



**ROLE AND EFFICIENCY OF PERSONAL INCOME TAX
RELIEFS IN PROMOTING EMPLOYMENT
AND SOCIAL GOALS IN LATVIA**

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Abstract

Economic crisis that started in 2008 substantially influenced employment and social indicators in Latvia. Flexibility of labour market helped to reverse negative trends and already in 2010 overall situation started to improve, but many problems remain. Unemployment level is high, economic activity is decreased; a lot of workers emigrate because of weak labour demand and low wages. Declining labour income increases poverty risks especially for households with children. There are risks of high structural unemployment and inactivity trap of less skilled worker, as well as of further emigration and persistent employment in informal economy.

Labour income taxation could influence employment and social issues substantially. During the budget consolidation process in Latvia tax wedge on labour income increased, and for low wage earners it is now by about 4 pp higher than EU average. Theoretical and empirical evidence confirms that taxation have strong impact especially on working decisions of low-income earners. This is one of risks to further improvement of employment.

Tax wedge on labour income consists of social security contributions and personal income tax. PIT is seen generally as better candidate for change because SSC are linked to tax payer's future benefits. Taking into account Latvian flat income tax, main instrument to influence low-wage workers are tax reliefs – non-taxable minimum and allowance for dependants. Tax rate change would be more beneficial to better paid workers.

Author proposes to increase PIT non-taxable minimum to the level that allows reaching EU average tax wedge. This would help to increase employment in low-skill segment, decrease inactivity and unemployment traps and improve social situation of affected households. However if target is to decrease attractiveness of emigration and informal employment, increase of non-taxable minimum up to the level of minimum wage should be considered. Both proposals are very costly to the budget, and need to be coordinated with other labour market institutions.



Introduction

In Latvia debate about labour taxation linkage to employment issues is elevated recently since many labour market characteristics show weaknesses – during the economic crisis of 2008-2010 unemployment levels increased and employment and activity rates decreased considerable, there are comparatively high outward migration due to lack of domestic employment opportunities and high wage differences with EU15, persist informal employment and labour tax evasion, shady tax moral. Existing labour market problems are challenging also due to ageing and accordingly growing risks to sustainability of social security system by increasing dependency ratios. Additionally there are related issues of equity and poverty, where income taxation plays also prominent role.

There are budget constraints to any fiscally negative measures as consolidation process continues.

Labour costs are influenced directly through social security contributions and personal income tax. This article is focused on PIT as better candidate for change. In its current flat design most of labour market incentives could be constructed only through tax reliefs, which will be main focus of this article. Employment and related social policy depend also from the other labour market institutions (minimum wage, regulations) and also budget expenditures.

The aim of the paper is to analyse existing tax wedge on labour income, and its relation to the employment, with special focus on the role of existing tax reliefs in the law on personal income tax in Latvia. The research methodology is based on analysis of statistical data, studies of economic and scientific literature, and national legislation.

The main emphasis in article will be on low-income workers as this employment segment has higher risks and could gain most from possible changes in PIT reliefs. Author proposes reform options to improve labour market and social conditions, evaluating also their costs.

1. Theoretical Framework of Labour Tax Impact on Employment

The taxation of labour income can influence the level of employment in an economy through its effect on both the level of unemployment and the size of the labour force. Labour taxation drives a wedge¹ between the total labour costs faced by employers and the real consumption wage received by employees. This will generally affect both labour demand and labour supply decisions. [3, 14]

In perfectly competitive labour market, taxation would have no effect on unemployment as the real wage would adjust so that market would clear. [3, 24] Higher taxation would reduce voluntary supply of labour if net wages would be below the level acceptable to some individuals (so increasing inactive population, but not affecting unemployment). In practice however taxation affect unemployment levels, but indirectly through alleviating or exacerbating non-tax distortions created by the other labour market institutions – specifically out-of-work benefits and wage setting institutions. [3, 25]

The effect of taxation on labour supply will vary in different population groups. Individuals will respond differently to a change in the real consumption wage depending on

¹ The tax wedge is ratio of total labour taxes to total labour costs.



