1 Policy options for reform

This chapter summarises the recommendations for tax and benefit reform that have been identified as part of this review. The chapter sets the scene for tax reform by describing an overview of the economy, providing observations on the tax and benefit system and identifying areas for general economic reform. Tax and benefit policy reform options are provided across a range of areas including personal income tax, social security contributions, unemployment benefits, housing benefits, social assistance and child benefits. Tax reforms for self-employed individuals focus on the business certificate regime, the individual-activity regime and on owner-managers of closely-held corporations.

Box 1.1. Summary snapshot of tax policy reform recommendations

This box provides a summary list of the tax policy reform recommendations that have been identified as part of this OECD Tax Policy Review. The reforms cover the tax and benefit system and include a special focus on the taxation of self-employed individuals.

Personal income tax

1. Consider introducing a middle PIT bracket to raise PIT revenues and reduce income inequality.
2. In the near-term, continue to increase the basic allowance to support progressivity.
3. Link increases in the basic allowance to inflation or wage growth.
4. Continue not to tax SSC pension benefits under the PIT.
5. Investigate the options for not only relying on the basic allowance as the main source of PIT progressivity in the system over the medium-term.
6. Investigate introducing an in-work benefit to compensate for the PIT and SSCs faced by low-income employees.
7. The in-work social assistance could be eased and the duration of assistance could be extended to improve work incentives.
8. Retain the rule introduced in 2022 making employers pay all employment-related payments into employee bank accounts, which is a step in the right direction.

Social security contributions

1. Further reductions to the employee SSC ceiling should not be undertaken.
2. Continue not to levy SSCs on pensions.
3. Maintain the employer SSC floor but evaluate its risk to hiring of low-income workers.
4. Diversify the sources of financing to the welfare system.
5. Shifting the funding of the basic part of social insurance pensions from SSCs to general taxation was a step in the right direction, but more could be done.

Unemployment benefit

1. Widen unemployment benefit coverage.
2. Consider easing the minimum SSC contribution period for unemployment benefit further.
3. Alternatively, consider easing the minimum SSC contribution period for unemployment benefit for young workers.
4. An automatic adjustment mechanism for unemployment benefits would likely face design challenges.
5. Continue not to tax unemployment benefits.
6. Maintain the unemployment benefit’s maximum cap.
7. At least maintain, and do not reduce, the current unemployment net replacement rates.
8. Consideration could be given to extending unemployment benefit duration to one year.

9. Alternatively, a targeted unemployment benefit duration beyond one year could be aimed at pre-retirement age individuals.
10. More broadly, support unemployment benefits by pursuing policies that raise wages.
11. Finance the unemployment benefit extension through policies that support higher wages.

Housing benefits

1. Consideration could be given to expanding the availability of the housing benefit.
2. The housing benefit could be reviewed and modified if those who benefit face limited poverty risks.
3. Consider evaluating the effects on income inequality and poverty of the real estate tax and housing supports more broadly.
4. If income bunching is detected where the housing benefit is withdrawn, the benefit could be tapered more gradually.

Social assistance and child benefits

1. Increase social assistance benefits by raising SSI or by other means to support income adequacy.
2. The indexation mechanism of the SSI could be improved.
3. An evaluation could be considered of simultaneously increasing state-supported income and rebalancing the equivalence scales to target single individuals and couples.

Self-employed business certificate regime

1. The tax burden in the BC regime should be increased and better aligned with the IA.
2. In the short-term, the lump-sum payment could be increased and reformed.
3. In the medium-term, consider replacing the lump-sum payment with a proportional tax on turnover.
4. The revenue eligibility cap should be reduced to a cap that is below its current level to target only micro-businesses.
5. Once the revenue cap is reduced, good practice suggests that it should be indexed with inflation.
6. The cap should be aligned and evolve with capacity of tax administration.
7. The BC regime sector eligibility restrictions could be abolished to reduce vertical and horizontal inequities so that the BC regime is available to all small businesses.
8. The BC regime should be designed in the context of the wider tax system and in particular its role in providing a smooth progression to the IA regime.
9. Enhance migration from the BC regime through supporting administrative and accounting training.
10. Periodically monitor the migration flow between the BC and IA regimes.

Self-employed individual-activity regime

1. Raise the PIT rate in the IA regime to better align with the PIT rate faced by employees and raise PIT revenues.
2. Broaden the SSC base in the IA regime to better align with that of employment.
3. Align the SSC deductibility rules between the IA regime and employment.
4. The SSC ceiling in the IA regime and employment could be harmonised to reduce tax arbitrage.

5. There may be scope to harmonise SSC and health SSC payments on a monthly basis.
6. The health SSC floor could be retained as it appears to produce minimal behavioural distortions.
7. The design of the tax credit could be reformed in line with a standard progressive PIT system to prevent rising METRs.
8. The tax credit design could be better designed and should be reformed to align with the SE income distribution.
9. The presumptive cost deduction could be abolished so that IA taxpayer report costs and incomes which would strengthen the tax admin's capacity to successfully monitor and enforce compliance.
10. There is scope to reform the tax rules for self-employed farmers.

Self-employed incorporated businesses

1. Consideration could be given to raising the dividend tax rate to reduce tax arbitrage.
2. The reduced 5% CIT rate regime could induce tax arbitrage and should be further investigated.

Setting the scene for tax reform

Despite a recovering economy, structural employment challenges remain. The economy and the labour market in Lithuania are recovering from the covid crisis. GDP per capita has grown rapidly since 2019 and above the average growth rate in the OECD and the Baltics. Labour force participation and employment are high. The unemployment rate is on downward path, reaching 6.5% in 2022. However, a range of structural demographic, health and skills challenges remain that will hinder the development of the labour market and the economy more broadly. The working-age population is declining at about 1% per year on average. The population is aging rapidly with the share of the population aged over 65 expected to reach 32% by 2050, above both the OECD and Baltic averages. Linked to aging, poor health is a barrier to employment. Life expectancy is relatively low in international comparison.

Long-term unemployment is stubbornly high and informality is high. The unemployment rate is high among young women. It is also high among older individuals, particularly men, relative to the OECD average. The share of long-term unemployment (i.e. more than a year) is stubbornly high and has barely declined. A pool of vulnerable individuals are thus locked-out of the labour market having not secured a job before unemployment benefits expire after 9 months. This is despite a sharp decline in benefits as individuals' transition from unemployment benefit to social assistance benefit. While some long-term unemployed individuals may have been unable to find work due to skill and qualification mismatches, others may have been unwilling to work due to low disposable formal incomes (after paying taxes) and potentially relatively attractive disposable informal incomes.

Despite Lithuania's strong economic performance in recent years, the size of informal economy remains large in international comparison. Informality as a share of GDP in Lithuania had closely followed that of Estonia up to 2017 but it has since diverged moving notably higher in recent years. Informality in Lithuania is partly driven by high taxes and envelope wage (i.e. a part of salary in the form of an undeclared cash payment) is of greater concern than other forms of under-reporting.

