Europe's Banking Crisis: Latvia's Third Option

Neither Devaluation nor Austerity, but Tax Restructuring

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As Europe's banking crisis deepens, Greece's and Spain's fiscal crisis spreads throughout Europe and the US economy stalls, most discussions of how to stabilize national finances assume that only two options are available: "internal devaluation" – shrinking the economy by cutting public spending; or outright devaluation of the currency (for countries that have not yet joined the euro, such as Eastern Europe).

The Baltics and other countries have rejected currency depreciation on the ground that it would delay EU membership. But as most debts are denominated in euros – and owed mainly to foreign banks or their local branches – devaluation would cause a sharp jump in debt service, causing even more defaults and negative equity in real estate. Devaluation also would raise the price of energy and other essential imports, aggravating the economic squeeze.

Sovereign governments of course can re-denominate all debts in domestic currency by abolishing the "foreign currency" clause, much as President Roosevelt abolished the "gold clause" in U.S. bank contracts in 1933. This would pass the bad-loan problem on to the Swedish, Austrian and other foreign banks that have made the loans now going bad. But most government leaders find currency devaluation so unthinkable that, at first glance, there seems to be only one alternative: an austerity program of fiscal cutbacks.

The EU, IMF and major banks are telling governments to run budget surpluses by cutting back pension and social security programs, health care, education and other social spending. Central banks are to reinforce austerity by reducing credit. Wages and prices are assumed to fall proportionally, enabling shrinking economies to "earn their way out of debt" by squeezing out a trade surplus to earn the euros to carry the enormous mortgage debts that fueled the post-2002 property bubble, and the new central bank debt taken on to support the exchange rate.

The Baltic States have adopted the most extreme monetary and fiscal austerity program. Government spending cutbacks and deflationary monetary policies have shrunk the GDP by more than 20% over the past two years in Lithuania and Latvia. Wage levels in Latvia's public sector have fallen by 30%, and the central bank has expressed hope that the wage squeeze will continue and lower private-sector wages as well.

The problem is that austerity prompts strikes and slowdowns, which shrinks the domestic market and investment. Unemployment spreads and wages fall. This leads tax receipts to plunge, because Latvia's tax system falls almost entirely on employment. Half of the employers' wage bill goes to pay the exorbitant set of flat taxes amounting to over 51%, while a VAT tax absorbs another 7% of disposable personal income. Yet the central bank trumpets the wage decline as a success – and would like even further shrinkage!

Property prices have plunged too, by as much as 70%. Mortgage arrears have soared to over 25 percent, and defaults are rising. Downtown Riga and the Baltic beach suburb of Jurmala are filled with vacancies and “for sale” signs. Falling prices lock mortgage-burdened owners into their properties. Meanwhile, the virtual absence of a property tax (a merely nominal rate in practice of about 0.1%) has enabled speculators to leave prime properties unrented.

About 90% of Latvian mortgage debts are in euros, and most are owed to Swedish banks or their local branches. A few years ago, bank regulators urged banks to shift away from collateral-based lending (where the property backed the loan) to “income-based” lending. Banks were encouraged to insist that as many family members as possible co-sign the loans – children and parents, even uncles and aunts. This enables banks to attach the salaries of all co-signing parties.

The next step is to foreclose on the property. Bank regulators are concerned only with maintaining bank solvency (mainly for a foreign-owned banking system) not with the overall economy. Their model is Estonia which combined stable finances with 15% economic shrinkage in 2009, and was rewarded by last month’s promise of entry into Euroland.

The result is that instead of running the banking system for the economy, Latvia and other post-Soviet economies are managing their economies to maintain bank solvency – as if the indebted population is really expected to spend the rest of their lives paying off the deep negative equity left in the wake of bad loans.

This is causing such havoc that some business owners are emigrating to escape their debts. The newspaper Diena recently published an article about a woman of modest means in the mid-sized Latvian town of Jelgava. After taking out a 40,000 lat ($65,000) mortgage she lost her job. The bank refused to renegotiate and auctioned off her property for just 7,500 lats, leaving her still owing 30,000 for the shortfall, to be paid out of future income.

