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The impact of the tax system on gender equality in Estonia

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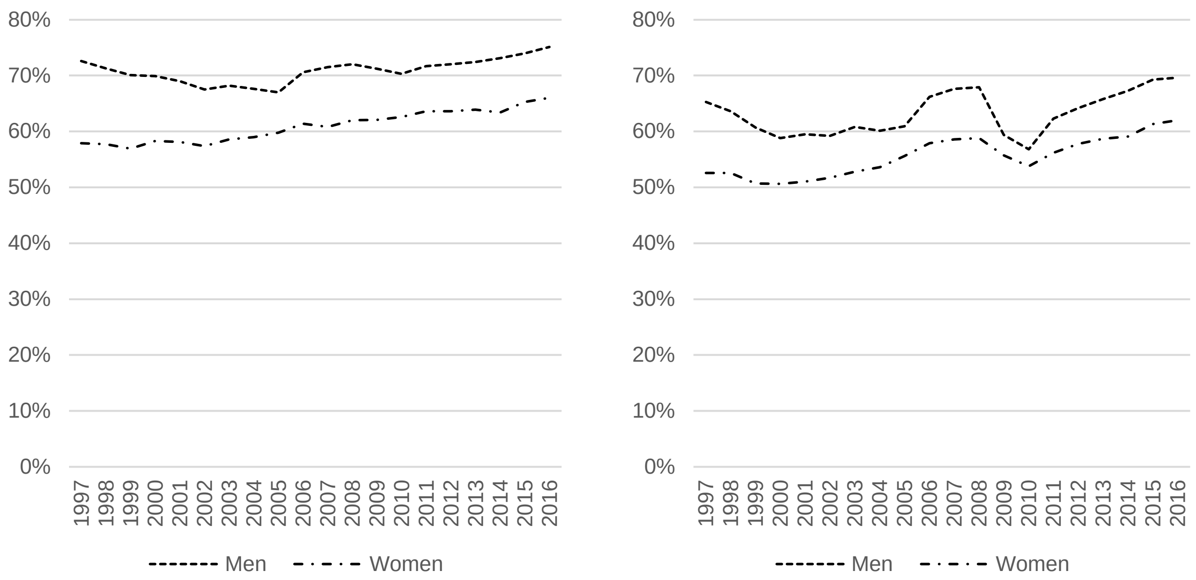
1. Country Context

1.1. Women in the Estonian labour market

Estonian women's labour market participation and employment rates are relatively high, exceeding the EU average. Nevertheless, gaps remain, reaching about 9 percentage points in participation rates and 7.6 percentage points in employment rates in 2016 (see Figure 1). This is higher than in Nordic countries such as Sweden, where the difference between men's and women's employment rates is less than four percentage points.

Figure 1: Participation rate (left) and employment rate (right) for men and women aged 15-69, 1997-2016.



Source: Statistics Estonia.

Estonian women's employment is characterised by the prevalence of full-time employment. The share of part-time workers among women is less than half that of the average of EU-28 countries. Nevertheless, as is common elsewhere, women are more likely to work part-time than men. The share of part-time workers among all female employees has been below 10% in the past, but increased to 13% during the recession in 2008 and has remained at a relatively high level up to 2016 (see Figure 2).

Figure 2: Share of part-time workers among male and female employees, 1989-2016.

Source: Statistics Estonia.

1.2. Taxation of income in Estonia

1.2.1. Taxation up to 2017

Since 1994, Estonia's system of taxation has been characterised as a simple and transparent flat tax system. At first, all labour income was taxed at 26%; over time, the tax rate has been reduced to the present level of 20%. Although the tax rate is flat, the basic income tax exemption (as of 2017, €2,160 in 2017 or €180 on a monthly basis) adds a certain degree of progressivity. In addition, social tax and health insurance tax, at the rate of 33% in total, is paid on labour income. Unlike many other countries, social tax is formally an employer's tax in Estonia.

Since regaining independence from the Soviet Union, the law has always allowed for joint declaration of income by married spouses. This allows the couple to benefit from making use of the total amount of the individual tax exemptions in case one of the spouses has not worked or has otherwise not used up his or her tax allowance. In case both of the spouses have been employed throughout the year, there is no benefit from declaring income jointly rather than individually. Even in case of non-employment, there are many situations in which the individual may in fact be using the income tax exemption: most benefits such as the unemployment insurance benefit, parental benefit etc, and pensions, are taxed with income tax.

Note that joint declaration of income has always been optional in Estonia: even if married, the spouses have always had the option to declare their income separately. Furthermore, it cannot be said that the joint declaration of income is in any way the "default" option for married couples, either from the point of view of the law or on income declaration forms or the user interface of the Tax Board's online service. As such, the characterization of Estonia's tax provisions as "family-based" rather than "optional" in Thomas and O'Reilly (2016), quoted in the discussion paper, is incorrect.

According to the Estonian Tax and Customs Board, 157,000 persons submitted joint declarations in 2015, making up 13.4% of all income tax declarations. The share of joint declarations has steadily decreased from 28% a decade ago (Pärgma 2016).

