



Fiskālās disciplīnas
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EXPENSIVE LENIENCE

Tax Morale in Latvia

ABSTRACT

This report looks at tax morale, the intrinsic motivation to pay taxes, in Latvia in relation to the government's commitment to reducing the shadow economy. Both local and international studies have indicated that Latvia has a considerable shadow economy, which has a serious impact on tax revenues. The current government of Latvia has declared that it plans to increase revenues primarily by reducing the size of the shadow economy. Recently, the importance of social norms and moral convictions on compliance with tax law has been given greater attention by academic researchers and international organisations. This approach focuses on factors that foster voluntary compliance and increase the social and psychological costs of non-compliance. Drawing on the tax morale literature and using the results of a survey carried out in April 2016, this report shows that Latvia's population is lenient towards tax evasion and many people have experience of tax evasion. Furthermore, low satisfaction with one's financial situation, public services and the government suggest that increasing government revenues may be difficult without increasing trust in the tax system and the fairness of the fiscal exchange more generally.

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Introduction

Latvia's *Stability Programme 2016-2019*¹ notes that Latvia has traditionally been a country with a low tax burden. Eurostat data on budget outcomes in 2014 confirm this. In 2014 Latvia's tax revenues (including social security contributions) accounted for 29.2% of the country's GDP. Historical data shows that this is not an anomaly; Latvia's tax-to-GDP ratio has consistently hovered around the 28%-29% mark. Meanwhile, the European Union average has been 39%-40% of GDP².

While the government of Latvia has previously expressed an intention to increase the tax-to-GDP ratio to 1/3, the current government has declared that it plans to reach this tax-to-GDP ratio by 2020³. To this end, the World Bank was commissioned to do a review of the current tax system⁴, which could assist the government in developing a new approach to tax policy. However, the government's plan to increase tax revenues will primarily be directed at limiting the shadow economy and improving tax collection.

Both local and international studies have indicated that Latvia has a considerable shadow economy. The estimates vary, but the consensus is that economic activities taking place outside the formal economy account for a large part of Latvia's GDP. This has a serious impact on government tax revenues, as a significant portion of income in Latvia goes untaxed. This is further compounded by the fact that Latvia's tax revenues compare unfavourably to those of other members states of the European Union.

Adjustments to the operation of revenue bodies and the development of effective law enforcement and evasion-deterrence strategies are of great importance. However, addressing the causes of informality also requires insight into compliance behaviour and the reasons for non-compliance and tax evasion.

Recently, the issue of tax morale has begun to attract the attention of academics (e.g. Torgler 2007), public officials (e.g. Walsh 2012) and international organisations (e.g. OECD). Tax morale can be broadly defined as the intrinsic motivation to pay taxes, and, even though its effect is difficult to quantify, it is a potential way of explaining the variation between the levels of compliance with tax laws in different countries. There is a growing body of literature that looks at differences in tax morale between countries, the determinants of tax morale and its relationship with the size of shadow economies. What is more, tax morale in Latvia has also been studied (Mickiewicz, Rebmann and Sauka 2013). Even though the study focused on entrepreneurs, one of the primary researchers has raised this question in relation to tax evasion in general⁵.

This paper looks at tax morale in Latvia, primarily in the context of increasing government revenues. The focus of the paper is a survey on tax morale commissioned by the Fiscal

¹ http://www.fm.gov.lv/files/fiskalapolitika/2016/FM_SP_ENG_2016-2019.pdf, accessed on 30/08/2016.

² http://ec.europa.eu/eurostat/statistics-explained/index.php/Tax_revenue_statistics, accessed on 29/08/2016.

³ *Declaration of the Intended Activities of the Cabinet of Ministers Headed by Māris Kučinskis*, available at: http://www.mk.gov.lv/sites/default/files/editor/deklaracija_en.pdf, accessed on 29/08/2016.

⁴ <http://www.fm.gov.lv/lv/aktualitates/jaunumi/nodokli/51990-pasaules-banka-veiks-latvijas-nodoklu-sistemas-izvertejumu>, accessed on 11/08/2016.

⁵ <http://www.lsm.lv/lv/raksts/ekonomika/zinas/petnieks-latvija-pietrukst-emocionalas-motivacijas-maksat-nodoklus.a160605/>, accessed on 11/08/2016.

Discipline Council of the Republic of Latvia, which was carried out in April 2016. I commence by providing a brief overview of the shadow economy in Latvia. I continue by describing tax morale and related concepts pertaining to social norms. Finally, the findings of the survey are reported, and I suggest that tax morale may be able to explain the lenience of the population towards tax evasion. What is more, I argue that tax morale may be of particular interest and relevance due to the possibility that improved tax morale is associated with increased tax revenues and lower law enforcement costs.

Shadow Economy in Latvia

The shadow economy mainly refers to various forms of underreporting (e.g. profits), untaxed income and undeclared work and transactions. The prevalence of tax evasion, informal economic activity and underreporting means that a large share of a country's economic activities go either untaxed or undertaxed. In this sense, the shadow economy is a problem for all countries, since it limits government revenues that could be used, among other things, to improve public services or increase fiscal buffers. Furthermore, substantial shadow economies almost invariably mean that a higher portion of government revenues must be allocated to enforcement measures.

The consequences of shadow economies are not limited to a loss of revenues, however. Non-compliance has implications for social equity (Torgler 2007). The provision of public services is financed by taxpayers, yet the benefits (e.g. infrastructure, publicly financed education) are enjoyed by all. That is to say, tax evaders cannot be excluded from using them. This may stimulate the feeling that fiscal burdens are distributed unfairly, weaken civic-mindedness and motivate an even greater part of society to leave the formal sector and justify tax evasion on the grounds that other citizens or the state are not fulfilling their obligations. In other words, shadow economies have negative fiscal effects and disruptive social effects, which may exacerbate the fiscal effects and negatively impact the state's ability to provide adequate quality services.