Wages and minimum wages have increased rapidly. Disposable income inequality is high, with Lithuania placing among the top 6 OECD countries, which is typical in a rapidly growing economy. The redistributive role of taxes and transfers is relatively low. Of the redistribution that does occur, three-quarters is from transfers and one-quarter from taxes. Wages in Lithuania have increased rapidly, significantly above both the OECD and Baltic averages over the past decade. However, wages in Lithuania remain at only 65% of the OECD average in 2020. To keep pace with rising wages and to support low-income workers, the Lithuania government has sharply raised the minimum wage in recent years and done so more rapidly than in many countries. Despite the minimum wage hikes, minimum wages represent less than half of the average wage, below the OECD average. Minimum wages set the reference bargaining price for all workers in the Lithuanian economy (formal and informal), it may risk inducing higher informal wages (the ‘lighthouse effect’).

Poverty rates are high for some groups. Median disposable incomes, which remain somewhat low, are linked to poverty. Poverty rates in Lithuania (and the Baltics) are high in international comparison. They have fallen only modestly since 2015. Countries with smaller working-age population shares like Lithuania often have higher poverty rates. The unemployed are hardest hit by poverty in Lithuania, with more than half of all unemployed individuals being at risk of poverty. This reflects limited coverage due to strict eligibility criteria with only one-third of the registered unemployed receiving unemployment benefits. Poverty risk for the unemployed is 7 times greater for the employed, as wages have outpaced unemployment benefits. The high poverty risk among the unemployed underlines the importance of using the participation tax rate measure in Lithuania to measure the attractiveness of moving from unemployment to work (discussed later). Single individuals and single parents also face high poverty risks, partly as they have no partners to cushion income shocks. These family types also represent jobless younger people, who have high unemployment rates.

A steep work to retirement 'income cliff' means elderly Lithuanians are working longer, especially women. Poverty risk among retired Lithuanians increased to 40% in 2020, up from 35% in 2019. Employment among retirement-age Lithuanians has also increased to 26% up from 22% in 2018, reflecting the need to supplement low incomes and pensions. A decade after retirement-age, incomes decline by more than half on average. This ‘income cliff’ is steeper and occurs sooner for lower income individuals than higher income individuals. This may partly be explained by lower income workers in more manual jobs being unable to work for longer unlike higher income office workers. The ‘income cliff’ links to Lithuania’s pension replacement rates, which are among the lowest of OECD countries. However, pension incomes are highly redistributive in Lithuania, evidence by the difference in net pension replacement rates between low and high incomes. The reduced wages of older employees is reflected in lower SSCs and PIT paid.

Single households in Lithuania are often comprised of elderly women and poverty rates are high for both groups (separately and there is overlap between them). One reason is that women have lower pensions due to shorter contributions, earlier statutory retirement and career breaks. A further reason is the old-age gender gap in Lithuania whereby the life expectancy of Lithuanian women is ten years above that of Lithuanian men. Consequently, Lithuanian women are expected to have an additional 6 years in retirement compared to Lithuanian men, making them additionally vulnerable to poverty that could arise from a sharp work to retirement ‘income cliff’.

Lithuania extended early retirement options in 2021. However, that may put further pressure on the pension system by reducing already low pensions and amplifying the pension cliff. Rising life expectancy will outpace increases to the retirement age, which also adds pressure to the pension system.

Despite a strong economy contributing to a rising tax-to-GDP ratio, social spending is low. Lithuania was one of only a few OECD countries to increase both GDP and tax revenues during covid in 2020. A strong labour market has played an important role with much of the tax-to-GDP ratio increase attributable to increased PIT revenues. However, Lithuania’s tax mix has a relatively high 62% share of distortive taxes in total taxes. Property taxes, which are among the least harmful to growth, play a minor role in Lithuania. Despite recent tax-to-GDP ratio rises, social spending as a share of GDP remains relatively low. This includes relatively low spending on unemployment benefits, reflecting shorter than average durations and strict eligibility rules, in addition to relatively low spending on health and old age benefits. Table 1.1

provides a summary snapshot of economic indicators in Lithuania compared against the average in the OECD average and the Baltics (i.e. Latvia and Estonia).

Table 1.1. Economic indicators

	Lithuania	OECD	Baltics
Economic and labour market recovery			
% change in GDP per capita (USD constant PPP), 2019 - 2022	9.1	2.9	8.6
Labour force participation rate, % of pop (age 15 - 74), 2022	72.4	67.3	70.3
Employment as % of working-age pop (age 15 - 74), 2022	67.7	62.2	66.1
Unemployment rate, 2022	6.5	5.5	6.0
Demographic, health and skills challenges			
% working-age population (age 15 - 74), 2022	73.5	74.2	73.6
% population aged over 65 in 2050	32.3	25.4	29.8
change in % population aged over 65, 2018 - 2050	12.5	8.1	9.8
Life expectancy at birth, 2020	75.1	80.4	77.0
Difference life expectancy between women and men (in years), 2020	9.9	5.5	8.8
% field of study mismatch, 2016	34.9	32.2	35.1
% overqualified for job, 2016	21.2	16.8	13.1
Labour market challenges and informality			
Long-term unemployment rate (> 1 year), % of unemployed, 2020	29.0	18.4	22.3
Long-term unemployment rate among 65+, 2020	23.3	10.4	28.9
Employment rate among workers aged 65 - 69, 2020	26.1	22.9	30.8
Change in employment rate among workers aged 65 - 69, 2018 - 2020	4.1	0.6	1.8
Size of informality as % of GDP, 2020	20.4	15.1	21.0
Change in size of informality as % of GDP, 2015 - 2020	5.5		2.9
Income inequality, wages and minimum wages			
Disposable gini coefficient, 2019	35.7	31.3	32.4
Average annual wages, in constant prices USD PPP, 2020	31,811	49,165	30,298
% change in annual average wages, 2010 - 2020	4.9	0.8	3.9
Real minimum wage growth, 2015 - 2020	11.8		4.2
Minimum wage to average wage, 2020	48.8	54.7	44.9
Poverty rates and pension replacement rates			
Poverty rate, 2020	20.9	16.7	21.2
Change in poverty rate (in p.p), 2015 - 2020	-1.3	-0.7	-0.9
Net pension replacement rates, 2020	30.7	61.3	44.6
Net pension replacement rates at 50% of the AW, 2020	44.0	73.7	53.8
Tax revenues and social spending			
Tax-to-GDP ratio, 2020	31.3	33.2	33.2
Change in Tax-to-GDP ratio (in p.p), 2010 - 2020	3.0	1.9	2.3
Distortive taxes as a share of total taxes, 2020	62.0		56.5
Social spending as % of GDP, 2017	16.7	20.0	17.1

Note: Baltics refers to an unweighted average of Estonia and Latvia. In case of informality, OECD average is an unweighted average of selected available countries. In case of the poverty rate, OECD average refers to EU27. OECD Revenue Statistics classify social security contributions (SSCs) as tax revenues. SSCs are similar to but not the same as tax revenues. Like taxes, SSCs are compulsory. Unlike taxes, SSC benefits can depend on SSC contributions having been made.
Source: OECD Economic Outlook No 110 December 2021. Various OECD statistics.

