

# Economic models – implementation in reality



SSE RIGA

## Gaming the System: Side Effects of Earnings-Dependent Benefits

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## What and why do we study?

- ▶ We study labor income tax evasion in Latvia;
- ▶ Economists say that people start paying taxes once they are given the right incentives;
- ▶ If future benefits depend on declared earnings, then motivation to declare the true earnings is stronger;
- ▶ Also, economists know that people are very quick in adjusting their income to enjoy more favorable tax rules;
- ▶ We study the consequences of 2005 reform, when the childcare benefit in Latvia was tied to parents' earnings;
- ▶ Our hypothesis is that **this reform increased incentives to declare true earnings during pregnancy.**



## 2005 reform of the childcare benefit

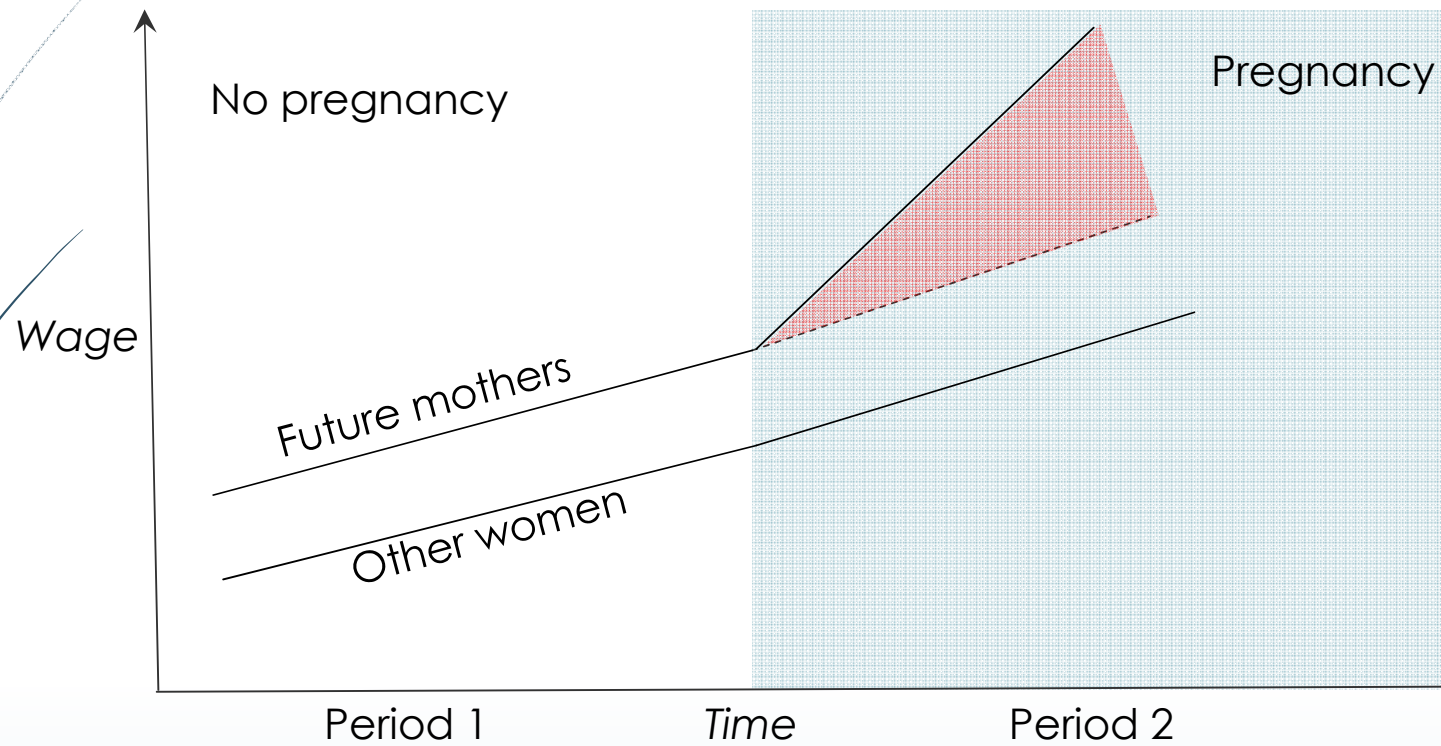
- ▶ Before the reform: childcare benefit was fixed amount – 43EUR per month;
- ▶ Starting January 2005, monthly benefit - 70% of the previous gross earnings;
- ▶ Paid until the child is 1 year old;
- ▶ Benefit qualification period was 12 month, ending 3 months prior to the birth of the child;
- ▶ There was 5-months overlapping of benefit qualification period and pregnancy.



