Executive summary

Setting the scene for tax reform

Despite a rapid recovery from the pandemic, Lithuania faces several structural demographic, employment and economic challenges. The economy and the labour market in Lithuania have recovered from the pandemic. GDP per capita has grown rapidly since 2019. Labour force participation and employment are high. The unemployment rate is on a downward path. Strong economic performance has contributed to a rising tax-to-GDP ratio. However, the country faces several structural challenges. The share of the population aged over 65 is expected to reach 32% by 2050. The working-age population is shrinking at about 1% per year on average. In addition, a pool of vulnerable individuals are locked-out of the labour market. The share of long-term unemployment is high and many long-term unemployed are unable rather than unwilling to re-enter employment. Poor health, skill mismatches and an educational divide in the country contribute to the employment challenge. Notwithstanding the rapid increases in wages in recent years, including minimum wages, disposable income inequality is among the highest in the OECD, the redistributive role of taxes and transfers is limited and social spending as a share of GDP remains comparatively low.

Poverty rates are high, particularly for the unemployed, single individuals and the elderly. 1 in 5 people face poverty risk in Lithuania. The unemployed are hardest hit by poverty, with more than half of all unemployed individuals facing poverty risk. The elderly face the highest risk of poverty across the age groups. A decade after the retirement age, incomes have declined by more than half on average. This 'income cliff' is steeper and occurs sooner for those on lower income than those on higher incomes. Net pension replacement rates in Lithuania are among the lowest in the OECD. In addition, a growing share of retired Lithuanian are working, in part to supplement low incomes. Women have lower pensions due to shorter contributions, earlier eligibility for retirement and career breaks but also because the life expectancy of Lithuanian women exceeds that of Lithuanian men by a decade, making older women particularly vulnerable to poverty.

The design of the tax and benefit system

The tax wedge has declined over the past two decades, narrowing the gap with the OECD average. Lithuania's tax wedge (i.e. the difference between the labour costs to the employer and the corresponding net take-home pay of the employee) is similar to Latvia and Estonia for most family types, except for low-income families with children where it is significantly lower. Single parents face lower tax burdens than individuals at all income levels due to child benefits but especially at low incomes. Negative tax burdens faced by low-income single parents and higher tax burdens faced by single individuals imply that single individuals, who face quite high poverty risks, shoulder much of tax burden at low-income levels.

Several family types face high unemployment and poverty traps. Unemployment traps (i.e. where generous benefits paid to the unemployed and/or high tax rates imposed on workers create little incentive to enter work) are quite high for several groups including low-income single individuals, parents and second earners. The attractiveness of entering work from unemployment in Lithuania for a single person at the average wage (AW) is among the lowest in the OECD as measured by the participation tax rate (PTR). Although unemployment benefits are the largest contributor to the disincentive to enter work, reducing them further would be challenging given the high poverty rates among the unemployed. Aside from unemployment benefits, weak incentives to enter work at low incomes compared to the OECD average are driven by personal income tax (PIT), social security contributions (SSCs) and the absence of in-work benefits (i.e. tax reductions or cash transfers that are conditional on labour market participation). Thus, reducing the high PIT and/or SSCs at low incomes and introducing in-work benefits would alleviate the high unemployment traps. Inactivity traps (i.e. where generous benefits are paid to an inactive individual thus 'trapping' them in inactivity) are less problematic in Lithuania due to relatively low social assistance benefits and because unemployment benefits are progressively cut at longer unemployment spells. Poverty traps (i.e. disincentives to increase work due to a targeted government support being phased-out) are high for several groups including low-income single families with children and larger-size low and middle-income single and couple families. The contributors to the disincentive to progress in work include the additional PIT and SSCs that would be paid upon earning more but also the withdrawal of social assistance benefit. Social assistance benefit protects low-income families but also produces work disincentives, which underscores the importance of developing active labour market policies that link benefits to participation in training programmes to prevent skill loss. Poverty traps may also arise from the withdrawal of the child and housing benefits. If income bunching is detected where the latter is withdrawn, a more gradually tapering should be considered. The income disregards rule introduced for both social assistance and child benefits since 2018 provides an additional albeit modest incentive to progress in work.

There are several reform options in the area of personal income tax. Following the introduction of a progressive PIT rate system in 2019, income inequality has barely improved. Despite cuts to the top PIT rate threshold in recent years, it remains high. To be liable for the top PIT rate, employees would need to earn in the top 1% of employment income. As a result, very few employees face the top PIT rate. Tax modelling conducted as part of this Review shows that the introduction of a middle-income bracket in the PIT rate schedule would raise PIT revenues and reduce income inequality. In the near-term, Lithuania should continue to increase its basic allowance (BA) following its redesign in 2022. The BA should be linked with inflation or alternatively wage growth rather than being set annually by government as is currently the case. Over the medium-term, Lithuania should aim to rely not only on the BA as the main source of PIT progressivity in the system. The BA design is untargeted as most of its benefit goes to workers earning between the minimum and average wage (rather than those on lower incomes) and it produces modest spikes in the marginal tax wedge near the minimum wage, which could contribute to the income bunching that is observed there. In addition, Lithuania could investigate introducing an in-work benefit in the future to compensate for the PIT and SSCs faced by low-income employees that contribute to the work disincentive. If an in-work benefit that decreases with income were introduced, a flat BA could be considered which would enhance transparency and reduce marginal effective tax rates. Lithuania's in-work social assistance could be broadened by reducing the required time to register to be eligible for it and extending the period of its full retention.