Personal income tax

Consider introducing a middle PIT bracket to raise PIT revenues and reduce income inequality. Despite the top PIT rate threshold being cut in recent years, it remains high in the context of the employment income distribution. As a result, very few employees face the top PIT rate. To be liable for the top PIT rate, employees would need to earn in the top 1% of employment income. The introduction of a third middle PIT bracket could be considered which would effectively act as a de facto top PIT bracket if the current top PIT rate bracket were retained (given that so few employees face the current top PIT rate). The introduction of a middle PIT bracket at 2 annual AW at PIT rates of 24%, 26% and 28% could raise PIT revenues by 1.5%, 2.3% and 3.2% respectively. Almost all of the additional PIT would be raised from employees in the top income quintile and particularly in the top decile. The introduction of a middle PIT bracket would lead to a modest reduction in income inequality.

In the near-term, continue to increase the basic allowance to support progressivity. The basic allowance is the main source of progressivity in the PIT system. Steady increases in the BA in recent years have taken many low incomes out of the PIT net increasing progressivity. The 2022 basic allowance redesign introduces more progressivity in to the tax system through both a higher basic allowance and a faster tapering rate as income rises.

Link increases in the basic allowance to inflation or wage growth. The BA is not indexed in Lithuania. It is however set annually by the government informed by the increase in the MMW (the MMW is in turn set by the government, unions and employers indexed based on the MMW as a share of the forecast AW). Indexing the BA to inflation is relatively common internationally. A rationale for a BA generally is to help cover job-related expenses. Since job-related expenses will increase with inflation, it follows that the BA should be at least inflation-linked. Inflation in Lithuania was reported as among the highest in the OECD, with the CPI reaching 18.9% in May 2022. Linking the BA to inflation in Lithuania would maintain its value in real terms for low-income workers. The BA should be linked at least to inflation. Whether the BA should be linked to a measure that might outgrow inflation, such as the MMW or the AW, is a policy choice for Lithuania. However, by linking the BA to increases in wages instead of inflation, a relatively larger share of workers could be exempt from PIT when wages outpace inflation. The purpose of a BA and a progressive PIT system is that higher wages translate to higher PIT.

Continue not to tax SSC pension benefits under the PIT. Non-deductibility of SSCs support the case for not taxing future SSC pension benefits under the PIT as they have effectively already been taxed through higher PIT. Unlike in many OECD countries, SSCs are not deductible in Lithuania. This implies that Lithuanians have lower disposable incomes than would be the case otherwise.

Investigate the options for not only relying on the basic allowance as the main source of PIT progressivity in the system over the medium-term. Recent increases in the BA may not have increased the share of workers paying no PIT due to rapid wage growth. BA hikes that remove an increasing share of workers from the PIT net could pose a risk to PIT revenues. The BA is somewhat untargeted as it benefits some high earners (up to just under twice the AW) as well as low-income workers. Due to the structure of the wage distribution, the largest share of the BA benefit went to workers earning between the MMW and the AW rather than to workers below the MMW. The BA produces modestly high METRs at about 1/3 and 1/2 of the AW. These METR spikes occur near to the MMW. A large share of Lithuanian employees earn wages at or near the MMW. If employees respond to the marginal tax rates at these incomes, it could induce poverty traps for some. There is evidence of employee income bunching at the MMW, particularly among older, married and female employees.

Investigate introducing an in-work benefit to compensate for the PIT and SSCs faced by low-income employees. Low-income Lithuanian workers face somewhat high effective PIT rates in addition to even higher and less progressive employee SSCs. Financial incentives to work could be improved by either cutting welfare benefit levels or introducing in-work benefits while leaving benefits unchanged. An in-work benefit, which provides income supplement to individuals and families provided they work, could support incentives for formal work by compensating for high PIT and SSCs, which drive the tax wedge for lower income workers. In-work benefits also have the option of being financed with PIT rather than SSC revenues so there is no loss to SSC funds. However, a challenge of designing an in-work benefit in Lithuania is that it could add to an already complex tax and benefit system. It would also come with budgetary and behavioural consequences. The introduction of an in-work benefit would then need to be planned carefully. If an in work benefit were introduced, a flat BA could be considered which would enhance transparency and reduce METRs.

The in-work social assistance could be eased and the duration of assistance could be extended to improve work incentives. Lithuania operates in-work social assistance for individuals starting new jobs, but its current scope is limited. Few individuals avail of the IWSA due to several strict eligibility criteria. Redesigning the in-work social assistance with in-work benefit characteristics could improve work incentives but it would not be without challenges. In-work social assistance could be increased beyond the level of social assistance similar to Slovenia to increase work incentives but this would come with several drawbacks including that it is costly and may prevent work progression.

Retain the rule introduced in 2022 making employers pay all employment-related payments into employee bank accounts, which is a step in the right direction. Lithuania is a relatively high cash economy according to ECB survey data. This policy brings Lithuania in line with many countries that have introduced stricter enforcement making it compulsory for employers to pay salaries through a bank account.

Social security contributions

Further reductions to the employee SSC ceiling should not be undertaken. Despite cuts to the SSC ceilings since their introduction in 2019, they remain high in international comparison. High SSC ceilings ensure higher earners make a financial contribution to the social welfare system. Lowering the SSC ceiling would reduce the financial contribution from high earners and potentially undermine SSC sustainability, which will come under further pressure due to aging and associated health challenges. Raising the SSC ceiling would weaken the link between contributions and benefits. The high employee SSC ceiling may arguably be unequitable given that some higher earners will pay SSC contributions on a greater share of their income but receive no correspondingly higher pension SSC entitlement as a result. Abolishing the employee SSC ceiling as was done for the employer SSC would bring the SSC system closer to being a tax. This would undermine the purpose of the SSC system to link contributions with benefits. Raising the SSC ceiling could risk arbitrage opportunities for employees to switch to more lightly taxed self-employment income sources.

Continue not to levy SSCs on pensions. Most OECD countries levy SSCs on pensions. The SSC rate is always lower on retirees. Typically, health SSCs are levied (rather than pension or unemployment SSCs), which older workers disproportionately use and benefit from. Not levying SSCs on pensions weakens pension sustainability relative to most OECD countries who do.

Maintain the employer SSC floor but evaluate its risk to hiring of low-income workers. The employer SSC floor ensures that low-income workers pay a minimum SSC contribution and indirectly ensures that they benefit from a minimum social benefit (widening social insurance coverage). The employer SSC floor encourage employers to engage in the formal economy by helping to reduce the under-reporting of hours worked. At low-income levels, the employer SSC floor contribution is the largest contributor to total SSC contributions. This produces a perverse effect because the tax system makes it relatively more expensive for employers to hire low-income than high-income workers because the employer SSC is higher as a share of gross income at low incomes than at high incomes. If employers are responsive to the employer SSC component of labour cost at low incomes, this could reduce hiring at low incomes. Some evidence is consistent with employers reducing hiring where the SSC floor applies. Employers hire employees just below the SSC floor exemption age cut-off at a greater rate than employees just above the age cut-off.