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their individual preferences and family characteristics. Tax will affect decisions of participation, numbers of hours worked, but also amount of effort an individual is willing to put into his or her work, including long-term decisions on occupation and education. Tax will also influence decision to engage in tax avoidance or evasion (including working in the informal sector). Tax could bias forms of compensation. [3, 10]

The demand for labour is affected by the ratio of tax wedge that is passed over to employer.

The more elastic is the labour supply (and/or demand) curve the more harmful is the tax wedge for employment. In case of standard convex aggregate labour supply (and demand) curves, a high tax wedge affects especially for relatively low wage earners. Since one of the main factors explaining real wage differential is the skill level, one can argue that the negative employment effect of the tax wedge would be most severe for low-skilled workers. [5, 5-6] The situation in low-wage segment of employment is made even more complex by other labour market institutions – such as minimum wage and social benefits creating e.g. unemployment, inactivity and low-wage traps.

Empirical evidence suggests that low-income workers, single parents, second earners and older workers are relatively responsive to changes in labour income taxation, particularly at participation margin. In addition, taxable income elasticities suggest that higher-income individuals are more responsive to taxes than middle-income and lower-income workers. [3, 10]

Consequently there is need to design tax policy targeting individual employment groups at different income levels and family characteristics to address most pressing issues effectively with minimal fiscal costs.

Tax wedge consists of personal income tax and social security contributions. Both are good candidates for change as if labour market is enough competitive it doesn't matter who will formally benefit from them initially employer (SSC) or employee (PIT, SSC). But it is important how potential tax cuts effects the average and the marginal labour costs (progressivity).

However if there are relationship between amount of SSC paid and benefits received (as it is case in Latvia), the negative impact from SSC on labour supply could be smaller. [4, 23]

This makes personal income tax first candidate to explore for possible reforms to improve labour market conditions.

2. Employment and Income Development²

Labour market in Latvia showed continuous improvement over the last decade, and most indicators maximum positive values reached at the end of 2007 with unemployment level close to 5% of economically active population.

Economic crisis substantially influenced labour market with unemployment level exceeded 20% of economically active population at the beginning of 2010. Situation improved markedly afterwards, but unemployment level is still high – 14.4% in III quarter of 2011. Mostly this improvement comes from the better employment opportunities, but partly it is explained also by declining economically active population. This development is influenced by demographic change with less young people entering labour force and increase in discouraged

² Data cut-off date 10 January 2012.



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jobseekers. The latter stimulate also outward migration that according to estimates during the 2009-2010 reached 70 thousand people. [11, 76]

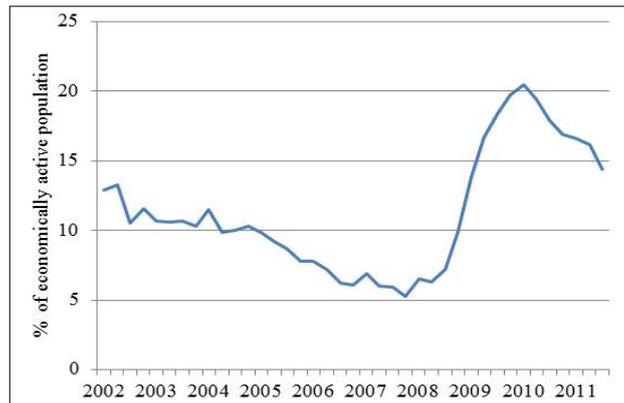


Figure 1. Unemployment

Source: Central Statistical Bureau of Latvia

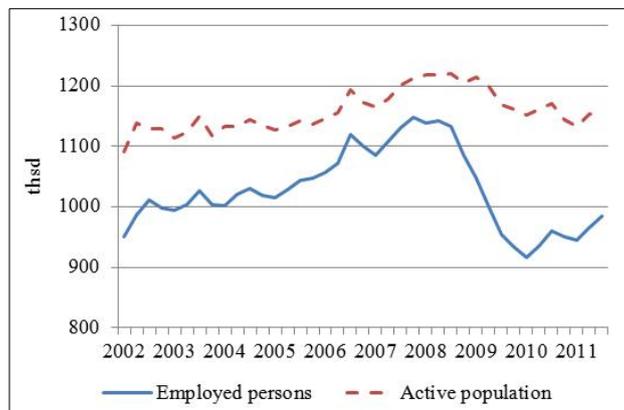


Figure 2. Activity and employment

Source: Central Statistical Bureau of Latvia

One of the reasons of high unemployment is changing structure of industries of economy. In the first phase of recovery job match (Beverage curve) suggested about flexible and effective labour market [6, 11]. But taking into account extent of the problem, there is substantial risk of increase of structural unemployment because of possible 'mismatch' between skills and the requirements of the new job opportunities. Long-term unemployment creates economic costs because of the damage to the skills and employability of those people out of work. High labour costs because of the existing labour market institutions for low-skill employment could deepen the problem.