Several sources have suggested that, relative to its GDP, the shadow economy in Latvia is more pronounced than on average in the European Union (Schneider 2015; OECD 2015a). In official publications this is often discussed in relation to Latvia's low tax-to-GDP ratio, and limiting the size of the shadow economy is proposed as a way of increasing government revenues in a non-distortionary manner. For example, the 2015 edition of *Tax Reforms in EU Member States* notes that Latvia has a high VAT compliance gap and widespread non-compliance (European Commission 2015). An OECD country report notes that the VAT system suffered a serious blow during the most recent financial crisis (OECD 2015a). The authors suggest that, as the economy recovers, the situation should improve, but they grant that tax evasion is entrenched.

The most recent *Shadow Economy Index for the Baltic Countries*⁶ was presented on 12 May 2016. The authors suggest that in 2015 the shadow economy in Latvia decreased by 2pp of GDP, whereas it increased in Lithuania and Estonia by 2.5pp and 1.7pp of GDP respectively. Consequently, the results for 2015 follow the downward trend of previous years, as the shadow economy accounted for 36.6% of Latvia's GDP in 2009. This trend must be qualified, however, by noting that Latvia still has the largest shadow economy of the three Baltic States. According to the authors, the main forms of tax evasion in Latvia are underreporting of business income and so-called "envelope wages" – untaxed salaries and payments.

⁶ More information available here: <http://www.sseriga.edu/en/centres/csb/shadow-economy-index-for-baltic-countries-2009-1015/>, accessed on 02/11/2016.

The problem of untaxed income and insufficient social security contributions may have serious long-term consequences. For example, in their review of the labour market and social policies in Latvia OECD experts noted that a large shadow economy creates substantial challenges due to the changing demographic situation (OECD 2016). According to their estimates, the old-age dependency ratio in Latvia will increase by 20% in the next decade. A contracting labour force in conjunction with widespread tax evasion and non-compliance creates difficulties for maintaining tax revenues and social security contributions at desired levels without further burdening members of the formal economy. This is why the aim to increase the tax-to-GDP ratio by limiting the shadow economy is preferable, as it seeks to extract revenues from previously untaxed economic activity.

In summary, Latvia has a significant economy that limits the available government revenues and may have a corrosive effect on civic-mindedness in the long-term. This has the potential to create complications in the future, as the population of working-age inhabitants decreases. In such a scenario, collecting the requisite amount of revenues without burdening members of the formal economy will become difficult and may lead to higher tax rates.

As noted in the introduction, the Latvian government has set a specific goal to limit the shadow economy. An OECD publication on understanding taxpayer behaviour notes that

[a] strategy solely based on deterrence can have major drawbacks and does not necessarily result in improved compliance behaviour and can even result in less compliance.

(OECD 2010: 39)

Activities and policies that aim to deter people from tax evasion have to be very pronounced and publicly visible in the absence of regulative social norms that are conducive to voluntary compliance.

A similar sentiment was expressed in an International Monetary Fund publication on corruption:

while it is important to take steps to change the incentive structure, including through a credible threat of prosecution, it is equally important to recognize that the kind of behavioural change required—especially in the case of systemic corruption—must be grounded in a core system of social values.

(International Monetary Fund 2016: 15)

Consequently, in what follows I argue that measures intended to deter individuals from tax evasion must be supplemented by an understanding of the causes of informality that goes beyond the assumption that evaders simply want to maximise income. For this reason, I will now turn my attention to a discussion of tax morale.

Motivating Voluntary Compliance: Tax Morale

As noted by Jon Elster (1989), among the most persistent cleavages in the social sciences is the one between two schools of thought – the first associated with sociology and the second closely related to economics. At its core, the difference concerns the nature of what determines and guides human behaviour. Sociologists stress the influence of social norms and the prevalence

of inertial behaviour, whereas economists emphasise the role of instrumental rationality. This cleavage has interesting implications in the context of tax evasion.

A seminal paper by Allingham and Sandmo (1972) argued, based on a utility-maximisation approach, that the frequency of tax evasion is negatively correlated with the probability of detection and the degree of punishment. In other words, your decision to cheat and evade taxes is based on the possibility of your being caught and penalised. Consequently, compliance could be improved by increasing the severity of punitive measures and the likelihood of being caught.

However, this approach to taxpayer behaviour overestimates the extent to which people will evade taxes and choose not to comply with tax law. Several studies have noted that the model proposed by Allingham and Sandmo predicts much lower levels of compliance than actually observed (Torgler 2007). In view of this, either people radically overestimate the omnipotence of the tax collecting agency and, by extension, the possibility that they will be caught, or there are other factors that influence people's choice to comply.

One of the explanations proposed to illuminate this discrepancy is that social norms and moral convictions motivate voluntary compliance. It has been suggested that taxpayer behaviour should be understood as a result of his/her personal norms and the social and economic environment in which he/she operates (Alm and Torgler 2004; OECD 2010; Torgler and Schneider 2007).

While both norms and laws regulate social life, norms are distinguished from laws by being uncodified. They can be both descriptive (and refer to behavioural regularities) and normative (and refer to desired behaviours). Bicchieri (2006) suggests that social norms generally involve both components, and the durability of such norms depends on their being common and people's expectations that norms will be respected and observed.

The question of why people comply with a norm is complex and does not lend itself to a simple resolution. Accounts that emphasise deliberation stress that agents take into account the costs of non-compliance and the benefits of compliance (Swedberg 2003). For example, the utility-maximisation approach referenced above is an explicit example of this. However, the deficiencies of the utility-maximisation approach suggest a different possibility – compliance is often automatic, does not involve conscious deliberation regarding costs and consequences, and exists without an explicit incentive structure in place. That is to say, compliance with a behavioural rule may be habitual and not require enforcement (Bicchieri 2006).

Nonetheless, in many cases our compliance may be conditional upon our recognition that a norm is legitimate and should, consequently, be respected. Norms of justice are of particular interest to this paper. It has been noted that the perceived fairness of the fiscal exchange (between citizen and state) is an important factor influencing people's choice to comply with tax law and the impulse to cheat (McGee 2012; Torgler 2007).