Diversify the sources of financing to the welfare system. The welfare system relies heavily on SSC for financing and to a lesser extent on transfers from government in international comparison. Healthcare funding had previously been shifted from taxes to SSCs. However, financing through the SSC system may be challenging, as it requires increasing already high SSC rates on low incomes. A more balanced financing mix may be optimal to prevent a drop in pension benefits given rapid aging and poor health outcomes. Financing the welfare system largely through general taxation could be envisaged. Financing social benefits through general taxation instead of SSCs can reduce the tax burden on labour income, particularly if social benefits are financed through taxes that do not bear solely on labour income. Reducing the tax burden on labour income through lower employer and employee SSCs can in turn provide greater incentives for employers to hire workers and for workers to participate in the labour market.

Shifting the funding of the basic part of social insurance pensions from SSCs to general taxation was a step in the right direction, but more could be done. In 2019, Lithuania partly shifted the funding of social insurance pensions from SSCs to general taxation (i.e. the PIT), but the reform will substitute for lost SSC funds (due to cuts in the SSC pension rate) rather than materially increase resources to the SSC fund.

Unemployment benefits

Widen unemployment benefit coverage. Current UB coverage is low. Only about a third of the unemployed registered with the Employment Services entitled to UB. Greater coverage is needed. Over half of the unemployed at risk of poverty. Many unemployed struggle to find work before UB expire. Poverty rates among employed rose in 2020. Unemployed are 7 times more likely to be in poverty than the employed, reflecting wages outpacing unemployment benefits.

Consider easing the minimum SSC contribution period for unemployment benefit further. Eligibility for unemployment benefit was eased with the minimum SSC contribution period cut to 12 months, in line with the OECD median period (some OECD countries provide up to 3 years). However, much higher poverty risks among the unemployed in Lithuania compared to the OECD support the case for easing further. However, the impact of reducing the minimum SSC contribution on poverty and UB coverage may be limited (MoSSL impact assessment).

Alternatively, consider easing the minimum SSC contribution period for unemployment benefit for young workers. Easing could be targeted at younger workers who have less time to build up SSC contributions. Youth unemployment rates in Lithuania are high in absolute terms and relative to the OECD. Youth unemployment is elastic in Lithuania and correlates with economic cycles.

An automatic adjustment mechanism for unemployment benefits would likely face design challenges. Lithuania is considering an automatic adjustment of minimum SSC contributions for unemployment benefit from 12 to 6 months during periods when the government declares an economic crisis. However, this could raise definitional and design challenges. Economic crisis would have to be carefully defined to determine when the automatic adjustment is triggered. Different types of economic crisis would also affect different workers differently and their relative need for reduced SSC contributions.

Continue not to tax unemployment benefits. UBs are taxed in several OECD countries but reducing the NRRs in Lithuania would risk pushing some of the unemployed further into poverty. The atypical non-deductibility of SSCs from the PIT base in Lithuania provides little justification for taxing UBs.

Maintain the unemployment benefit's maximum cap. The current UB cap design ensures that UB is somewhat linked to contributions paid for high earners. An individual earning twice the AW reaches the cap so that UB does not fall at longer unemployment spells. Cuts to UB cap would weaken the link with previously insured income for high earners and discourages workers from progressing in formal employment by investing in career (increasing income, effort and hours). Informality is already high in Lithuania. An increase in the UB cap is a potential policy option. It would have the advantage of strengthening the link with former income levels and enhancing formal work incentives. However, it could come at a cost, particularly during downturns in the event of many high-income workers becoming unemployed.

At least maintain, and do not reduce, the current unemployment net replacement rates. Although high at short unemployment spells vs OECD average, NRRs quickly fall for longer unemployment periods. Given that incomes are not particularly high, inflation is rising rapidly and the high poverty risks among the unemployed, NRRs should at least be maintained at current rates. A worker earning the minimum monthly wage in 2021 would be below the poverty line in the first three months of unemployment and more so thereafter. The low wage distribution in Lithuania suggests that the cohort who would face poverty risks in the event of unemployment is quite large. A poverty risk may also arises for older-workers if the 'income cliff' translates to much lower UB followed by much lower social assistance benefits.

Consideration could be given to extending unemployment benefit duration to one year. Lithuania's unemployment duration of 9 months is relatively short vs 12 month OECD average. Given field of study mismatches and under-qualification challenges, extending unemployment benefit duration would support reconnecting workers with jobs by giving them more time to find a job that matches their skills. Long-term unemployment is stubbornly high and barriers to employment include poor health. Eligibility for longer duration unemployment benefits could be made strictly conditional on participation in active labour market policies in addition to requirements to following training and develop in-demand skills such as ICT. An evaluation could be considered to determine whether additional unemployment duration would lead to greater skill acquisition and employment prospects. However, an extended unemployment duration would be costly, particularly when wages are rising which mechanically produce higher UBs.

Alternatively, a targeted unemployment benefit duration beyond one year could be aimed at pre-retirement age individuals. The unemployment benefit duration for pre-retirement age individuals (55 – 64 years) is currently 11 months compared to 9 months in the general population. However, this cohort are more likely to be unemployed for longer durations, reflecting additional challenges faced by older workers to re-enter employment including weaker ICT skills, skill mismatches and poor health. Extending unemployment benefit duration will give them more time to find a job rather than transferring to disability and early-retirement pension schemes. Extensions to the unemployment benefit duration should be designed so that the unemployed do not risk falling into unemployment at later unemployment spells.

More broadly, support unemployment benefits by pursuing policies that raise wages. Over the medium term, policies that support higher wages include investments in the upgrading, retaining and attracting skills and education that lead to improved job matching and productivity in addition to better health outcomes that reduce barriers to employment and supports longer working. Higher wages will mechanically increase UBs as they are set by the fixed UB rate (set by authorities but influenced by wage rate the economy) and the variable rate (directly linked to previous incomes). Higher wages thus avoids the need for higher fixed and variable rate changes. Higher wages facilitate the possibility of a higher UB cap that would strengthen formal work incentives. Rising wages have contributed to sharply rising PIT-to-GDP in recent years, which in turn contributes to higher tax-to-GDP ratios that can be used to support low social spending as a share of GDP. This broader picture highlights that tackling core economic challenges may be more impactful then making modest improvements in the tax and benefit system.

Finance the unemployment benefit extension through policies that support higher wages. The duration should not be financed through reduced net replacement rates (that could push some unemployed further into poverty) or reducing the max unemployment cap (that weakens the link between income and UBs) but rather through policies that raise wages.