1.2.2. Taxation from 2018 onwards

A government coalition, formed in 2016 of Social Democrats, the Centrist Party, and the conservative IRL, initiated a number of reforms regarding various aspects of taxation that will enter into force starting from 2018.

Joint declaration of income by spouses will remain an option. However, according to the Income Tax Act approved by the Parliament as of the writing of this paper, the basic income tax exemption will no longer be transferable between spouses. Certain tax-exempt expenses such as costs of training and interest on housing loans will remain transferable. Nevertheless, for the purposes of this paper, we will loosely term the reform the abolishing of the joint declaration, since the financial impact on families will be primarily due to the non-transferability of the basic exemption.

The flat tax at the rate of 20% will nominally remain in place. However, the income tax exemption will become more complex: the basic income tax exemption will be €6,000, but will be reduced by €1 for every euro exceeding €14,400 of annual income and reaching zero when annual income of 25,200 is attained. Thus, an additional element of progressivity (in a certain income range) will be introduced into the tax system. In effect, this is equivalent to a peculiar tax schedule with the following brackets:

- 0% for monthly incomes up to 500;
- 20% for income range 501-1200;
- 31% for the range 1201-2100;
- 20% for incomes above 2100.

At first glance, eliminating the transferability of the income tax exemption would seem to increase incentives for women to participate in the labour market, since the effective tax rate on participation will decrease: under the old system, if the previously inactive spouse entered the labour market, the income tax paid on the total income of the family would increase. However, such incentives would need to be considered in the context of the tax system in general: for example, in case of progressive taxation, changes in the marginal tax rates faced by the family can be very different from those under a flat tax system. Since Estonia is introducing both individual-only tax declarations and additional progressivity, the effects of these changes will have to be considered together.

1.2.3. The impact of taxation on women's participation

In general, two-earner households have been the norm in Estonia, the phenomenon of housewives being rare. Women's participation and employment is relatively high, supported by the extensive publicly subsidized network of pre-school educational institutions. This is a legacy from the Soviet times when full employment was considered the norm, and in a modernised form continues to be widely used. On the other hand, generous paternal leave policies (100% of previous earnings for 435 days) encourage women to stay away from the labour market for the first year and a half after childbirth.

Given that the income tax system has remained in principle the same over the past decades – with the exception of falling income tax rates – it is difficult to say what particular effects it may have had on women's participation in the past. With the flat tax rate and optional joint taxation, there have been no pronounced disincentives to participation associated with the family's income moving into higher tax brackets with the inactive spouse's participation. However, the incentive structure will change with changes in the system starting from 2018, which will be discussed below.

Figure 3 describes average tax rates on the family's income upon the previously inactive second earner's entry into employment. It is assumed that the first earner earns the average wage forecast for 2017 (€ 1,121). The horizontal axis describes different wage levels for the second earner as a percentage of the first earner's wage. The average tax rate is calculated as follows:

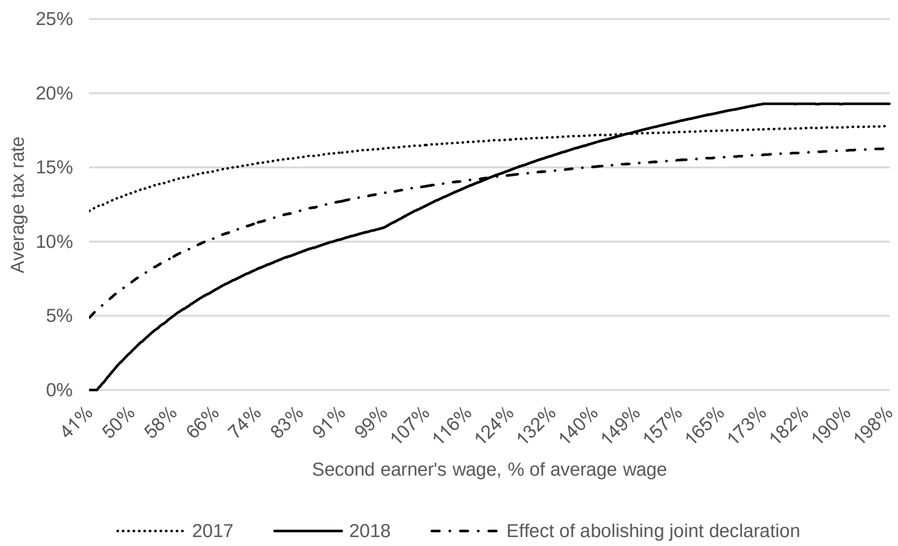
$$ATR = 1 - \frac{family\ net\ income_{IW} - family\ net\ income_{OW}}{family\ gross\ income_{IW} - family\ groww\ income_{OW}}$$

where the subscripts *IW* and *OW* indicate the second earner's being in work or out of work, respectively. The higher the average tax rate, the higher the disincentive to the second earner's participation.

We compare three scenarios: the current tax system is indicated by the line marked 2017, the future system is marked 2018 and the line in between the two considers a system in which the joint taxation were abolished but the basic exemption left as in the current system, indicating the effect on incentives purely due to abolishing joint taxation. Importantly, these calculations only consider taxes and no benefits.