Mortgage lending to fuel the property bubble has been financing the trade deficit – but now has stopped

Until the property bubble burst two years ago, euro-mortgage lending provided the foreign exchange to cover Latvia’s trade deficit. The central bank is now borrowing from the EU an IMF, on the condition that the loan will be used only to back the currency as a cushion. This seems self-defeating, because monetary deflation will cause financial distress, aggravating the bad-debt crisis and spurring financial outflows.

Can governments that promote such policies be re-elected to office? In Latvia and other East European economies, political parties are developing a Third Option as an alternative to devaluation, economic shrinkage and declining living standards.

This Third Option is to reform the tax system. It starts with the fact that Latvia’s bloated 50%+ tax package on employment means that take-home wages are less than half of what employers pay. Latvia has the worst remunerated northern European labor, yet it is proportionally the highest-cost to employers. And to make matters worse, real estate taxes are only a fraction of 1%. This has been a major factor fueling the real estate bubble. Untaxed land value is paid to banks, which in turn lend their mortgage receipts out to bid up property prices all the more – while obliging the government to tax labor and sales, raising the cost of labor and the price of goods and services. A similar high flat tax on labor and little property tax has plagued the entire post-Soviet block ever since 1991.

The good news is that this malformed tax system leaves substantial room to shift employment taxes onto the "free lunch" revenue comprised of the land's rental value, monopoly rents and financial wealth. At present, this revenue is left "free" of taxation – only to be pledged to banks.

Latvia's economy can be made more competitive simply by freeing it from the twin burden of heavily taxed wages and housing prices inflated by easy euro-credit. It has a wide margin to reduce the cost of labor to employers by 50 percent, without reducing take-home wages. A tax shift off labor onto the land's rental value would lower the cost of employment without squeezing living standards – and without endangering government finances.

Lowering taxes on wages would reduce the cost of employment without squeezing take-home pay and living standards. Raising taxes on property, meanwhile, would leave less value to be capitalized into bank loans, thus guarding against future indebtedness.

This was the policy that underlay Hong Kong's economic rise – the example that Latvian leaders hope to emulate as a banking service entrepot and international technology center (as Latvia was in pre-1991 Soviet times). Hong Kong promoted its economic takeoff by relying mainly on collecting the land's rental value, enabling it to minimize employment taxes (presently only 15%).

Shifting the burden of tax from labour onto land would therefore hold down the price of housing and commercial space, because rental value that is taxed will no longer will be recycled into new mortgages.

The tax shift also can bring down property prices, because rental value that is taxed no longer will be available for banks to capitalize into mortgage loans. Housing in debt-leveraged economies such as the United States and Britain typically absorbs 40 percent of family budgets. Reducing this proportion to 20 percent – the typical rate in Germany's much less indebted economy, where lending has been more responsible – could enable wage receipts to be spent on goods and services rather than as mortgage debt service. It thus would provide further scope for wage moderation without lowering living standards. This means that Latvians and other Eastern European countries do not need to sacrifice the economy on a cross of euro-debts and suffer from currency devaluation or austerity programs.

Shifting the tax off employees onto the land would cut the cost of living for Latvians, by holding down the price of housing and commercial space. The economic rent – income without any corresponding cost of production – would be paid to the government as the tax base rather than being "free" to be pledged to banks to be capitalized into mortgage loans. Property prices are determined by how much banks will lend, so taxing the land's rental value (but not legitimate returns on building and capital improvements) would reduce the capitalization rate, holding down property prices.

In sum, the problem with monetary deflation ("internal devaluation") is that it leaves the existing dysfunctional tax structures in place. The main issue in Eastern Europe and beyond over the coming years will be whether economies can free themselves from the twin burden of heavily taxed wages and inflated housing prices, while avoiding an overdose of needless austerity. The tax structure needs to be changed – along the lines that most countries in the West expected to see a century ago.

The aim should be to make the economy more competitive by minimizing the cost of living and doing business. The Third Option serves to bring property and monopoly prices in line with necessary costs of production. Taxing away "empty" pricing in excess of cost-value – economic rent – was part of the "original" liberalism of Adam Smith and John Stuart Mill, and indeed of classical economists from the French Physiocrats down through Progressive Era reformers.

The national parliamentary elections scheduled for this October will be fought largely over the Latvia Renewed economic development program, sponsored by Harmony Center the coalition of left-wing parties. At the latter's annual meeting on May 29-30, party leaders moved to start preparations to translate the above alternative into law and drawing up a land-value map of Latvia.

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