The SSC floor may need reform and a more balanced financing mix for the welfare system could be considered. Despite cuts to the SSC ceilings since their introduction, the SSC ceiling remains high in international comparison. Lowering the SSC ceiling would reduce the financial contribution from high earners and potentially undermine SSC sustainability, particularly given fiscal pressures due to aging and the associated health challenges. On the other hand, raising the SSC ceiling might weaken the link between contributions and benefits and risk arbitrage to more lightly taxed self-employment and capital income. On balance, further reductions to the employee SSC ceiling are not recommended. The employer SSC floor (i.e. an SSC floor ensures that a minimum SSC contribution is paid) contributes significantly to the tax burden at low incomes and produces a perverse effect whereby the tax system makes it relatively more expensive for employers to hire lower income rather than higher income workers. Analysis of the tax microdata suggest that employer hiring is responsive to the SSC component of labour costs where the

SSC floor applies. The employer SSC floor could be retained for now but analysis in this Review suggests that it may present a risk to the employment of low-income workers. A further detailed evaluation is needed. In addition, the welfare system relies heavily on SSCs for financing and further financing through the SSC system may be challenging given the already high SSC rates. A more balanced financing mix could be considered with greater financing from general taxation to help alleviate the tax burden on labour income.

Several unemployment benefit reforms could be considered including widening benefit coverage, easing the SSC minimum contribution period for younger workers and extending the unemployment benefit duration to one year. Over half of the unemployed face poverty risk as wages have outpaced unemployment benefits and many struggle to find work before unemployment benefits expire. Only about one-third of the unemployed registered with the Employment Services are entitled to unemployment benefit. The currently low levels of unemployment benefit coverage should be widened. Eligibility for unemployment benefit was eased with the minimum SSC contribution period cut to 12 months. High poverty risks among the unemployed support the case for easing further. Given the high youth unemployment rates, easing could alternatively be targeted at younger workers who have less time to build up SSC contributions. Consideration could also be given to extending unemployment benefit duration to one year given that Lithuania's unemployment duration of 9 months is relatively short vs the 12-month OECD average. Field of study mismatches and under-qualification challenges support the case for extending unemployment benefit duration by giving workers more time to find a job that matches their skills. Spending on active labour market programmes is low relative to other OECD countries and could be increased, particularly due to relatively low employment incentives and training.

State-supported income should be increased to support income adequacy. Despite improvements in income adequacy (i.e. minimum incomes as a share of disposable median income) in 2021, benefits of last resort remain below the poverty line and income adequacy remains modest in international comparison for single persons. Increasing social assistance benefits through increased state-supported income (i.e. a reference amount used to calculate benefits and income thresholds in Lithuania) or by other means would help to support income adequacy. The indexation mechanism of state-supported income could also be enhanced to keep pace with rising wages and inflation. More generally, Lithuania could evaluate the possibility of raising old-age pensions to curb the impact of low pension replacement rates.

The taxation of self-employed individuals

The business certificate regime tax burden should be increased and, over the medium-term, the current lump-sum payment should be replaced with proportional tax rate on turnover. Individuals can simultaneously belong to several different self-employment regimes including the standard regime called the individual-activity regime (IA regime) and a presumptive business certificate regime (BC regime) for smaller self-employed businesses. The number of individuals in the BC regime at about 88 000 in 2019 represents about half of the IA regime. The tax burden in the BC regime is below that of the IA regime and standard employees, producing a tax-induced incentive for self-employed businesses to remain taxable under the BC regime. The tax burden in the BC regime should be increased and better aligned with the IA regime. The current lump-sum payment under the BC regime has several advantages including simplicity, transparency and predictability. However, it is too low and should be increased. In the medium-term, the lump-sum payment could be replaced with a proportional tax rate on turnover, which would reduce the regressivity of the lump-sum payment and allow for businesses to more smoothly transition to the standard IA tax regime. The proportional tax rate on turnover should not be set by the municipalities, as is the case with the lump-sum payment, but instead should be set by central government to prevent shifting the administration of the tax to under-resourced municipalities and to reduce disparities between municipalities.

The business certificate regime eligibility cap should be reduced and the eligibility criteria should be redesigned such that the regime is open to all small self-employed businesses. The BC regime revenue eligibility cap is high - over 9 in 10 IA taxpayers having incomes below the cap. The high cap results in too many BC taxpayers, too few IA taxpayers and lost tax revenues. OECD analysis of the microdata shows that Lithuania could reduce the cap to EUR 20 000 or lower. Good practice suggests that once the cap is reduced, it should be indexed with inflation. The BC regime is only available to self-employed taxpayers operating in certain business activities, which induces various vertical and horizontal inequities. This eligibility restriction should be abolished such that the BC regime is open to all small self-employed businesses.