Housing benefits

Consideration could be given to expanding the availability of the housing benefit. Lithuania has one of the most generous HB schemes in the OECD. However, the reach of the HB scheme is limited. Expanding the availability of the housing benefit could be considered. The availability of the housing benefit could be expanded in particular to support single individuals. Single individuals have high poverty risks and are less likely to own property, a main source of wealth in Lithuania. The relative value of the HB for single individuals is lower compared to larger families (e.g. 7% of AW vs 20% of AW for a couple with a child). HBs for single individuals are withdrawn at lower incomes compared to larger families.

The housing benefit could be reviewed and modified if those who benefit face limited poverty risks. The housing benefit is not widely used in Lithuania but the number of individuals benefiting from it has grown steadily. The housing benefit is an alternative to renting social housing. The housing benefit does not appear to be particularly well targeted.

Consider evaluating the effects on income inequality and poverty of the real estate tax and housing supports more broadly. Lithuania has among the highest rates of homeownership in the EU. The value of housing assets is relatively high and concentrated at the top of the income distribution. The progressive real estate tax is designed to increase the tax burden on households with larger housing wealth assets. Households with smaller housing wealth assets are exempt from the tax (up to EUR 150 000). The exemption is relatively high compared to other OECD countries. The reform has the potential to raise relatively low property tax revenues in Lithuania. Recurrent taxes on immovable property, in particular when owned by households, are the least damaging tax to long-run economic growth. A possible challenge with this reform that could be considered further is whether the tax could excessively burden groups that, despite owning property, have low incomes and face poverty risk. The rental market in Lithuania appears to be thin and informal. There are no tax deductions on the income generated through rental activities.

If income bunching is detected where the housing benefit is withdrawn, the feasibility of tapering more gradually could be considered. The HB is withdrawn fully and immediately producing high METRs for single individuals who may then face poverty traps and who already face high poverty risks. There are also high METRs for two adult households with three children who face high poverty risks and two adult couples with two children who face moderately high poverty risks. If income bunching were detected, the administrative feasibility of tapering the housing benefit withdrawal could be considered.

Social assistance and child benefits

Increase social assistance benefits by raising SSI to support income adequacy. In addition to the scale of the poverty challenge, benefits of last resort reduce poverty to a lesser extent for single individuals and couples than in the OECD average. Despite improvements in income adequacy (i.e. minimum incomes as a share of disposable median income) in Lithuania in 2021, benefits of last resort remain below the poverty line. Income adequacy in Lithuania is modest in international comparison for single persons but among the highest for families with children.

The indexation mechanism of the SSI could be improved. The SSI is indexed in autumn in year T (to prepare for the state budget) based on the amount of minimum consumption needs (AMCN) calculated in year T–2 using inflation forecasts for year T-1. This time lag has resulted in recent increases in social benefit not keeping pace with rising wages and inflation.

An evaluation could be considered of simultaneously increasing state-supported income and rebalancing the equivalence scales to target single individuals and couples. Single individuals and single parents face high poverty risks and the max social assistance benefits are arguably low for these groups on an equivalised needs basis, particularly the former. Increasing the SSI and simultaneously reducing the equivalence scales after the second person would provide relatively greater support to single individuals and single parents.

Self-employed business certificate regime

Adherence to tax policy principles

The BC regime may violate the principle of horizontal equity (similar taxpayers should be taxed similarly) as it has a low tax burden relative to alternative organisational forms. The wide tax burden gap with individual-activity does not seem to have a strong justification. Incomes are higher in the BC regime (adjusted for time spent working) and demographics are broadly similar.

The BC may violate the principle of tax neutrality by encouraging tax arbitrage from IA taxpayers manipulating eligibility (e.g. sector reclassification and income suppression) and employees entering 'false self-employment' arrangements. To mitigate against the challenges of horizontal inequity and tax non-neutrality between the BC and IA regimes, and to enhance the design of the BC regime, there is a scope for a number of tax policy reforms as follows.

Tax liability reform options

The tax burden in the BC regime should be increased and better aligned with the IA. The tax burden in the BC regime is below the IA regime at middle and upper incomes and far below employees at all incomes. This provides a tax-induced incentive for IA taxpayers (at middle and higher incomes up to the BC regime cap) and employees (at any wage income) to reclassify in to the BC regime.

In the short-term, the lump-sum payment could be increased and reformed. The lump-sum payment has several advantages principally its simplicity, transparency and predictability. However, it is too low in relative and absolute terms and should be increased. While SSCs are sometimes incorporated within the lump-sum payment in some countries to support compliance and to encourage formalisation, the advantages of doing so in Lithuania are not particularly strongly. Moreover, the lump-sum payment could be set by central government and the municipalities funded differently. The setting of the lump-sum payment by the municipalities and allocation to municipality budgets places the administration burden of the tax on under-resourced municipalities, increases volatility to municipality budgets and risks regional competition for SE. It is also inconsistent with PIT revenues on other SE and employment income, which are set by central government and allocated between central and local government.

In the medium-term, consider replacing the lump-sum payment with a proportional tax on turnover, which would raise PIT revenues. Despite its advantages, the lump-payment is regressive and places a relatively high tax burden on the poorest taxpayers, which could discourage entry to SE. A proportional tax rate on turnover results in a tax liability that is linear relative to revenue and would be less regressive than the lump-sum payment. Since BC taxpayers already declare turnover, a proportional tax on turnover would add a minimal tax compliance burden in terms of computing the tax liability. A proportional tax on turnover could be used to more closely align the tax burden between the BC and IA regimes and support smooth transitions between the regimes (reducing horizontal inequity and tax arbitrage). A proportional tax on turnover is not without drawbacks including that turnover is relatively easy to manipulate. The proportional tax rate should be set by central government and not by the municipalities (unlike the lump-sum payment under the BC regime) to prevent shifting the administration of the tax to under-resourced municipalities. A proportional tax rate on turnover will operate more effectively above a VAT threshold where SE comply with VAT and report business costs because turnover under-reporting (i.e. a main drawback of a proportional tax on turnover) can be more effectively monitored and prevented by tax admin. Replacing the fixed lump-sum payment in the BC regime with a 3% proportional tax rate on turnover could increase total PIT revenues by 0.5%.

Tax regime eligibility

The revenue eligibility cap should be reduced to a cap that is below its current level to target only micro-businesses. The revenue cap in the BC regime is high relative to SE incomes, with over 9 in 10 IA taxpayers having incomes below the cap. This results in too many BC taxpayers, too few IA taxpayers and lost tax revenues. A reduced cap to for example EUR 20 000 would narrow the scale of the BC regime (improving horizontal equity) and could mechanically migrate about 20% of higher-income BC taxpayers to the IA regime (an even lower cap could be considered). This would raise PIT and SSC revenues and increase transparency for the tax admin (i.e. as costs are not reported in the business cert). The VAT registration threshold could be lowered in parallel with a reduced BC regime revenue cap, such that more businesses under the IA regime would be VAT liable. If SE above the cap can keep a record of their transactions and follow accounting rules, they might also be able to comply with the VAT. However, while this is a possible option for Lithuania to consider, a reform of the VAT threshold is outside of the scope of this project.

