

Inequality

IMPROVING POLICIES TO REDUCE INEQUALITY IN LATVIA

- ▶ Latvia faces high levels of income inequality and poverty. The tax and redistribution system only partially alleviates inequalities resulting from market incomes.
- ▶ Long-term unemployment and inadequate minimum social protection drive poverty among the working-age population.
- ▶ High tax wedges on low-earners currently hamper social inclusion by creating incentives for informal employment and to underreport wages from tax authorities. The recent tax reform, effective in 2018-20, addresses this issue by alleviating the tax burden though it is too early to assess its overall redistributive effect.
- ▶ Poverty is especially high among the elderly. Reducing old-age poverty would require strengthening the progressivity of the pension system and/or to review minimum pension provisions.

What's the issue?

Income inequality is high in Latvia compared to other OECD countries. The Gini coefficient, which takes values between 0 (most equal) and 1 (most unequal), stood at 0.35 in 2014, compared to the OECD average of 0.32. The average income of the top 20% of income earners is 6.4 times higher than that of the bottom 20%, compared to an average ratio of 5.4 in OECD countries. One specific feature behind the high level of inequality in Latvia is the very small size of the middle class.

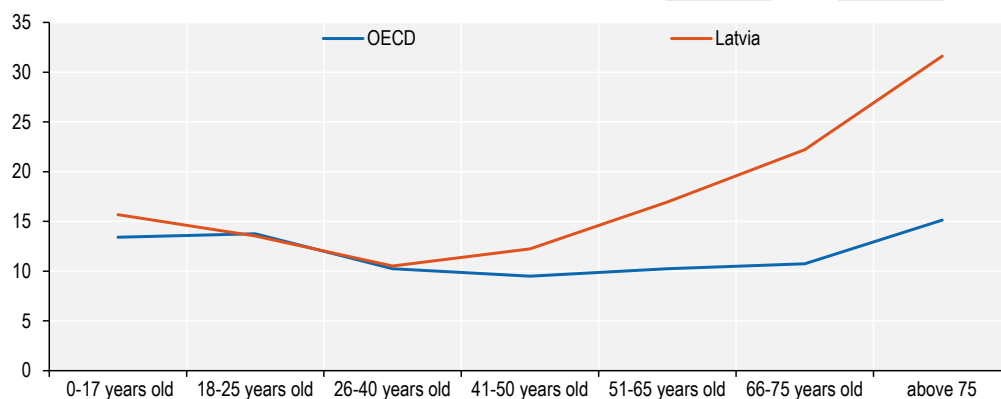
The incidence of poverty – the share of people living with less than half the median income – is high too, at 16%. This is higher than in any other European OECD country and significantly exceeds the OECD average of 12%. Poverty incidence is especially high among older adults: 27% of people aged above 65 are poor in Latvia,

compared to 13% in OECD on average. This is the second highest value in the OECD. Poverty rates are also relatively high among working-age individuals who are out of work, as unemployment benefits are reduced by half after six months and expire after nine months. Poverty is geographically concentrated in rural areas in the East of the country, where unemployment is wide-spread. High poverty on the one hand and poor access to good quality housing, poor access to health services, and financial access problems to vocational and higher education on the other hand are interlinked, implying the need for a broad-based policy response.

Latvia's redistributive system alleviates market income poverty and inequality to a lesser extent than in most other OECD countries. Income taxes and cash transfers

▶▶ Poverty is high in Latvia, especially among older people

Relative poverty rate by age group, in percent, 2015 or latest available year



Note: The poverty rate is the share of people in households whose income fall below half the median household income of the total population.
 Source: OECD, Income Distribution Database (<http://oe.cd/idd>).

reduce market-income inequality among working-age individuals by 19% in Latvia, compared to the OECD average of 25%. Fiscal redistribution reduces poverty among working age adults by 34%, compared to 44% on average in OECD. The recent tax reform, which will become effective in 2018-20, will strengthen progressivity and reduce the tax burden on low labour earnings. In particular, the tax burden will decrease from 40% (one of the highest in the OECD) to 33% (close to the OECD average) for low-wage single workers. Means-tested social assistance payments are low in international comparison, and plans to change the system are currently under review. However, financing of social safety nets would remain a local responsibility, putting pressure on weaker municipalities to restrict access to welfare benefits. The government's plans to raise social assistance payments are a welcomed step in the right direction.

Latvia faces tax revenue losses through a widespread phenomenon of "envelope wages" – formally registered workers receiving a, possibly sizeable, part of their pay informally. The OECD estimates that in Latvia, 28% of workers underreport more than a quarter of their earnings. A further channel for informal activity in the labour market is underpayment of wages in the form of underreported working hours and unpaid overtime.

Why is this important for Latvia?

Too high levels of inequality hamper social cohesion and can result in lost opportunities for many. Inequality can also lower social trust in institutions. When advantages and disadvantages are transmitted from one generation to the next, inequalities can grow over time.

Very high elderly poverty rates put into question the adequacy and social sustainability of the pension system. Fiscal sustainability is currently achieved mainly through the automatic reduction of benefits, which will likely increase old-age poverty in the medium and long term. The minimum pensions are very low compared to other countries. The recent tax reform will increase the non-taxable minimum for pensioners, but the poorest of them will not benefit from the reform since their pensions are tax-exempt.

Currently, the high tax wedge on low-wage workers represents an important obstacle to boosting employment rates among lower-skilled and undermines the redistributive impact of the fiscal system to reduce inequality. The tax burden reduction that the reform will introduce for some households is a step in the right direction, but its effect on some household groups (such as low-earner families with children or larger households with weak labour market attachment) and the overall redistributive effects still need to be seen.

Labour market informality damages the economy through illegal tax advantages and loss of public revenues. Underreported wages and working hours also weaken workers' social protection by eroding entitlements that depend on past social contributions. Wage underreporting is particularly damaging for pension contribution histories, wearing away future pension entitlements and increasing the risk of old-age poverty.

What should policy makers do?

- ▶ Include inequality as a factor informing the policy decision making process, for instance by making systematic assessments of the distributive incidence of fiscal policy part of the preparation and development of major fiscal reforms on both the spending and revenue sides.
- ▶ Ensure that social transfers contribute to reducing poverty and inequality, for example by further improving access to social assistance benefits and introducing earned income tax credit for low-wage workers.
- ▶ Tackle informality and underreporting by increasing the benefits of formal employment, reducing the costs of formalisation and optimising tax law enforcement methods.
- ▶ Provide more generous grants for students attending vocational schools who are from low-income families.
- ▶ Once significant progress in tackling informality and underreporting is made, further steps should be taken towards increasing progressivity of the tax system and strengthening its redistributive properties.
- ▶ Strengthen redistributive elements in the pensions system, while maintaining incentives for building up pension capital, for instance by increasing minimum pension levels and ensuring that each year of work is rewarded with an increase in benefits.



Further reading

OECD (2016), *OECD Review of Labour Market and Social Policies: Latvia 2016*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264250505-en>

OECD (2016), "Inequality Update - November 2016". <https://www.oecd.org/social/OECD2016-Income-Inequality-Update.pdf>

OECD (2015), *In It Together: Why Less Inequality Benefits All*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264235120-en> <http://oe.cd/init2015>.

OECD Centre for Opportunity and Equality, <http://www.oecd.org/inclusive-growth/inequality-and-opportunity/>