In view of considerations alluded to above, recent research has given considerable attention to social and psychological factors, and the role that norms and questions of justice and fairness play in determining compliance behaviour. It has been argued that deterrence and punitive measures play a role when norms and convictions fail (Brathwaite 2009), and the deficiencies of the utility-maximisation approach mentioned above suggest that there is a need to study the motivation of taxpayers from a more nuanced perspective – one that does not see people's choices as largely being determined by the desire to maximise pay-off.

Among approaches of this kind, the concept of tax morale has become prominent and attracted the attention of both academics and international organisations (e.g. OECD). Tax morale can be defined as the intrinsic motivation to pay taxes that arises from an individual's moral convictions, rather than a fear of punitive measures. In other words, one pays taxes because one sees this as an obligation and a way of contributing to one's society, not because one is afraid of the consequences. Consequently, in a society with high tax morale the possibility that individuals will look for ways to cheat is lower, and people may not even consider cheating on their taxes.

What Influences Tax Morale?

Many factors have been identified as potential contributors to, or determinants of, tax morale, including:

- ✓ Perception of the fairness and equity of the fiscal exchange;
- ✓ trust in government;
- ✓ perception of the extent of corruption and non-compliance;
- ✓ financial satisfaction;
- ✓ sociodemographic indicators.

First of all, perception of the fairness and equity of the fiscal exchange influences tax morale. If the amount deducted in taxes is perceived as being appropriate, given the services provided for it and the redistributive functions it fulfils, people may be less motivated to evade taxes. In this sense, transparency of public finances may contribute to improvements in tax morale. A clear account of how tax revenues are used may give people a better sense of whether the exchange is fair and their interests are respected. Indeed, it has been noted that a more positive perception of social expenditures is associated with higher tax morale (OECD/FIAPP 2015).

Secondly, trust in, and satisfaction with, the government and public institutions influences tax morale. If the government is perceived as being responsible and doing a good job, tax morale will be higher. Indeed, trust in the government is associated with accountability (Torgler 2007), whereas distrust may derive from the perception that the government is wasteful and does not treat taxpayers fairly.

Thirdly, tax morale is influenced by the perception of corruption and non-compliance. As I noted in the section on the shadow economy, it is believed that people will question the need to respect tax law if there is a widespread belief that corruption and non-observance are routine. Furthermore, the perceived personal "costs" associated with tax evasion may be lower if the individual believes that disregard for the law is common. This also bears on trust in the government and public institutions, as economies can be adversely affected when a society has lost confidence in the competence of its government (International Monetary Fund 2016). The reputation of officials handling tax issues is particularly relevant in the context of tax morale (OECD 2013). Consequently, the perception of the revenue collecting agency and its representatives may make a considerable contribution to how people view paying taxes, and deterrence strategies should focus on honouring compliant behaviour and making it clear that non-compliance is and will be sanctioned.

Fourthly, financial satisfaction has been identified as a determinant of tax morale. While the exact mechanism may not be clear, survey data suggest that people who are satisfied with their financial situation are less likely to justify tax evasion (Lago-Peñas and Lago-Peñas 2010; Luttmer and Singhal 2014).

Finally, a number of sociodemographic indicators are considered important in the context of tax morale. It has been argued that women, married people and religious people generally have higher tax morale and justify tax evasion less frequently (McGee 2012; Torgler 2007). Furthermore, pronounced ethnic-linguistic fractionalisation has also been identified as a contributing factor, with the marginalised groups showing lower tax morale. Finally, employment status has been identified as a potential contributor to tax morale. In particular, self-employed people are believed to have a lower tax morale due to the fact that taxes (specifically – the amount deducted from their income) are more visible to them and there are more opportunities to evade taxes.

The observed effect of the above factors illustrate that tax morale is an additional dimension to consider when attempting to limit the shadow economy. Even though the precise impact of tax morale is difficult to quantify and identify, it has a meaningful effect on compliance – higher tax morale is associated with higher compliance and, consequently, higher tax revenues. This decreases the need to raise tax rates, as revenues are improved through higher compliance. Furthermore, this also means that fewer resources have to be devoted to enforcement as higher tax morale reduces peoples' attempts to cheat on their taxes. The precise nature of the relationship between enforcement and tax morale is complicated, however.

Enforcement and deterrence activities

As noted earlier, the activities of tax revenue bodies and the punitive measures at their disposal are significant in the absence of social norms conducive to compliance (Brathwaite 2009). In short, deterrence is important when norms break down. This suggests a peculiar link between enforcement and tax morale, but the exact dynamic of this relationship is somewhat unclear.

It has been suggested that the voluntary compliance component in tax morale should be complemented by the idea that people do, in fact, overestimate the probability that they will be audited and caught (OECD/FIAPP 2015). Compliance with tax law can be enforced if institutions are effective and the threat of sanctions is credible. Enforcement activities, therefore, play a crucial role in guaranteeing compliance. What is more, enforcement activities can have a positive effect on tax morale by signalling that compliance with tax law is, indeed, important (Walsh 2012). In other words, the visibility of enforcement activities can improve tax morale by making it clear that non-compliance and free-riding are unacceptable, and paying your taxes is the right thing to do.

However, intrusive and punitive enforcement activities can have a reverse effect by implying that non-compliance is widespread, thus crowding out voluntary compliance (OECD 2013; Torgler 2007). Taxpayers routinely overestimate the extent to which others evade taxes. To rectify this it has been suggested that revenue bodies should emphasise that compliance with tax laws is widespread in order to assuage the concerns of honest taxpayers that others are not paying their fair share. Emphasis on non-compliance and the resulting sanctions runs the risk of perpetuating the idea that tax evasion is common.

Consequently, finding the right balance between high levels of voluntary tax compliance, low levels of social tolerance for non-compliance, and the visible presence of enforcement activities in the public sphere may be difficult. The revenue body should be able to manage public perception of the acceptability and regularity of compliance, but avoid creating the feeling that it unjustly persecutes people. If it fails to do so, enforcement activities can exacerbate non-compliance.

Justified Evasion: A Question of Fairness and Trust

Robert McGee (2012) makes the startling claim that ‘[t]o argue that a taxpayer is never justified in evading a tax, no matter how unfair the tax or corrupt the government, is simply untenable’ (2012: 23). This is corroborated by research suggesting that fairness and trust are important motivators of compliance – people comply more readily if they trust the authorities.