Once the revenue cap is reduced, good practice suggests that it should be indexed with inflation. When the eligibility criteria is revenue, good practice is to index the cap to inflation to prevent erosion over time.

The cap should be aligned and evolve with capacity of tax administration. The extent to which there is scope for introducing policies that shift taxpayers from the BC regime to the IA regime (e.g. reducing the BC regime eligibility cap) will partly depend on the current and evolving capacity of the tax admin since IA taxpayers have relatively more complex tax affairs (e.g. they report business costs unlike BC taxpayers).

The BC regime sector eligibility restrictions could be abolished to reduce vertical and horizontal inequities so that the BC regime is available to all small businesses. The BC regime is only available to SE operating in certain specified business activities. This implies that taxpayers with different turnover in the same sectors will face the same tax liability (‘vertical inequity’) while others that perform similar activities to BC taxpayers (but are ineligible for it) would have similar profits but face different tax burdens (‘horizontal inequity’).

Migration between regimes

The BC regime should be designed in the context of the wider tax system and in particular its role in providing a smooth progression to the IA regime. The current SE design does not provide businesses with incentives to smoothly migrate from the BC to the IA regime. There are sharp rises in METRs and AETRs above the BC regime revenue cap. There is income bunching below the revenue cap. The avoidance of VAT registration is an additional deterring factor. The high share of low-income IA taxpayers raises broader design rationale questions as to the role of the BC regime and the extent to which it aims to support low-income SE to formalise and grow.

Enhance migration from the BC regime through supporting administrative and accounting training.

Periodically monitor the migration flow between the BC and IA regimes.

Self-employed individual-activity regime

Adherence to tax policy principles

The IA regime may violate the principle of horizontal inequity. The lower IA tax burden is driven by a range of tax design features that advantage SE over employment. These include lower statutory PIT rates, narrower PIT and SSC bases, deductible SSCs and a lower and broader SSC ceiling. These design features violate the principle of horizontal equity by taxing similar taxpayers differently. In the absence of a strong rationale (e.g. the authorities prefer to encourage small business growth and SE face greater job uncertainty), they may be unequitable.

The IA regime may violate the principle of tax neutrality as it encourages tax arbitrage from employment to SE. An employee may be able to do the same work for their employer at a reduced tax burden by incorporating as an IA taxpayer. Justifying rational exist for some departure from these principles for the SE but they should be weighed against arbitrage and tax revenue risks. To mitigate against the challenges of horizontal inequity and tax non-neutrality between the IA regime and employment, and to enhance the design of the IA regime, there is a scope for a number of tax policy reforms as follows.

Tax liability reform options

Raise the PIT rate in the IA regime to better align with the PIT rate faced by employees and raise PIT revenues. Statutory PIT rates in the IA regime are always lower than PIT rates on employees. Effective PIT rates in the IA regime are lower than on employees at most incomes. To support fairness and reduce tax arbitrage between employment and SE, the IA PIT rate could be aligned with the standard 20% PIT rate for employees. Aligning the IA PIT rate with the employee PIT rate would meaningfully shift the IA tax burden upwards, but it would remain below that of employment. Aligning the IA PIT rate and simultaneously cutting the tax credit threshold to zero would better align the tax burden and the tax burden distributional shape with that of employment. Increasing the PIT rate in the IA regime from 15% to 20% and simultaneously cutting the tax credit threshold from EUR 20 000 to EUR 5 000 would raise total PIT revenues by about 1%.

SSC design

Broaden the SSC base in the IA regime to better align with that of employment. IA taxpayers face a narrower SSC base (of 63% of gross income under the presumed cost deduction) than employees (of 100% of gross income). The IA SSC base could be broadened to better align with the employee SSC base. Broadening the SSC base from 90% to 100% of taxable income would increase the tax burden very modestly.

Align the SSC deductibility rules between the IA regime and employment. In the absence of a justifying rationale, SSC deductibility could be afforded to employees and SEs more equally. This could be achieved directly by disallowing IA taxpayers from deducting pension SSCs.

The SSC ceiling in the IA regime and employment could be harmonised to reduce tax arbitrage opportunities. There does not appear to be a strong rationale for lower SSC ceilings on IA which imply that high-income IA benefit from reduced SSC burdens. Raising the IA SSC ceiling to align with that of employees would increase the SSC burden on high-income IA and raise SSC revenues modestly, particularly on high earners. Aligning the SSC ceiling would reduce arbitrage opportunities for high-income employees to become SE to reduce their tax burden. Aligning the scope of the SSC ceilings (i.e. the employee SSC ceiling excludes health SSCs but the SE ceiling includes health SSCs) would similarly reduce tax arbitrage opportunities. SSC ceilings should be applied on a combined income, irrespective of the type of activity form which the income is derived.

There may be scope to harmonise SSC and health SSC payments on a monthly basis. IA taxpayers currently pay SSCs on an annual basis and health SSCs on a monthly basis. Converting the annual SSC payment to a monthly payment has the advantage of reducing the risk of SSC arrears to the tax admin and providing taxpayers with a clearer picture of their financial situation throughout the year as payments are made monthly. For those with an employment contract who report SSCs on an annual rather than monthly basis, monthly reporting could be optional.

The health SSC floor could be retained as it appears to produce minimal behavioural distortions. As the health SSC floor expires it produces an increased marginal tax wedge but few IA taxpayers appear to respond to it.

Tax credit design

The design of the tax credit could be reformed in line with a standard progressive PIT system to prevent rising METRs. As the tax credit is tapered in the IA regime, increasingly higher effective PIT rates are paid on total taxable income (up to the max PIT rate of 15%). As a matter of design, this is unlike in a standard progressive PIT system where a higher PIT rate is levied only on that part of income above a higher PIT bracket. Consequently, the tax credit design will produce rising METRs for IA taxpayers because earning an additional euro of income faces a higher statutory tax rate that applies to the entire taxable income (rather than just the part of income above a higher PIT bracket).

The tax credit design could be better designed and should be reformed to align with the SE income distribution. The tax credit in the IA regime could be better designed in the context of the SE income distribution. The tax credit will not introduce much PIT progressivity in the IA regime because too few IA taxpayers report sufficient incomes within the income range where it has been set. From the perspective of incentives, of the few taxpayers that that are impacted, a rising METR will in the first instance encourage sales suppression (i.e. tax evasion) and secondarily discourage business growth.

Presumptive cost deduction

The presumptive cost deduction could be abolished so that IA taxpayer report costs and incomes which would strengthen the tax admin's capacity to successfully monitor and enforce compliance. The presumed cost deduction is insufficiently generously to be preferred to declaring actual costs because when SSCs are excluded, the standard deduction represents on 17.7% of income. The actual costs faced by most small businesses may exceed this. Despite this, more than 4 in 5 IA taxpayers opt for the presumptive cost deduction. There are advantages to a presumed cost deduction including simplicity for taxpayers and the tax admin. However, a main drawback of a majority of IA taxpayers opting for the presumptive cost deduction is that the tax admin has limited transparency on the actual operations and costs of business within the IA regime. On top of limited transparency in the IA regime, Lithuania operates a presumptive BC regime with a high revenue eligibility cap where costs are also not required to be reported. Taking the two unincorporated SE regimes together, this implies that the tax admin has cost information on only about 1 in 10 businesses. This lack of information may weaken the tax admin's capacity to successfully monitor and tackle compliance in the IA regime.