## Our approach

- Economists always look for counterfactuals
- Think about this in terms of drug testing: what has happened as a result of treatment compared to what would have happened in its absence?
- In our case: what would the wage of a pregnant woman be, if she did not get pregnant?

## Our approach (cont.)

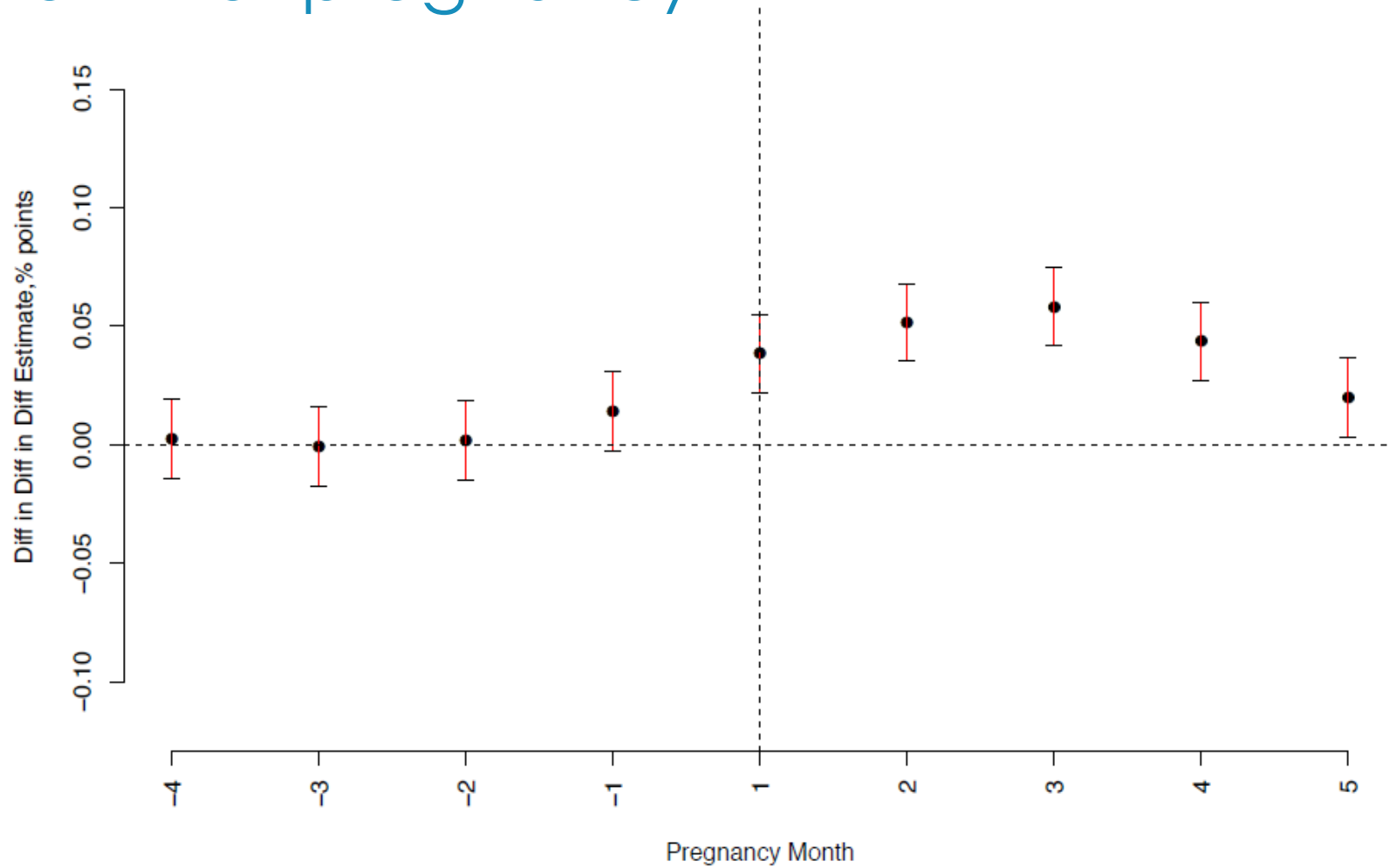




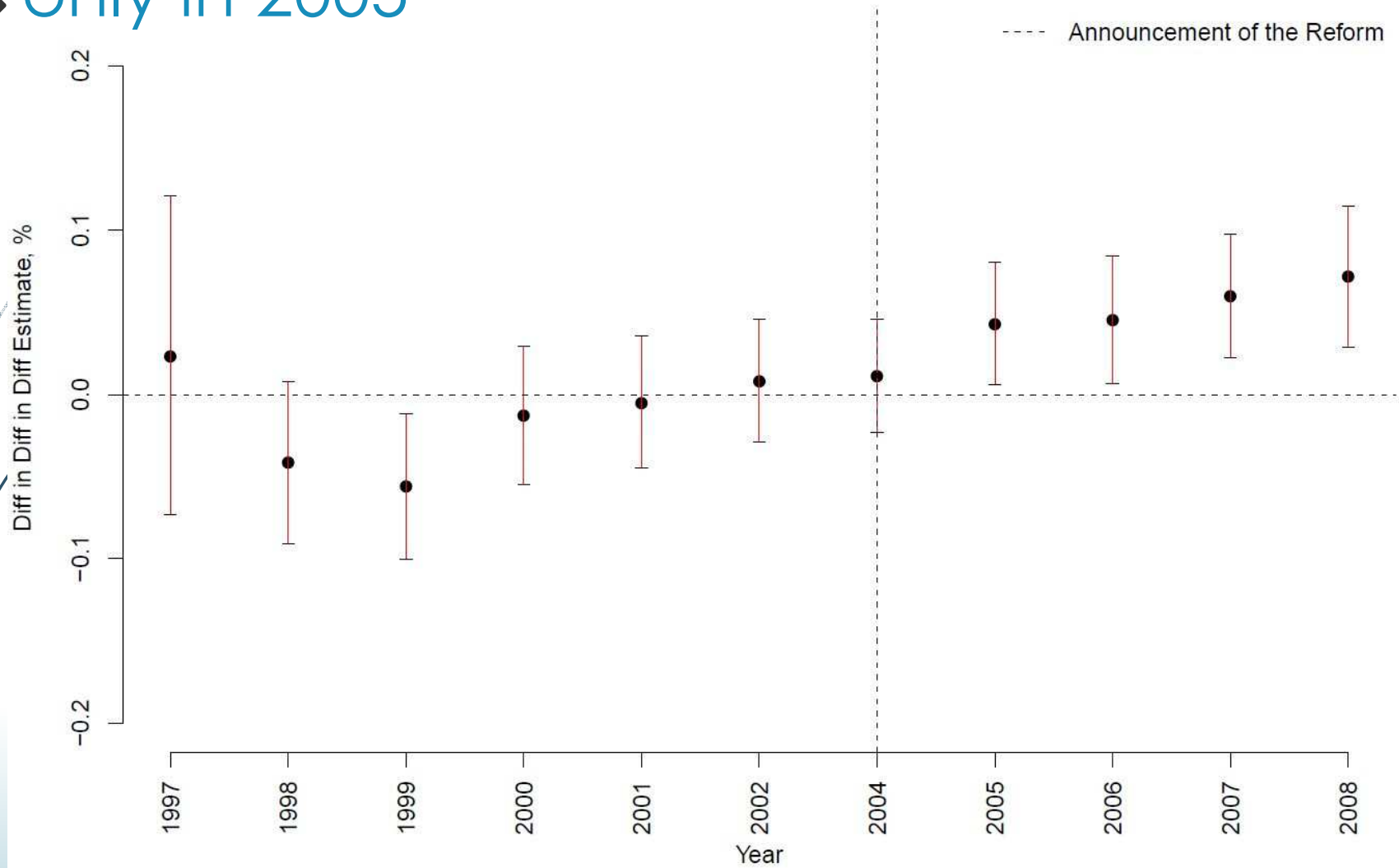
## Data

- Data about declared monthly wage of all Latvian employees in 1996 – 2010;
- Anonimized data! (we don't see any personal information);
- We know if the employer is a public or a private sector entity.