Table 1

Employment by kind of economic activity

	Structure (%)	Change (%)
	2010	2010/2008
Primary industries	9.8	0.0
Manufacturing	14.3	-21.6
Electricity, gas and water supply	1.9	-16.1
Construction	7.0	-47.6
Wholesale, retail trade, hotels and restaurants	19.3	-16.1
Transport and communication	9.9	-12.2
Other private services	16.1	-5.3
Public services	21.8	-11.5

Source: Ministry of Economy of Latvia [9, 11]

Employment turbulences caused substantial changes to the wages in economy. Average wage declined, and share of minimum wage receivers increased substantially. The latter could be one of the indicators of increased tax evasion (underreporting), but also undeniable shows the real increase of share of low-wage workers in total employment. This is indirectly confirmed also by the popularity of 100 lats (approx. 142 euro) work-benefit programme³ for unemployed, showing considerable amount of workers who agree to work for very low level of compensation.

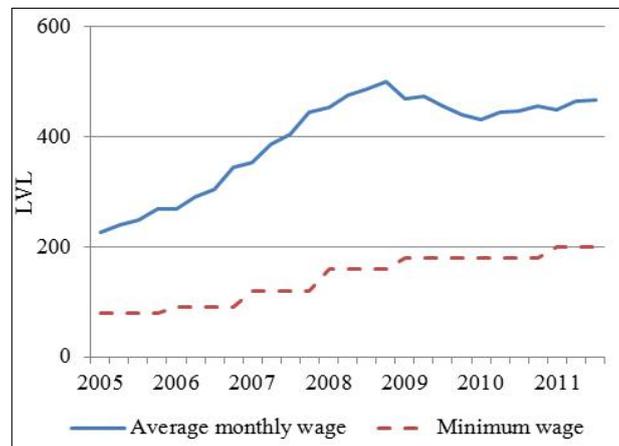


Figure 3. Average and minimum wage

Source: Central Statistical Bureau of Latvia

³ Programme of public works 2009-2011 in Latvia to provide a safety net to the long term unemployed not covered by the unemployment insurance and other social programs, where participants received benefit 100 lats per month.



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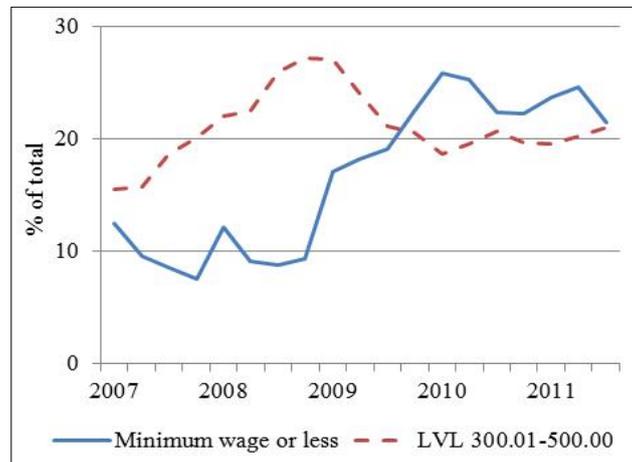


Figure 4. Share of workers at minimum wage and average wage intervals

Source: Central Statistical Bureau of Latvia

Equity and poverty issues are closely linked to the existing labour market conditions and labour taxation as important redistribution mechanism. Role of benefits is of course also very important.