The business certificate regime should be redesigned to provide a smooth progression to the individual-activity regime. There are sharp rises in the marginal and average effective tax rates above the business certificate regime revenue eligibility cap. There is evidence that self-employed individuals bunch their income just below the cap. Thus, the current design does not provide self-employed individuals with incentives to smoothly migrate from the BC regime to the standard IA regime. Progression could be better supported through targeted accounting training coupled with periodic monitoring of migration flows between regimes.

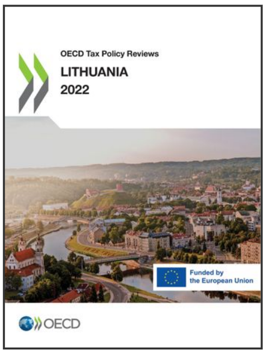
The individual-activity regime is characterised by a range of tax design features that need reform because they advantage self-employed individuals over standard employees. Effective PIT rates in the IA regime are lower than for employees across most of the income distribution. To support fairness and reduce the tax arbitrage between employment and self-employment identified as part of this Review, the IA regime PIT rate could be aligned with the standard 20% PIT rate for employees. Aligning the PIT rate would meaningfully shift the IA tax burden upwards. Alternatively, aligning the PIT rate and simultaneously cutting the tax credit threshold would better align the tax burden and the tax burden distributional shape with employment. IA taxpayers face a narrower SSC base than employees, which could be broadened to better align with the employee SSC base. In the absence of a justifying rationale, SSC deductibility could be afforded to employees and SEs more equally by disallowing IA taxpayers from deducting pension SSCs. Lastly, the SSC ceiling in the IA regime and employment should be harmonised to reduce tax arbitrage.

The design of the IA regime tax credit needs reform. As the tax credit is tapered in the IA regime, increasingly higher effective PIT rates are paid on total taxable income. As a matter of design, this differs from a standard progressive PIT rate system and induces rising marginal effective tax rates. The tax credit will not introduce much PIT progressivity because too few taxpayers report incomes within the income range where it applies. Of the few taxpayers that are impacted, a rising marginal effective tax rate could encourage sales suppression (i.e. tax evasion) and discourage business growth. The tax credit design could therefore be reformed in line with a standard progressive PIT rate system and with regard to the self-employed income distribution. One-third of IA regime taxpayers are farmers and most self-employed farmers are exempt from PIT and face narrowed SSC bases relative to non-farmers, despite having high and diverse income sources compared to non-farmers. There is scope to reform the tax rules for self-employed farmers.

The presumptive cost deduction in the IA regime should be abolished and the design of the tax system should not encourage non-transparency and under-reporting. The presumptive cost deduction (i.e. IA self-employed can deduct a presumed 30% of income instead of declaring actual costs) limits transparency for the tax administration on the actual operations and costs of self-employed businesses. The opacity of the IA regime's presumptive cost deduction adds to a presumptive BC regime with a high revenue eligibility cap where business cost are not required to be reported. Taking the two unincorporated self-employed regimes together, the tax administration has cost information on only about 1 in 10 businesses. The lack of reporting transparency is compounded by the comparatively high VAT registration threshold, which means that few self-employed need to comply with VAT. To strengthen the tax administration's capacity and credibility to effectively monitor and tackle compliance, the presumptive cost deduction could be abolished. More broadly, and in light of Lithuania's large informal economy driven by high taxes and envelope wage, it is essential that the design of the tax system does not encourage non-transparency and under-reporting.

There is scope to introduce rules that oblige manager-owners of closely-held corporations to pay themselves a minimum level of salary to offset the tax-induced incorporation incentives. Individuals can organise as an incorporated business and choose the type of income they receive. The tax-induced incentives depend on the corporate income tax (CIT) rate regime. Under the standard 15% CIT rate, there is a tax-induced incentive to be self-employed relative to incorporation at middle incomes but not at lower incomes. Under the 5% CIT rate, incorporating and distributing profits as dividends is always preferable to drawing a salary as an owner and mostly preferable to self-employment. Closely-held corporations also have the option to retain profits for distribution in the future. Currently, manager-owners are obliged to pay themselves above the minimum wage.

Automatic exchange of information could present new opportunities. Capital income is concentrated in top decile of employees, particularly in the top 1%. Under the new automatic exchange of information (AEOI) rules, it has become more difficult for an individual to conceal capital income abroad and tax administrations have become more effective at verifying compliance. AEOI could present opportunities to increase the level of taxation of capital income at the individual level.



From:

OECD Tax Policy Reviews: Lithuania 2022

Access the complete publication at:

https://doi.org/10.1787/53952224-en

Please cite this chapter as:

OECD (2022), “Executive summary”, in *OECD Tax Policy Reviews: Lithuania 2022*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/52e63595-en