As can be seen from the figure, abolishing the joint taxation decreases the average tax rate on participation significantly at all levels of the second earner's labour income. If we add to this effect the new sliding-scale tax exemption regulation, the reduction in tax disincentives to participation is reduced even more at levels below 124% of average wage. However, at higher levels of second earner's wage (over 150% of average), the new system presents higher disincentives to participation than under the current system. However, given that the group potentially earning less than 124% of average is much larger than the group earning over 150% of average, the former effect can be expected to dominate.

Figure 3: Average tax rates under the current tax system (2017), the new system (2018) and the effect of abolishing transferability of income tax exemption.



Source: Author's calculations.

It will be interesting to see in the coming years what effect these changes in incentives will have on women's participation and employment. Although changes in tax incentives are substantial, there are factors that limit their potential effect on employment. This can be seen if we consider the reasons for women's inactivity. According to the Estonian Labour Force Survey, the main self-reported reasons for women's being out of employment are studies (25% of inactive women), being of pension age (22%), maternity or parental leave (20%), and illness or disability (20%). Together, these four reasons account for 87% of women's inactivity at ages 16-69 (81% among inactive legally married women). Thus, many inactive women have important other considerations than tax incentives to take into account when making the decision on whether to join the labour force. Not least among such considerations are child care costs and social benefits (particularly the parental benefit, which penalises employment during benefit receipt), the full treatment of which is outside the scope of this paper. Furthermore, legally married women, i.e. those to whom regulation regarding joint taxation potentially applies, account for only 37% of all inactive women.

2. Policy Debate

As described above, Estonia's tax system is at present in the process of substantial change, particularly in regard to joint taxation of spouses that is the topic of the discussion paper. The scope of the changes under debate is indicated by the abolishing of the transferability of the spouse's income tax exemption when declaring taxes jointly – effectively eliminating a substantial part of the rationale of joint declaration.

Nevertheless, the political debates around the aspects of the tax system influenced by the reform are still very much ongoing. The conservative Reform Party, a leading opposition party at the time of writing, announced in April its intention to bring joint declarations back. In May 2017, i.e., before the new regulation has even entered into force, the government coalition announced that the extent of transferability of income in joint declarations will be reviewed in the future. Thus, it is at present too early to say what final form the regulation will eventually take and how long-lived the changes will be.

Conservative opposition parties opposed limiting or eliminating the joint declarations. One of the criticisms appealed to family values, pointing out that the reform increases tax obligations of married couples. The governing coalition countered that criticism by arguing that the introduction of the new tax exemption regulation more than compensates the loss of tax reimbursement.

Another criticism focused on the perceived conflict between the individual tax declaration and the legal concept of joint property as stipulated in the Family Act. It is unclear, however, why there was no such conflict previously in case of married couples who opted for individual declaration of income, as has always been allowed by the law.

Noteworthy regarding the policy debate around joint declaration is the complete absence of any discussion of gender issues. For the governing coalition, limiting the options in the joint declaration of income was a measure of reducing the costs for the government due to tax reimbursement. The government needed it to compensate the loss of revenue due to the introduction of the sliding-scale tax exemption, an initiative to lower the tax burden on low wage earners. It has thus been seen as a budget measure, not one of gender equality of labour force participation.

3. Transferability aspects

The transferability of the Swedish experience could be viewed in different ways. On the one hand, it could be said that Estonia has adopted a change in the tax system which is similar in a crucial aspect to Sweden’s. On the other hand, the starting point of the reforms has been very different (progressive taxation in Sweden vs the flat tax system in Estonia), which affects the labour market impact of the respective reforms.

Furthermore, the rationale for the reform and policy debate has been very different in the two countries (gender equality vs budget income issues). In the absence of a popular grassroots initiative for the reform as in Estonia in contrast to Sweden, joint taxation will probably be restored and presented as a family-friendly policy.

4. Conclusions and recommendations

Although women’s participation and employment rates are high in Estonia, gaps vis-à-vis men’s rates remain higher than in Sweden. Starting from 2018, Estonia will adopt a new regulation of income tax declaration which is similar to Sweden’s in the aspect of non-transferability of the basic tax exemption. It can be expected to reduce the disincentives to previously inactive spouses’ participation. To what extent this will manifest in women’s higher participation and employment remains to be seen, given that other obstacles to participation (health issues, care obligations, language skills, etc) will remain for part of the inactive population. However, given Estonia’s (semi-) flat income tax system and already high female participation and employment rates, such impacts can be expected to be modest.

Two recommendations can be made based on the above discussion. First, the obvious one, that the analysis of the incentives and disincentives to employment should include other aspects of tax and benefit reform. In case of Estonia, the reform package included aspects that, when considered jointly, introduced both incentives and disincentives for persons with different earning power. Second, efforts should be made to give the proposal to introduce individual taxation a wide popular base (lacking in Estonia, in contrast to Sweden), otherwise the policy may be vulnerable to reversal by its opponents.

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