McGee’s claim points to the possibility that in some cases evasion may be justified. That is to say, even if a person has high standards of tax morale, he or she may feel justified in not paying taxes if certain conditions fail to be satisfied. Several chapters in the volume edited by McGee develop different approaches to tax evasion and suggest possible scenarios in which tax evasion would be an ethically acceptable behaviour. However, for the purposes of this paper I shall focus on arguments that treat paying taxes as a conditional obligation of the citizen who accepts taxation in principle.

Firstly, tax evasion may be justified if the government is perceived as unjustly persecuting vulnerable individuals for not paying taxes⁷, but does not address misconduct in more financially intensive sectors.

Secondly, tax evasion may be justified on the grounds that the state or government is not entitled to a part of your income. There may be a belief that, all things being equal, individuals have a duty to pay taxes. However, if there are legitimate concerns that the government will not use them for the common good and provide quality public services, people may start justifying tax evasion. In short, the taxpayer agrees to pay taxes if the state fulfils its duties.

Thirdly, tax evasion may be justified on the grounds that there is widespread corruption amongst public officials, and public institutions only serve the interests of specific groups. This may increase public distrust in the government. Much like in the previous case, individuals may believe that paying taxes is a duty. However, the perception that the distribution of the common resource pool is unequal and unjust makes tax evasion justifiable.

Thus, it could be argued that the duty towards the state to pay taxes is conditional upon the state guaranteeing a fair distribution of the collected resources and their investment in public goods of the appropriate standard. This, however, leads us to a point raised earlier. Participants of the shadow economy are not denied access to public services, which are often funded through tax revenues. Tax evaders, therefore, enjoy the benefits at the cost of their fellow citizens. If such behaviour goes unsanctioned, this may erode the public’s willingness to participate in the formal sector.

In view of this, several authors have argued that it is unethical to evade taxes if honest taxpayers are burdened (McGee 2012). In this case the duty to pay taxes is towards other citizens, rather than the state. However, the persecution of people who do not pay taxes when (i) corruption is rampant and (ii) there is a widespread perception that tax revenues are not distributed fairly and efficiently dampens the impulse to pay your fair share.

Now that I have outlined different aspects to consider when thinking about tax morale, I will move on to a discussion of the survey results.

Survey on Tax Morale: Summary of the Main results

Several studies have noted that there may be widespread acceptance of tax evasion in Latvia.

⁷ See: <http://nra.lv/latvija/166016-nodoklis-piecreiz-lielaks-neka-pelna.htm>, accessed on 02/11/2016.

A *Eurobarometer* study⁸ on undeclared work was carried out in 2013. The results showed that 11% of Europeans had acquired goods or services in the past year where they have had good reason to believe it involved undeclared work. Furthermore, in Eastern, Central and Southern Europe money earned from such activity often constitutes a significant proportion of people's annual income. This indicates that respondents in these areas often rely on income that is not taxed. Countries with the highest proportions of respondents who have undertaken undeclared paid activities, apart from regular employment, in the previous year were Latvia, the Netherlands and Estonia (11% in each).

The results of the 2008 iteration of the *European Values Survey* indicated that people in Latvia have below average tax morale, and estimates of the size of shadow economies in the European Union suggest that Latvia has widespread tax evasion.

As noted in the introduction, there has been a study devoted to tax morale in Latvia (Mickiewicz, Rebmann and Sauka 2013). Even though the study focused on entrepreneurs, it looked at firms' disposition to pay taxes and factors that increase or decrease it.

In March 2016, the Fiscal Discipline Council commissioned *Latvijas Fakti* to carry out a survey on tax morale in Latvia. The decision was based on the desire to contribute to the ongoing discussion of tax policy changes from a perspective seldom developed systematically in public debate. Specifically – the social tolerance of, and attitude towards, tax evasion.

The survey was conducted in April 2016, and the sample consisted of 1029 respondents. 53% of respondents were female, and 47% were male. The results of the survey pertain to several issues alluded to above.

People's satisfaction with their financial situation is average-to-low. The results of the survey indicate that, on the whole, respondents were somewhat dissatisfied with their financial situation. This is consistent with previous results; Eurostat data from 2013 indicate that satisfaction with one's financial situation in Latvia is below the European Union average. However, fewer people are currently dissatisfied with their financial situation.

Males and females had almost identical views on their financial situation. Satisfaction was higher for people with higher education and for those in the highest income categories. Satisfaction was lower for people in the oldest age group and people living in Latgale.

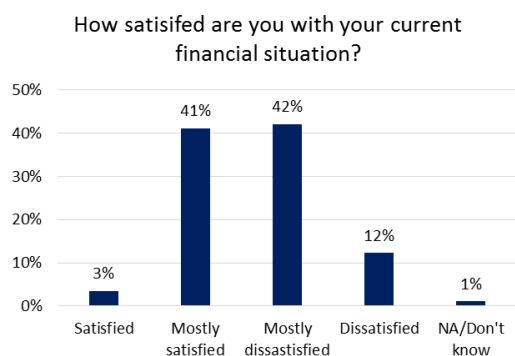


Chart 1.1 Source: Council survey

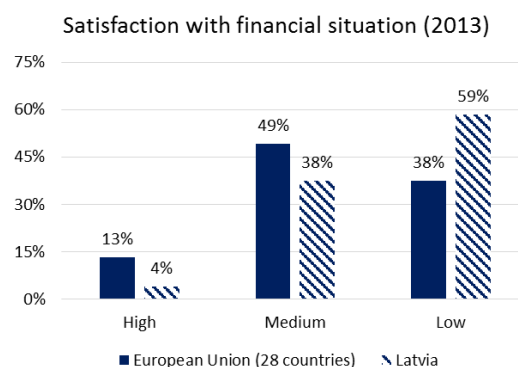


Chart 1.2 Source: Eurostat

As mentioned above, research shows that satisfaction with your financial satisfaction has an influence on tax morale. Even though Latvia's tax morale indicators were quite low compared to other European Union countries, the results of our survey suggests that people whose

⁸ Available at: http://ec.europa.eu/public_opinion/archives/ebs/ebs_402_en.pdf, accessed on 18/10/2016.

satisfaction was below the Latvian average had almost exactly the same attitude towards paying taxes.