In 2007 wages and salaries were main source of subsistence for 68.3% of households, this share decreased to 58.6% in 2009. As amount of social transfers increased, full or partial loss of wage income was behind substantial decrease of disposable income during the crisis. In 2010 55.4% of households answered that they with difficulty pay for usual necessary expenses, up from 44.4% in 2007. At risk of poverty rate before all transfers increased from 37.1% in 2007 to 43.7 in 2009. Transfers improved overall situation considerable, and this rate after all transfers even improved – 21.3% in 2009 comparing with 25.5% in 2007. This could be also one of the main drivers behind decrease of Gini coefficient to 36.1 in 2009. [1] Gradual phasing out of additional crisis related social safety net however without sufficient improvement in employment could deteriorate poverty risks in the medium term.

Most vulnerable types of households are households with children, especially those with 2, 3 and more children or households with one adult and children. Average consumption expenditure per capita in households with 3 or more children in 2010 was below average of 1st quintile, but those with two children below average of 2nd quintile. For comparison average consumption expenditure of one person households belongs to 4th quintile. [7] This clearly shows the impact of dependants to the household wealth.

Summarising, labour market after immense worsening showed good flexibility, declining wages improved competitiveness of economy allowing to reverse negative trends of employment. Unemployment level however remains high and employment at minimum wage increased considerable. Rapidly changing structure of industries risks increasing structural unemployment and inactivity in the medium term. Weak employment opportunities and relatively low wages increases also emigration creating long-term sustainability risks. Households with two and more children have low relative consumption expenditure and



increased poverty risk. These groups could be positively affected by decreasing tax wedge on low income.

3. Personal Income Tax on Wage Income

Personal income tax rate on wage income in Latvia is 25%⁴. The flat income tax system was introduced in Latvia in 1994 and proved to be as one of cornerstones of tax policy. Flat tax system is favoured by its simplicity and helps to avoid penalising for being productive and earning more money.

PIT contain one universal tax relief applicable to the all employees – non-taxable minimum (basic allowance), which ensure 0 tax rate for part of income and tax progressivity in general. In 2012 non-taxable minimum is set LVL 45 (approx. EUR 64) per month or LVL 540 (approx. EUR 768) per year.

Another widely used tax relief is tax allowance for dependants, which in 2012 is set LVL 70 (approx. EUR 100) per month or LVL 840 (approx. EUR 1195) per year for each dependant.

There are several other tax reliefs which could affect labour income – additional tax allowances for people with disabilities, pensioners' non-taxable minimum.

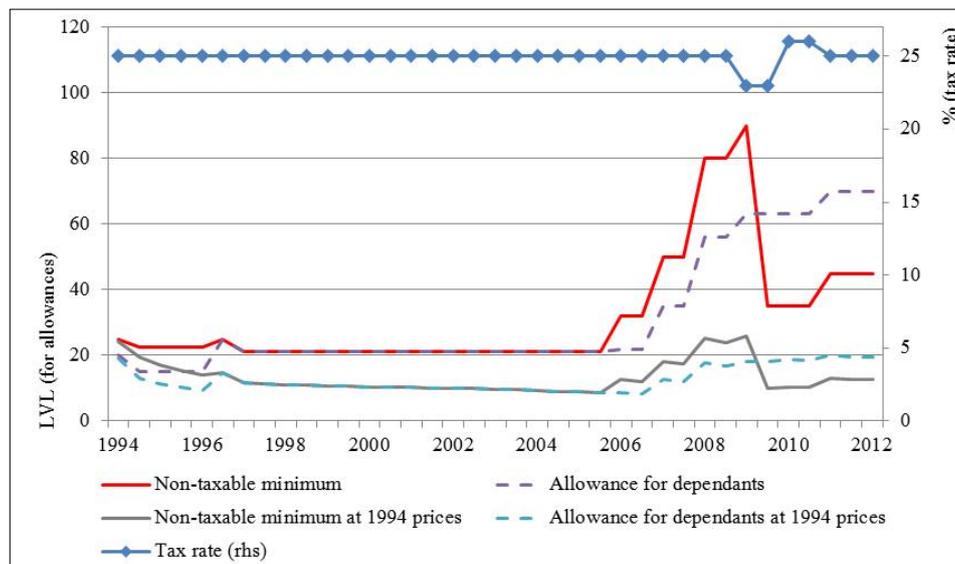


Figure 5. PIT rate (rhs) and non-taxable minimum (lhs) 1994-2012

Source: Ministry of Finance of Latvia, author's calculations

Based on yearly PIT declaration tax payers could deduct following expenses which could be attributable to the social goals of society – expenses for medical treatment, vocational

⁴ Here and further PIT is analysed as tax on wage, excluding other tax bases, for full coverage see Law on Personal Income Tax.