# Results – wages start growing in the 1<sup>st</sup> month of pregnancy

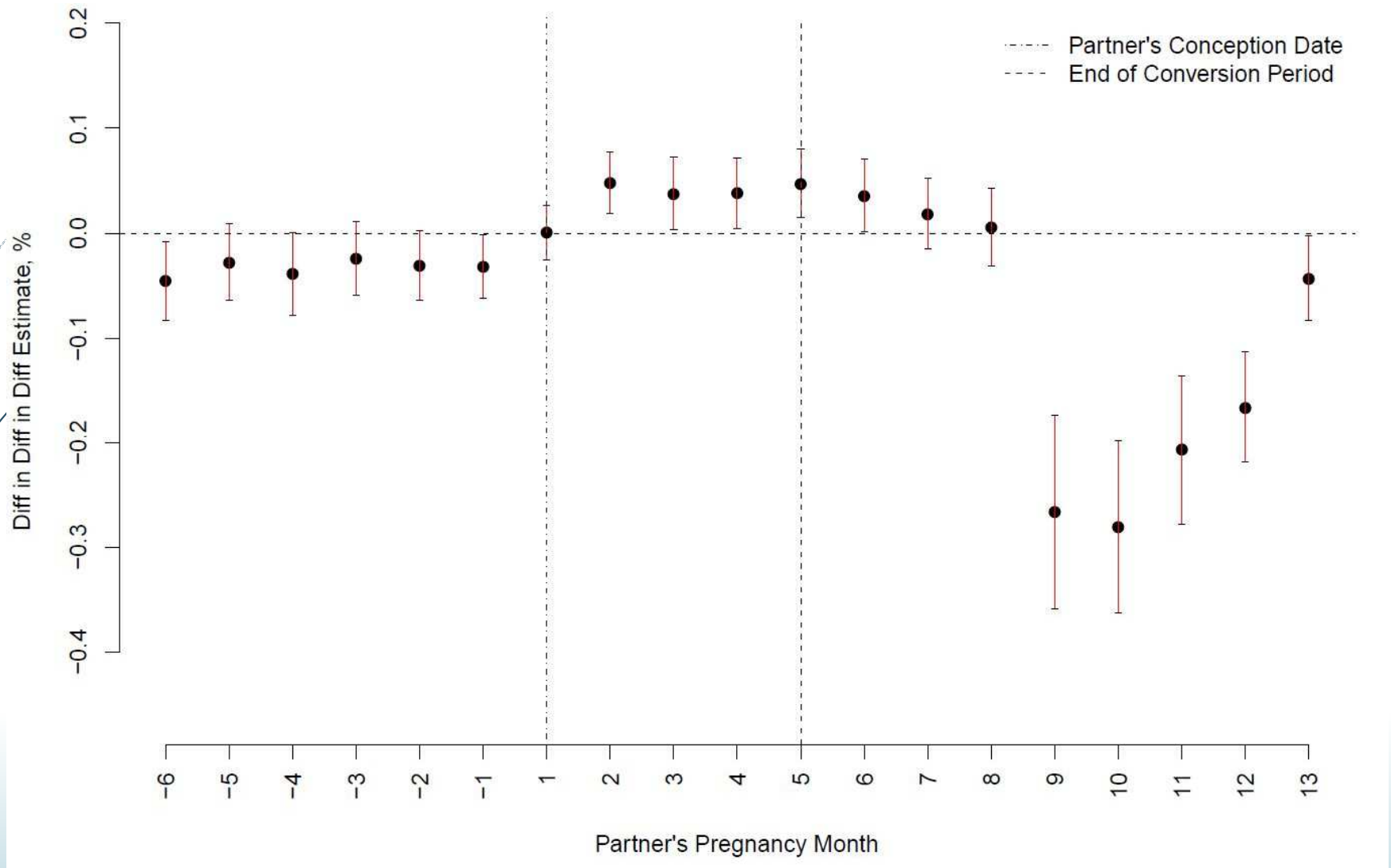


# Results – the effect starts to appear only in 2005





# Results for men





## Conclusions

- ▶ Tying benefits to earnings increased incentives to declare higher earnings;
- ▶ But wage legalization is only temporary, wages come back after the end of benefit qualification period;
- ▶ Tying benefits to earnings can be not effective in reducing informality if benefit qualification period is short and includes time when the person knows if/when she will be eligible for the benefits.



# Thank you for attention!

## Questions for discussion:

1. Do you think exclusion of the pregnancy period from the benefit qualification period might help in putting more pressure on employers and reduce the prevalence of "envelopes"?
2. Any other suggestions to policy makers on how to address the problem of "envelope" wages?

# Results – the effect is stronger in small firms