However, people who were dissatisfied with their financial situation (12%) were more lenient towards tax evasion.

People in Latvia have low trust in state institutions, and trust in the State Revenue Service is below average. Trust in the government represents that citizens are confident that the government will act appropriately and fairly – the legitimacy of a government is contingent upon it being trusted by its citizens. From 2007 to 2014 on average confidence in national governments across OECD countries declined 3.3 p.p. from 45.2% to 41.8% (OECD 2015b).

The results of the survey indicate that the parliament, the government and the State Revenue Service perform poorly on trust indicators.

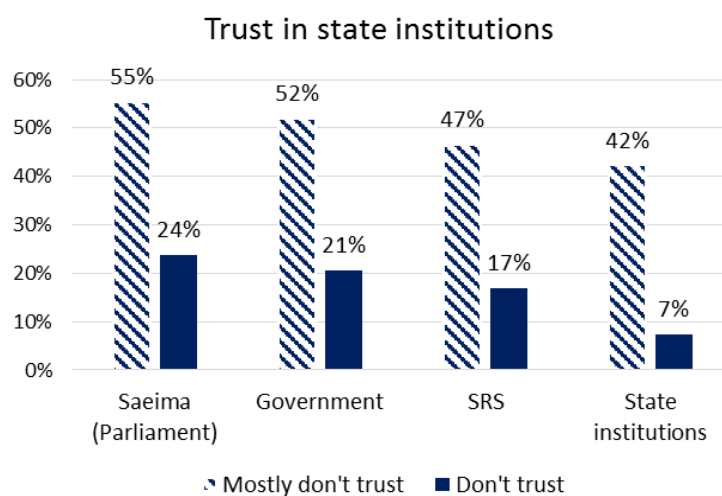


Chart 2 Source: FDC Survey

Eurostat data from 2013 suggest a similar picture, even though trust in the political system in Latvia is comparable to the European Union average.

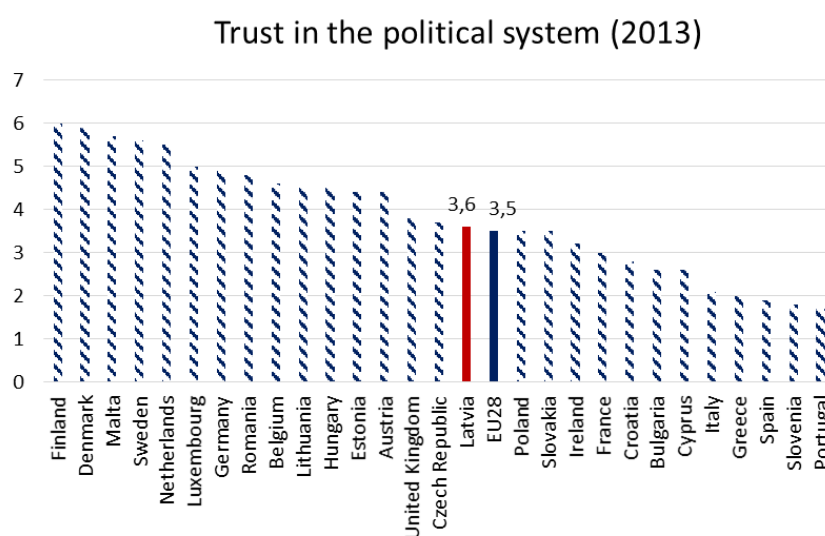


Chart 3 Source: Eurostat

A review of the literature suggests that trust in the tax collecting agency has an influence on tax morale. In the case of Latvia, trust in the tax collecting agency was lower than trust in state

institutions (but higher than trust in the parliament and government). People with lower financial satisfaction were, on average, less trusting of the SRS, whereas people from the higher income categories were more trusting.

Furthermore, those who did not trust the SRS, showed a more lenient attitude towards tax evasion. This leniency, however, has nothing to do with the attitude towards the SRS in particular. People who did not trust the government and parliament showed almost exactly the same results overall.

The population of Latvia is critical of the way tax revenues are spent and the quality of public services. The survey asked respondents about their perception of the quality of infrastructure (e.g. roads), internal security (e.g. police), education, health care services and social security services.

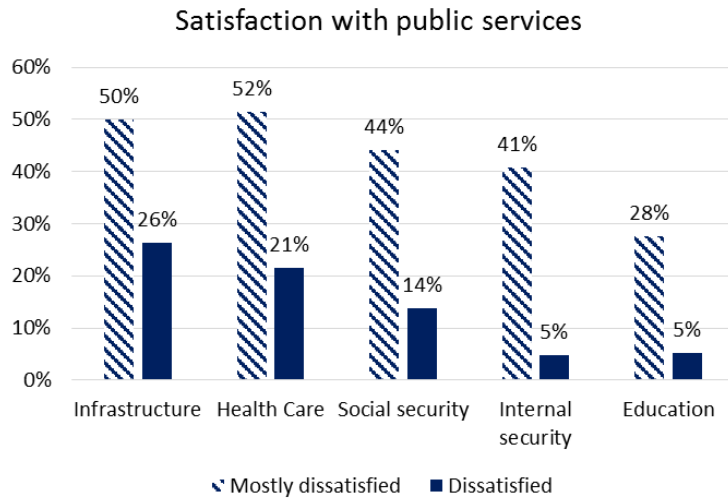


Chart 4 Source: Council survey

The above graph shows that people were largely critical of the quality of public services. Education and internal security performed comparatively well, whereas infrastructure and health care fared the worst. Furthermore, the responses showed that people were not happy with the way the government spends tax revenues.