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training and obtaining education, health insurance premium contributions to insurance companies, long-term life insurance contributions, and contributions to private pension funds. There are set maximum limits for these deductions.

Before 2006 there were few substantial changes to the main elements of PIT, but from 2006 tax policy activities were directed at lowering of the labour tax burden especially for low-wage workers by gradually increasing non-taxable minimum up to LVL 90 per month (approx. EUR 128) in first half of 2009. Also amounts of many other allowances were increased. To a great extent however these activities could be interpreted as indexing inflation (that accelerated especially after accessions to EU in 2004) which decreased real values of allowances.

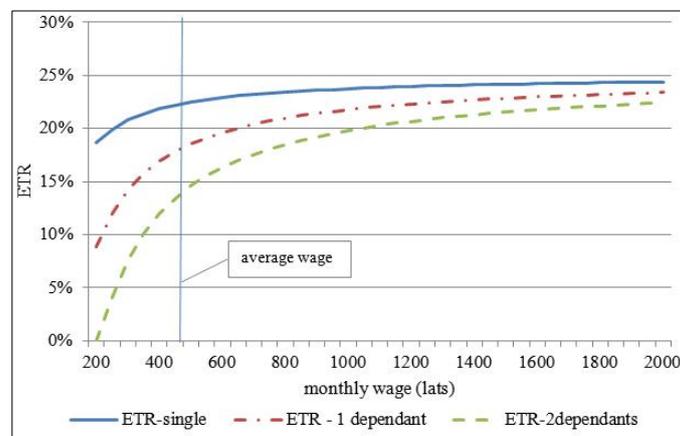


Figure 6. Effective PIT rates

Source: Ministry of Finance of Latvia, author's calculation

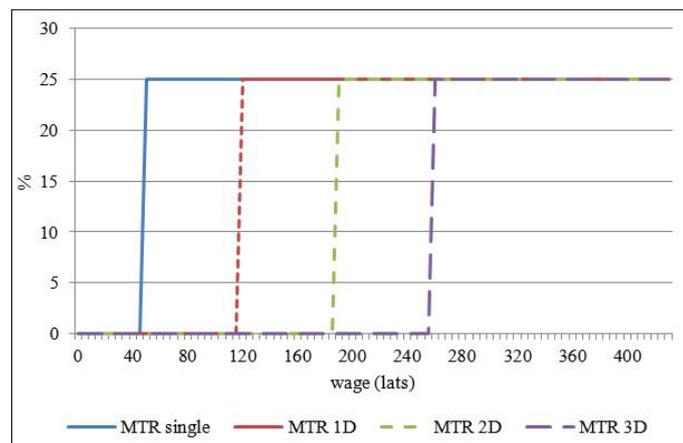


Figure 7. Marginal PIT rates

Source: Ministry of Finance of Latvia, author's calculation



During budget consolidation process that started in 2009 tax burden on wages increased⁵, which partly reversed previous policy measures in this field.

Effective PIT rate taking into account relatively low level of non-taxable minimum starts from 18.7% for minimum wage than grows to 22% for average wage and 24% for double average wage receivers. If tax payer has registered dependants effective tax rate decreases e.g. with two dependants effective PIT rate at minimum wage level is 0%, at average wage 14%, but at double average wage 19%.

Marginal PIT rate taking into account flat nature of income taxation in Latvia switches between 0% and 25% in the points where ends application of tax allowances.

4. Tax Burden on Labour

The statutory rates of labour taxes don't tell the entire story, as tax reliefs and compliance issues could change actual tax burden considerable.

In Latvia PIT statutory flat rate is 25%, SSC – 35.09%. However actual tax revenues from labour income divided by the labour earnings show implicit tax rate on labour only about 30%. This indicator suggests that overall labour tax burden in Latvia is lower than EU average – 36%.