Farmers

There is scope to reform the tax rules for self-employed farmers. SE farmers comprise 1/3 of IA taxpayers. Despite SE farmers having relatively high and diverse income sources compared to non-farmers, they face relatively generous tax rules. Most SE farmers are exempt from PIT and face narrowed SSC bases. A detailed examination of the taxation of SE farmers goes beyond the scope of this report.

Incorporated businesses

Consideration could be given to raising the dividend tax rate to reduce tax arbitrage. An unincorporated individual can organise as an incorporated business and choose the form to realise their return. Incorporating a business and distributing all profits as dividends is mostly tax-favoured at high and low incomes whereas SE is mostly tax-favoured at middle incomes. Incorporating and drawing a salary as an owner is never tax-favoured. Lithuania may consider introducing rules that oblige manager-owners of closely-held corporations to pay themselves a minimum level of salary to somewhat offset the tax-induced incorporation incentives. However, the issue of international arbitrage and the return to capital has not been investigated as part of this report and further work is needed to develop a fuller picture of dividend taxation.

The reduced 5% CIT rate regime could induce tax arbitrage. Under the standard 15% CIT rate, incorporating and distributing profits as dividends is tax-favoured at both low and high incomes. SE is favoured at middle incomes. Taxpayers are indifferent between the two regimes at high incomes. Under the reduced 5% CIT rate, incorporating and distributing profits as dividends is tax-favoured at low and high incomes but SE is preferred at middle incomes.

Table 1.2. Summary of the most and least tax-favoured organisational forms based on the AETR, by income and CIT regime

<table>
<tr><td>CIT regime and incomes</td><td>Unincorporated</td><td colspan="2">Incorporated
Distribute all profits as:</td></tr>
<tr><td>**Standard CIT rate**</td><td>IA regime</td><td>Dividends</td><td>Salary</td></tr>
<tr><td>Low</td><td>-</td><td>+</td><td></td></tr>
<tr><td>Mid</td><td>+</td><td></td><td>-</td></tr>
<tr><td>High</td><td colspan="2">+</td><td>-</td></tr>
<tr><td colspan="4">**Reduced CIT rate**</td></tr>
<tr><td>Low</td><td>-</td><td>+</td><td></td></tr>
<tr><td>Mid</td><td colspan="2">+</td><td>-</td></tr>
<tr><td>High</td><td></td><td>+</td><td>-</td></tr>
</table>

Note: + most tax-favoured based on the AETR – least tax-favoured based on the AETR. Where two regimes are most tax-favoured, this indicates they are equally tax-preferred (i.e. they have the same AETR). In the standard CIT rate case, low, mid and high incomes refer to below 20% of AW, 20% - 200% of AW and above 200% of AW. In the reduced CIT rate case, low, mid and high incomes refer to below 60% of AW, 60% - 120% of AW and above 120% of AW. The hypothetical framework makes several assumptions and should be interpreted with caution. More detail on this table is described in the section on incorporated businesses.

Observations on the tax and benefit system

Despite aging, the long-term fiscal sustainability may be favourable in Lithuania according to OECD long-term fiscal outlook modelling. This is partly due to a strong relative fiscal position, low spending and high employment. Sustainability will be further bolstered by rapidly rising tax revenues that are not beyond revenue-maximising levels (Guillemette and Turner, 2021[1]).

The introduction of the progressive PIT system, when coupled with the introduction of the SSC ceiling system, has not translated to much reduction in income inequality. Despite the introduction of a progressive PIT rate system in 2019, coupled with increases in the basic allowance, there was minimal improvement in income inequality as measured by the Gini coefficient in Lithuania 2019. This is partly attributable to the simultaneous introduction of the employee and employer SSC ceilings followed by the subsequent cuts to the employee SSC ceiling in 2020 and 2021, which reduced the SSC burden on higher earners. The abolition of the employer SSC ceiling in 2021 increased the SSC burden on higher income employers, but it was modest due to a low employer SSC rate. Lithuania has undergone a major reshuffling of its labour tax mix. Employee SSC revenues have gone from playing a minor role in the tax mix in 1995 to a major role in 2020.

The personal income tax system could be more progressive at the top. For low-income single individuals, average ETRs in Lithuania are high in international comparison, reflecting high SSCs. At higher incomes, average ETRs are relatively flat. The PIT burden on low-incomes as a share of the PIT burden on high-incomes is the fifth highest in the OECD in 2021, indicating little PIT progressivity. When employer

SSCs are included in the ETR (a non-standard methodology), ETRs in Lithuania change from being comparatively high to low but the ETR structure continues to be quite flat at higher incomes.

The tax wedge has declined over the past two decades, narrowing the gap with the OECD average. The tax wedge fell before and during the Great Financial Crisis (GFC), more recently during the 2019 labour tax reform and during the 2020 COVID-19 pandemic that followed it.

Low-income single individuals shoulder much of the tax burden at low income levels. Unlike in many OECD countries, low-income single parents earning half the AW in Lithuania face negative tax wedges. Negative tax burdens faced by low-income single parents and higher tax burdens faced by single individuals imply that single individuals shoulder much of tax burden at low income levels. Lithuania's tax wedge 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 (which are subtracted from PIT and SSCs in the numerator of the tax wedge equation), but especially at low incomes (where they are more valuable relative to income).

Although the withdrawal of the additional child benefit produces modest METRs, a redesign of the benefit would likely add excessive complexity to the benefit system. There is a sharp but brief spike in the marginal tax wedge below the AW as the additional child benefit is withdrawn. Similarly sharp and brief spikes in the marginal tax wedge for single parents are also found in Poland and Slovenia as benefits are withdrawn. Single parents, more than half of whom face poverty risks, face modest METRs because of the withdrawal. Couples with two children, who face modest poverty risks, also face modest METRs. The extent to which families at risk of poverty are responding to these METRs by keeping their income below the point of withdrawn could be confirmed by an income bunching analysis using the tax record data. In the event of bunching, the additional child benefit could be more gradually tapered. In the event that bunching is limited, a tapering would likely add excessive complexity for a benefit of a relatively small amount. Anecdotal evidence from Lithuania appears to point towards the latter.