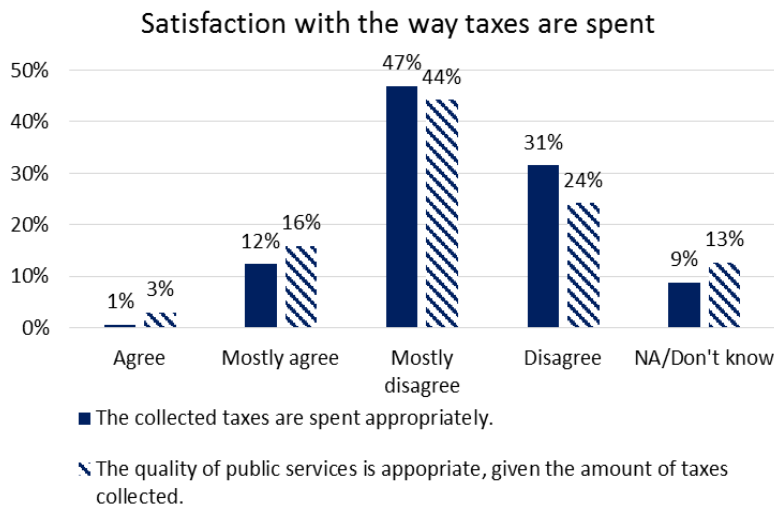


Chart 5 Source: Council Survey

People in Riga had a more positive response to both questions, as did people who were satisfied or mostly satisfied with their financial situation. Earlier in the report it was noted that perception of the fairness of the fiscal exchange may affect people's willingness to pay taxes. In the case of this survey, people who agreed or mostly agreed that the collected taxes are spent appropriately were, on average, more dismissive of tax evasion and more positively disposed towards the SRS.

People have a dismissive attitude towards corruption and tax evasion, but they believe that these are widespread in Latvia. The results of the survey indicate that people find tax evasion and giving and accepting bribes to be unjustifiable acts. In all three cases the majority of respondents believed that the practice is unjustifiable or mostly unjustifiable.

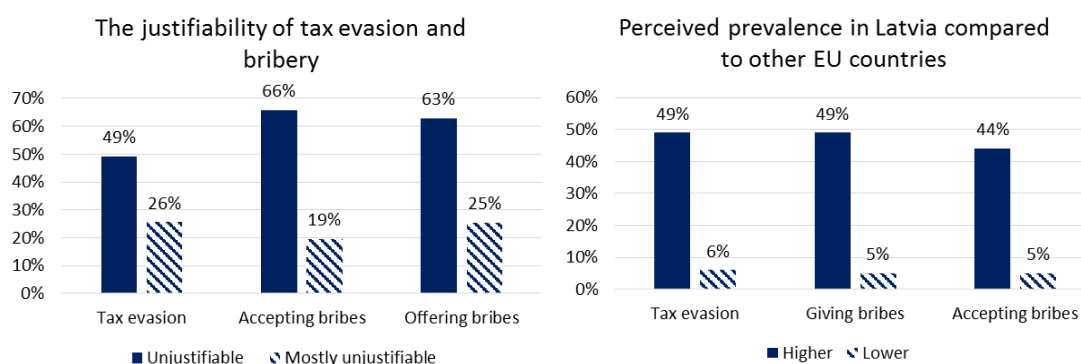


Chart 6.1 Source: Council survey

Chart 6.2 Source: Council survey

Furthermore, 81% of respondents agreed or strongly agreed that paying taxes is a duty of the people living the country. Nonetheless, a considerable portion believed that tax evasion and bribery were more widespread in Latvia than the European Union. This may have an adverse effect on tax morale, as people who thought tax evasion is more prevalent than in the European Union were even less trusting of the SRS.

People's tolerance for tax evasion is low but common. The results above show that the negative attitude towards bribes (both giving and accepting them) is more pronounced. Only 49% of respondents believed that not paying taxes is unjustifiable, whereas the scores for giving and accepting bribes were higher – 63% and 66% respectively. Furthermore, 18% of all respondents said they would justify or probably justify not paying taxes. While this is less than one fifth of all respondents, it shows that a considerable part of Latvian society find tax evasion acceptable. This is further illustrated by the question on whether it is always necessary to pay the appropriate taxes.

It is always necessary to pay the appropriate taxes when paying for a good or service.

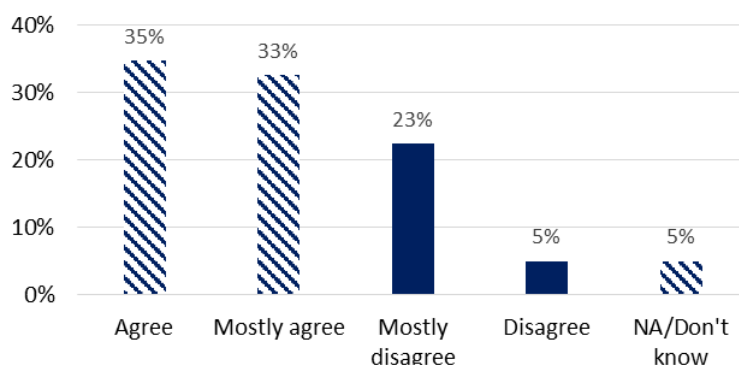


Chart 7 Source: Council survey

The results show that 28% disagreed or somewhat disagreed with the statement that it is always necessary to pay the appropriate taxes. People from Vidzeme and the oldest age groups were more principled in their commitment to paying taxes. The overall result, I would argue, resonates with the responses to the previous questions and indicates a lax attitude towards tax evasion. The results of our survey are similar to the results obtained in the 2008 iteration of the *European Values Survey* where Latvia was among the most tolerant countries in questions pertaining to tax evasion.

Many respondents have experience of tax evasion. The responses indicated that receiving an untaxed salary of paying for services without asking for a receipt is a common occurrence.