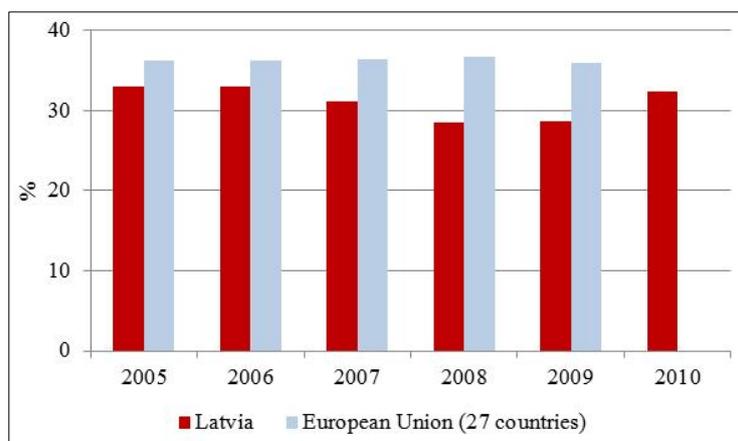


Figure 8. Implicit tax rate on labour

Source: European Commission [2], author's calculation

Development of tax wedge shows that during the crisis tax burden increased on all categories of workers and progressivity of labour taxes decreased. Main cause behind this is lower non-taxable minimum of PIT.

Looking at tax indicators together with the benefit systems allows better to understand existing and potential labour market problems in the segment of low-wage workers. One such indicator is unemployment trap, who measures the proportion of gross earning taxed away (by

⁵ However increase of labour taxes was much smaller than that of taxes on consumption and property.



higher taxes and withdrawal of benefits) when moving from unemployment to employment. Other is low wage trap that measures the proportion of gross earnings taxed away (by higher taxes and withdrawal of benefits) when gross earnings increase.⁶

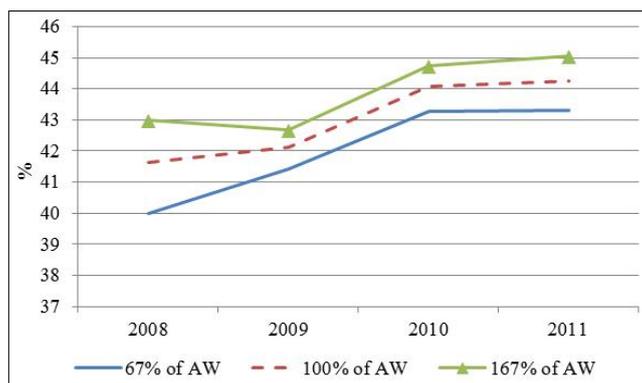


Figure 9. Tax wedge

Source: European Commission [2], author's calculation

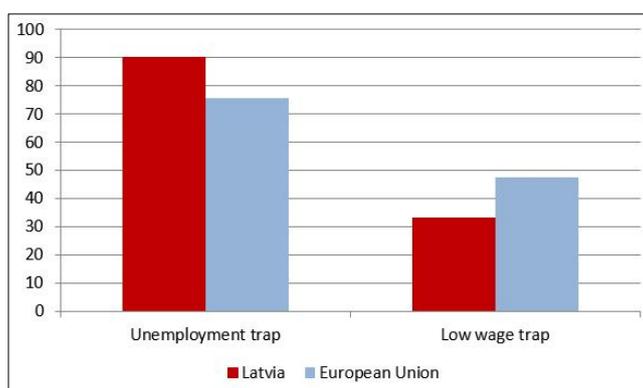


Figure 10. Unemployment and low wage traps in 2010

Source: European Commission

5. Fiscal Importance of PIT and Costs of Tax Reliefs

It should be emphasized obvious budget constraint to any fiscally negative tax change. The last adopted 2012 budget contains consolidation measures in the amount of about 1% of GDP, targeting general government budget deficit to 2.5% of GDP. Further deficit reduction is

⁶ Eurostat for unemployment trap uses earnings at 67% of average wage, for low wage trap wage increase from 33% to 67% of average wage.



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still planned with the aim to achieve balanced or even surplus budget in the medium term to ensure stability of macroeconomic environment.

Revenues from personal income tax plays important role in the general government budget. In 2012 they are planned 812 million lats or 5.6% of GDP and constitute 19.7% of total revenues⁷. 80% of PIT revenues are going to local governments, but 20% to central government. PIT provides 84% of local government total tax revenues making them especially vulnerable to any changes in personal income taxation.

