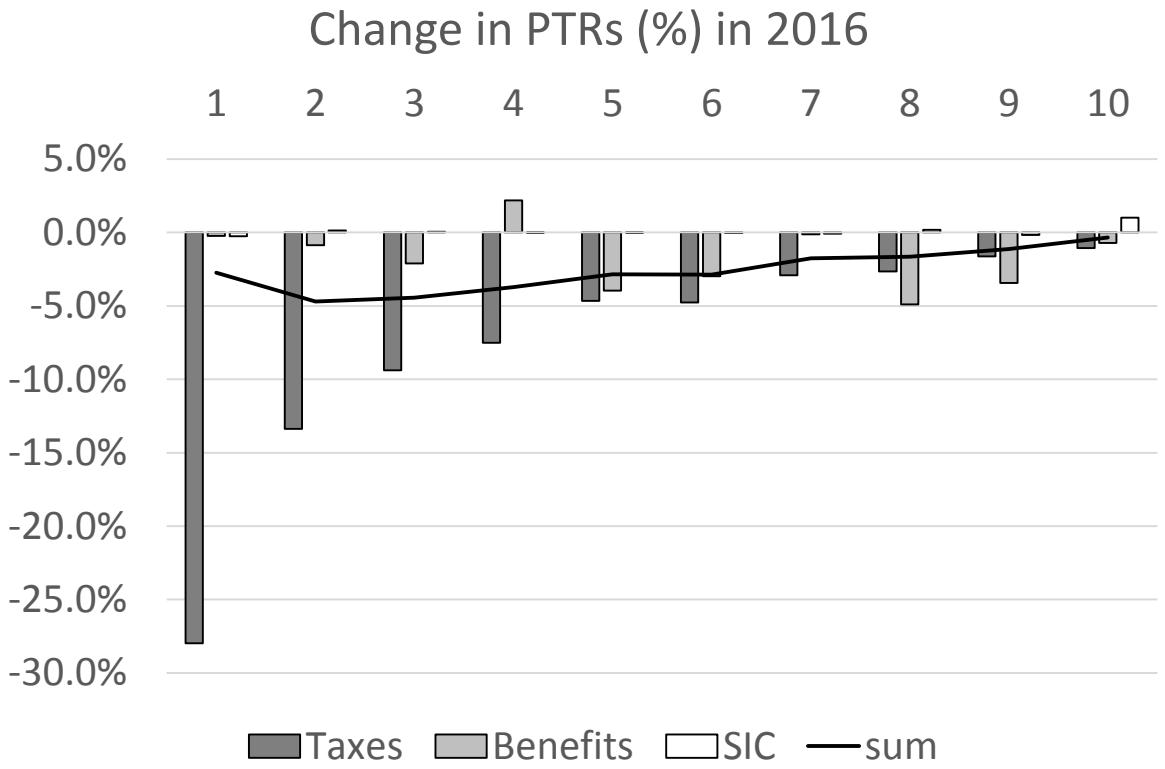


Fig. 3.b. **Pre reform contribution of taxes, benefits and social insurance contributions to PTRs in Latvia by deciles of equivalised income, in 2015 computed taking into consideration both employed and unemployed**



Change in PTRs (%) due to reforms of labour taxes in 2016, comparing with the baseline 2015 system

Source: author's calculations using EUROMOD-LV and EU-SILC 2012 data (2011 income)

Conclusions:

- In average, the labour tax reform reduced the PTR by 0.85 percentage points increasing incentive to work at all of the Latvian population

- The change in PTRs due to reform for the low-income earners is the second least while they face the highest PTRs that and the strong disincentive to participate in the labour market.

- The PTRs calculated for employed, unemployed and inactive, are noticeably lower than calculated only for employed along 1st-3rd decile, that is explained by the fact that hypothetical income from employment (imputed using Heckman two stage estimation method) reduced the eligibility for means-tested benefits for the part of the population.

Conclusions (cont.)

- The poor groups of population from the lowest deciles gain from the implemented reforms aimed at the increase of the allowance for dependents for all taxpayers and the non-taxable minimum.

- Nevertheless, the gain from PIT is cancelled out due to the design of means-tested benefit system that makes the benefits the major contributor to high PTRs in the lowest deciles of income distribution.

- The calculated PTRs do not reflect the real size of the effect of the introduction of solidarity tax.