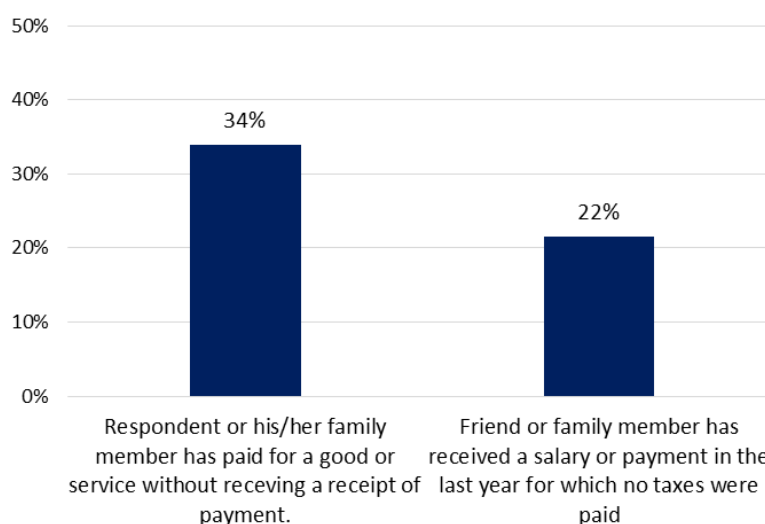


Chart 8 Source: Council survey

The results show that 34% of all respondents have paid for good or services without asking for a receipt and 22% of respondents noted that a friend or family member had received untaxed income in the last year. This is congruent with answers to the previous questions, and suggest that tax evasion in Latvia is widespread, even though the majority believes that paying taxes is a duty and evading them is not justifiable.

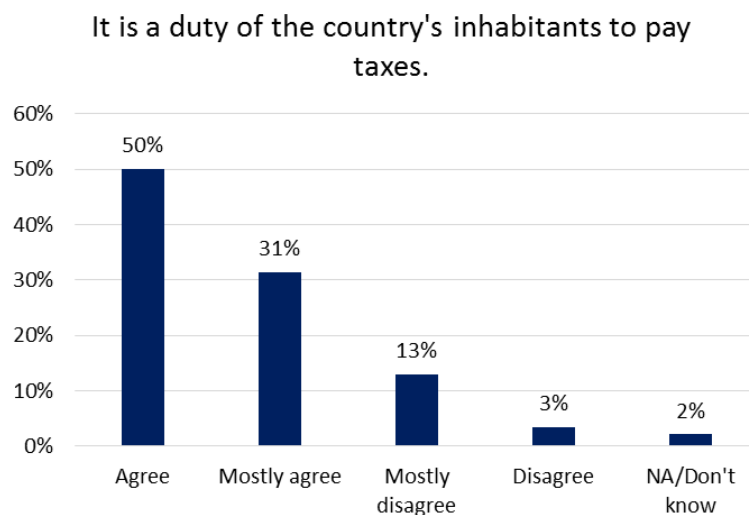


Chart 9 Source: Council survey

That is to say, while there is agreement in principle that paying a share of one’s income in taxes is the right thing to do, actual practice suggests that exceptions are made on a regular basis – not paying taxes is a common occurrence.

The tax system in Latvia is believed to be unfair. Whether or not citizens perceive the exchange of taxes for public services fair influences their willingness to pay taxes. Our survey shows that 74% of all respondents believe that the tax system in Latvia is not fair.

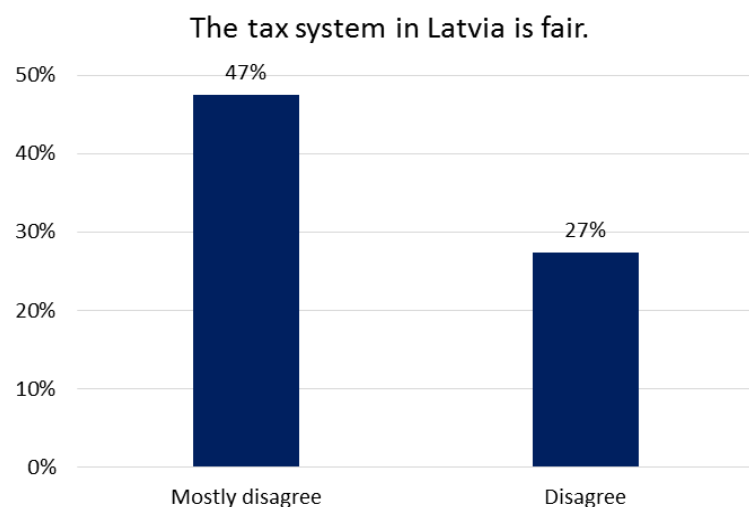


Chart 10 Source: Council survey

However, people with higher financial satisfaction and higher incomes were more positive in their assessment, as were people in the 15-24 age group.

The majority think that the state should provide more services in general and fund health care to a greater extent, but this is offset by an unwillingness to pay higher taxes. The survey shows that the state should have a greater role in providing for its citizens. This, as the results indicate, is especially true of the provision of health care.

Expensive lenience

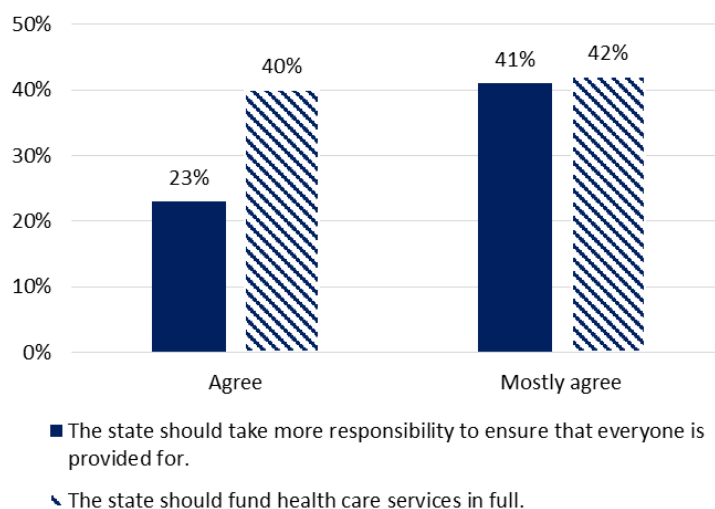


Chart 11 Source: Council survey

While this would suggest that Latvia's population would be in favour of a welfare state, such an interpretation requires additional research and corroboration. For example, the results of a social survey published by the *Baltic International Bank*⁹ in June 2016 show that the number of people in favour of a welfare state declines once the need for higher taxes is made explicit.