Tax reliefs are costly especially for universal allowances as non-taxable minimum.

Provisions of PIT allowances and deductible expenditures (with employment (making work pay) or social character) costs in revenues forgone amounted 453 million lats or 3.3% of GDP in 2011, int.al. non-taxable minimum 101 million, pensioners non-taxable minimum 261 million, allowance for dependants 71 million. [10, 22]

6. Options for Reform

The previous analysis shows that existing tax wedge on low income could be characterized as high creating a numerous risks for low-wage (low-skill) employment, including inactivity and unemployment traps, but also poverty problems. The latter is especially important for households with dependants. Tax wedge on low earnings in Latvia is above EU average and neighbouring countries, creating also cost competition problems for industries relying on more simple jobs. High tax wedge stimulates also tax evasion by working in informal economy or underreporting the incomes.

The results of World Bank study suggested that, for a given GDP growth rate, each percentage point difference in the tax wedge is associated with a decrease in employment growth by 0.5-0.8 percentage points. [5, 10]

Existing PIT system in Latvia allows dealing with this issue through tax allowances – non-taxable minimum and allowance for dependants. Changes in basic tax allowances influence primarily workers with wage below average and have only marginal impact on high-wage workers.

In case of Latvia amounts of these allowances are approved by the government regulation and are not linked to the changes in the law or direct parliamentary approval.

In this paper are discussed following options for reform:

- 1) decreasing tax wedge for low-wage workers to the level comparable with EU average and other Baltic states;
- 2) decreasing tax wedge for low-wage workers by 10 percentage points.

Decreasing tax wedge for low-wage workers to the level comparable with EU average and other Baltic states

According to the authors estimation tax wedge for low wage earners (67% of average wage) in 2012 in Latvia is 43½% that is about 4-5 pp higher than in other Baltic states and EU average. Estonia and Lithuania have similar flat rate income tax system with higher SSC but

⁷ PIT base includes also from capital income and earnings of self-employed and some other minor categories.



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lower PIT rates and higher basic allowances. To reach mentioned decrease of tax wedge PIT non-taxable minimum should be increased up to 100 lats per month. This would ensure tax wedge below 40% for low wage earners.

This measure in revenues forgone would cost to the budget about 110 millions lats. In case of positive outcome however one could expect higher employment through increase in participation rates, lower unemployment and increased labour demand. Government expenditure for social benefits should decrease as well. One could expect also decrease of informal economy. All these developments could compensate initially lost revenues. However as the precise benefits and their timing is very uncertain government initially should count on lower PIT revenues to avoid negative fiscal consequences. [5, 12]

Tax wedge is only one of the instruments that determines labour market situation, therefore premature and overly optimistic expectation should be avoided as this possible change needs to be coordinated with other labour market institutions.

Other justification for decrease of labour tax burden is tax competition between Baltic states.

Decreasing tax wedge for low-wage workers by 10 percentage points

First option foresees returning Latvian tax wedge to the level of other Baltic states, but at current juncture this probably will be not enough for tangible results especially if additionally to classical labour market problems we should add also emigration and informal economy issues.

Latvian labour market is integrated into common EU labour market. Latvian worker have opportunities to emigrate to the countries where tax burden for low wage jobs is lower and net wage and state benefits are higher. One of solution would be to increase PIT non-taxable minimum to the level of minimum wage [12].

Other justification for more sizeable decrease of tax-wedge is informal economy int.al. underreporting of actual wages. As suggested by recent opinion poll 20% of employees do not pay labour taxes at all or only partially, and 23% hold a view that paying taxes is not important. [8, 15]. If tax moral is not high, elasticities to tax changes could be smaller.

To ensure decrease of tax wedge by 10 pp non-taxable minimum should be increased up to 200 lats. It would cost to the budget about 315 millions lats. This solution needs significant compensatory revenue or expenditure measures.

Alternative solutions

Alternative solutions for decreasing tax wedge could be

- decrease of overall PIT rate – this would decrease tax wedge in all wage categories, but would decline also existing progressivity;
- introduction of lower PIT rate for low-wages – this would mean introduction of simple progressive taxation system with two tax brackets. It could have more pronounced impact on wage group in first bracket, but PIT would lose its simplicity, increase administrative burden and probably lower tax moral for those in higher tax bracket.