The majority think that tax revenues should be increased by reducing the size of the shadow economy, rather than raising tax rates or reviewing tax breaks. Several options were proposed for raising government revenues. 58.3% said that this should be done by reducing the size of the shadow economy. This would be preferable to raising tax rates and reviewing tax exemptions.

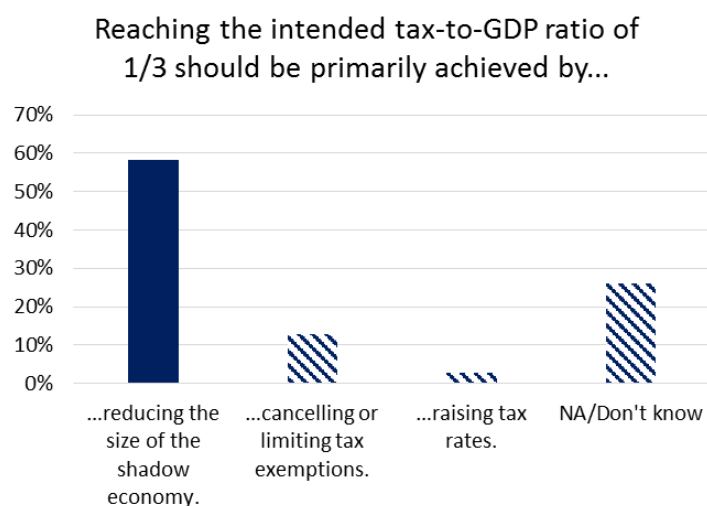


Chart 12 Source: Council survey

⁹ *Baltic International Bank barometer*, June 2016, available at; <http://www.bib.eu/en/about-bank/barometer>, accessed on 18/10/2016.

Analysis

Overall, the results of the survey show that Latvia performs poorly on questions that are used as proxies for tax morale and on questions that pertain to the potential determinants of tax morale.

The majority of Latvia's population thinks that tax evasion is not justifiable. Nonetheless, a considerable part of Latvia's society is lenient towards tax evasion, does not think that paying taxes is mandatory and has experience of tax evasion.

The perception that tax evasion and bribery are a common occurrence exacerbates the situation even further and creates an environment conducive to tax evasion. The frequency of tax evasion, coupled with the belief that many people do it, creates unfavourable conditions for high tax morale, as tax evasion may appear as a typical and morally neutral course of action. In other words, it may become normal both in the descriptive sense and normative sense.

Trust in state institutions in general and the revenue service in particular is low, the quality of public services is deemed unsatisfactory and the overall tax system is believed to be unfair. All these factors bear on the perceived fairness of the fiscal exchange, and, consequently, may affect people's disposition to pay taxes. If the public believes that the government is not fulfilling its obligations and being wasteful with tax revenues, tax evasion may appear justified and the personal costs associated with non-compliance may decline.

Furthermore, even though respondents expressed a preference for a welfare state, the prospect of higher tax rates reduced enthusiasm for public services. This is further compounded by low satisfaction with one's financial situation and the unwillingness to pay a greater share of one's income in taxes. Consequently, the preference for a reduction of the shadow economy as the primary way of increasing government revenues appears consistent with the other results, even though many people in Latvia rely upon income from undeclared work.

In summary, the government in general and the State Revenue Service in particular may encounter difficulties when attempting to increase tax revenues without addressing the issues mentioned above. Targeting areas where tax evasion is suspected and developing effective enforcement measures will improve compliance. Nonetheless, resolving the problem of tax evasion and non-compliance may also hinge on improving people's perception of the fiscal exchange – taxes and social security contributions for public services and social safety. However, trust in state institutions and the belief that tax evasion and corruption are widespread and morally neutral also requires attention.

Conclusions

Latvia's tax revenues have consistently been among the lowest in the European Union. The current government of Latvia has declared that it intends to reach a tax-to-GDP of 1/3 by 2020. This will primarily be achieved by reducing the size the shadow economy, which is among the biggest in the European Union.

Given Latvia's contracting labour force and increasing old-age dependency ratio, addressing tax evasion and non-compliance will assist in maintaining tax revenues and social security contributions at desired levels without further burdening members of the formal economy.

While effective enforcement strategies are crucial for compliance, this paper has argued that tax morale, or the intrinsic motivation to pay taxes, should also be considered. I have tried to show that recent discussions of tax evasion have emphasised taxpayer education and an

understanding of taxpayer behaviour that combines insights from economics, psychology and sociology. While the impact of tax morale is difficult to quantify precisely, it allows for a more complete understanding of non-compliance and provides new courses of action to increase government revenues.

The results of the survey commissioned by the Fiscal Discipline Council suggest that more attention should be paid to clarifying the link between the amount of taxes paid and the quality of public services. This may increase confidence in the fiscal exchange. Furthermore, a higher tax morale may be achieved by building trust in the tax system, the State Revenue Service and public institutions in general. In addition, the State Revenue Service should make a greater effort to make clear that tax evasion is not an acceptable course of action and emphasise that compliance is widespread and desirable.

Based on revised data from the Central Statistical Bureau from October 2016¹⁰, in 2015 the gap between the actual outcome¹¹ and the intended tax-to-GDP ratio of 1/3 was 1.03 billion euro. This is roughly equivalent to 4.2% of Latvia's GDP. The Fiscal Discipline Council has noted that reducing the shadow economy will not be sufficient to increase tax revenues to the desired level¹². New revenue measures and modifications to the existing tax framework will be necessary. Nonetheless, improving tax morale is a way of ensuring sustainable levels of compliance and reducing the amount of resources necessary for preventive measures.

¹⁰ Latvia's nominal GDP in 2015 was 24.348 billion euro, see: http://www.csb.gov.lv/sites/default/files/dokumenti/edp_tabulas_lv_oktobris_2016.pdf, accessed on 04/11/2016.

¹¹ In 2015 tax revenues and social contributions accounted for 7.002 billion euro, see http://www.fm.gov.lv/files/valstsbudzets/FMPask_D_131016_proj2017.pdf, accessed on 04/11/2016.

¹² *Fiscal discipline surveillance report 2016*, available at: <http://fiscalcouncil.lv/05-10-2016-surveillance-report>, accessed on 18/10/2016.

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