These alternative solutions are also costly. Decrease of PIT rate by 1 percentage points in revenues forgone would cost to the budget about 30 millions lats. If this decrease concerns only low-income workers impact of course would be smaller, but anyway substantial as majority of workers are receiving less than average wage.



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Options for social objectives of PIT reform

Poverty risk for low-wage earners especially with two or more children could be decreased by lower tax burden. This is done through allowance for dependants. So, increase of this allowance could improve incomes of families with children. However there is problem in the low wage segment that already now minimum wage receivers with two dependants use this allowance in full (and have 0% tax) and third dependant do not increase net wage. With further increase of allowance, this problem will intensify in wage levels more close to the average.

Regarding additional tax allowances for people with disabilities, pensioners' non-taxable minimum – these seems to be in line with their objectives and positive impact from their change would be limited.

Other mentioned PIT reliefs with social character were deductible expenses for medical treatment, vocational training and obtaining education, health insurance premium contributions to insurance companies, long-term life insurance contributions, and contributions to private pension funds. These could have limited impact on behaviour of low-wage earners, as they use less of these services than wealthier fellow citizens. Other constraint for low-wage earners could be the low amount of paid PIT, which would not allow them using reliefs in full. So these tax reliefs have important social merit and objectives, but have more impact on average-income and wealthier tax payers than on low-wage workers.

Conclusions and Recommendations

1. Labour taxation will generally affect both labour demand and labour supply decisions. The effect of taxation on labour supply will vary in different population groups. Individuals will respond differently to a change in the real consumption wage depending on their individual preferences and family characteristics. Tax will affect decisions of participation, numbers of hours worked, but also amount of effort an individual is willing to put into his or her work, including long-term decisions on occupation and education. Tax will also influence decision to engage in tax avoidance or evasion (including working in the informal sector). The demand for labour is affected by the ratio of tax wedge that is passed over to employer. The more elastic is the labour supply (and/or demand) curve the more harmful is the tax wedge for employment. In case of standard convex aggregate labour supply (and demand) curves, a high tax wedge affects especially for relatively low wage earners.
2. Tax wedge consists of personal income tax and social security contributions. Both are good candidates for change, however if there are relationship between amount of SSC paid and benefits received (as it is case in Latvia), the negative impact from SSC on labour supply could be smaller. This makes personal income tax first candidate to explore for possible reforms to improve labour market conditions.
3. Labour market after immense worsening showed good flexibility, declining wages improved competitiveness of economy allowing to reverse negative trends of employment. Unemployment level however remains high and employment at minimum wage increased considerable. Rapidly changing structure of industries risks increasing structural unemployment and inactivity in the medium term. Weak employment opportunities and relatively low wages increases also emigration creating long-term sustainability risks. Households with two and more children have low relative consumption expenditure and



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- increased poverty risk. These groups could be positively affected by decreasing tax wedge on low income.
4. According to the authors estimation tax wedge for low wage earners (67% of average wage) in 2012 in Latvia is 43½% that is about 4-5 pp higher than in other Baltic states and EU average.
 5. The results of World Bank study suggested that, for a given GDP growth rate, each percentage point difference in the tax wedge is associated with a decrease in employment growth by 0.5-0.8 percentage points.
 6. Existing PIT system in Latvia allows dealing with this issue through tax allowances – non-taxable minimum and allowance for dependants. Changes in basic tax allowances influence primarily workers with wage below average and have only marginal impact on high-wage workers.
 7. Author recommends following options for reform:
 - decreasing tax wedge for low-wage workers to the level comparable with EU average and other Baltic states;
 - decreasing tax wedge for low-wage workers by 10 percentage points in long-term.
 8. First option foresees to increase PIT non-taxable minimum up to 100 lats, second up to 200 lats per month. First option returns Latvia back in parity with other Baltic states, second option could be much more influential with expected positive effects also to emigration and informal economy.
 9. Fiscal costs of proposed reforms options are high, and it is important question how to finance it – as expected magnitude of benefits from reform and especially their timing are uncertain.

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