Whether the gap between the SSC floor and actual SSCs paid by vulnerable groups could be financed through general taxation depends on the extent to which the minimum wage is appropriately set and enforced. To encourage their employment, some vulnerable groups are exempt from the SSC floor (for example, parents that are receiving child-care benefits up until the child is 2 years of age, people with disabilities, those aged up to 24 years of age and the self-employed). The exemptions could contribute to these vulnerable groups receiving low social benefits (for example, illness benefits). Funding the gap between the SSC floor and actual SSCs paid up to the MMW for these groups through the state budget could help to support these groups. However, it could also encourage employers to try to pay full-time workers below the MMW if the MMW is set theoretically above worker productivity levels and MMW enforcement is relatively weak (i.e. if employers can pay workers below the MMW in the informal economy with limited risks of detection).

Alternative financing options for maternity leave and childcare benefits exist. Women can take maternity leave starting the 30th week of pregnancy. Since the rationale for maternity leave is that women are unable to work due to their health status (i.e. similar to sick leave), it could be funded by SSCs as it is an insurable event. Parents can take childcare benefit up to 2 years after a child is born. Childcare is paid to compensate for childcare costs and lost employment. Lithuania has argued that the former could be paid for by a basic flat amount from general taxation and the latter from SSCs. Following the same principle, a further possibility could be to finance childcare benefits and allowable leave through general taxation. If additional leave is used beyond the legal allowable limit, it could be financed with SSCs.

SSCs are a contributor to the disincentive to enter work at low incomes, even at short employment spells. Unemployment benefits are the largest contributor to the disincentive to enter work. Reducing them further is challenging given poverty rates among the unemployed. Excluding unemployment benefits, the largest contributors to the work disincentive are employee SSCs followed by PIT. At incomes up to AW, the contribution of SSCs is larger than the contribution of PIT. At twice the AW, the contribution of

SSCs and PIT are similar. Work incentives are relatively strong in Lithuania at higher incomes. At 200% of the AW, work incentives are in the middle of OECD countries and unemployment benefits as a share of gross income is similar to the OECD average. However, at low incomes near MMW, work incentives are particularly low (at a PTR of 100%, there is no financial gain to work and at a PTR of 50% work starts to pay). Differences in work disincentives between single persons and single parents are modest, largely because child benefits are provided to both those in and out of work.

Compared to the OECD average, Lithuania's lower work incentives are driven by larger unemployment benefits, PIT and the absence of in-work benefits. When employee and employer SSCs are combined, the contribution of total SSCs to the work disincentive in Lithuania is similar to the OECD average at several income levels. Compared to the OECD average, UBs and PIT in Lithuania make relatively larger contributions to the work disincentive (as measured by the non-standard PTR). This is particularly the case at lower incomes at and below the AW. In-work benefits increase work incentives in the OECD on average, especially at low incomes. Lithuania's in-work social assistance performs a similar function at low incomes by increasing work incentives. Long-term unemployed parents earning near the MMW continue to have modestly lower work incentives than the OECD on average due to mostly to higher PIT (i.e. at 20 months of unemployment, unemployment benefits, family benefits and social assistance benefits combined are lower 1in Lithuania than in the OECD average).

Low-income second earners have low incentives to enter work at short unemployment spells but quite strong incentives at long unemployment spells. Second-earners (often women) tend to be responsive to incentives in most countries. Second-earners in Lithuania have low work incentives at short employment spells, due mostly to high UBs and SSCs. This incentive structure might encourage some low-income second earners to stay on employment up to the expiration of unemployment benefits at 9 months. Work incentives are greater at longer unemployment spells due to low social assistance benefits. At longer unemployment spells, work incentives are even larger when the second earner has a higher income as the drop in social assistance outweighs higher PIT rates. This incentive would encourage low-income second earners to enter work if they had the opportunity, skills, training and health to do so. A significant pool of long-term and low-income unemployed second earners might indicate an inability rather than an unwillingness to work.

Disincentives to enter work are a more important area of policy concern than disincentives to progress in work. Poverty rates among the unemployed are high and rising in Lithuania. The research literature shows that tax policies are often more effective at the extensive margin (i.e. moving from unemployment to work) rather than the intensive margin (i.e. progressing in work).

General economic reform options

This section provides observations and general economic reform options based on this Tax Policy Review. For a comprehensive review of Lithuania's economy, the OECD has recently published its *Economic Survey of Lithuania 2022* (OECD, 2022[2]).

Disposable income inequality could be reduced. Disposable income inequality places among the top 6 OECD countries in 2019 and improvements have been limited in recent years. The role of the taxes and transfers in reducing inequality has also been limited. Three-quarters of the reduction is attributable to transfers, which is common among OECD countries. The extent to which the tax and benefit system can reduce income inequality will be challenged by rising market income inequalities and the degree to which benefits can be increased along with them (Černiauskas et al., 2021[3]). Minimum-income benefits will form a key part of the redistribution system due to its poverty avoidance and poverty alleviation objectives.

In the medium-term, raise social spending as a share of GDP and boost the low levels of spending on active labour market policies. Social spending as a share of GDP is low in Lithuania in international comparison. Increasing social spending would help to ensure that the incomes of those who are not benefiting from rapidly rising wages (e.g. the unemployed, inactive workers and individuals with health issues). Rising tax-to-GDP ratio could help to finance social spending. Spending on active labour market programmes is low relative to other OECD countries, particularly due to relatively low employment incentives and training.

Diversify the tax mix towards less distortive and underutilised taxes such as taxes on recurrent property. Almost two-thirds of taxes come from distortive as a share of total taxes. Distortive taxes include PIT, SSCs and CIT (OECD, 2010[4]).

Some evidence supports raising the minimum wage. The minimum wage in Lithuania is paid only for unskilled work (i.e. that does not require special skills or professional expertise). Skilled workers must be paid above the minimum wage. The minimum wage is indexed using the forecast AW. The minimum wage supports those on low incomes, a more equal information distribution and possibly support tax enforcement (Gavoille and Zasova, 2021[5]). The minimum to average wage ratio is low in international comparison. Raising the minimum wage would also mechanically raise unemployment benefits. At the same time, address the associated risks to informality that could arise through the so-called 'lighthouse effect' through improved enforcement.

Evaluate the possibility of raising old-age pensions to curb the impact of low pension replacement rates, the work to retirement 'income cliff', high and rising poverty among retired people and the need for a rising share of retired people to supplement low incomes by working. Old people are also the largest social group facing poverty in absolute terms so supporting old-age pension incomes will have a significant impact on improving inequality.

Evaluate the potential for establishing a link between retirement age and life expectancy when the pension age reaches 65 in 2026 to support the sustainability and adequacy of the pension system.

Consider reviewing the policy to extend early retirement options introduced in 2021, which may put further pressure on the sustainability of the pension system and reduce already low pensions.

Promote policies of healthier lifestyles to prevent poor health as a barrier to employment. Poor health is a barrier to employment, avoidable illness is high and the population is aging rapidly. Despite rising long-term life expectancy, healthy life expectancy is mostly decreasing.

Transition to a digital and knowledge-based economy with high-income and high-skill jobs to enhance weak subject skill matches and as a means to target the cause of poverty. Education outcomes and skills are comparatively poor, and skills mismatch are considerable. There are large income inequalities between those with basic and lower education. Government spending on education is below the OECD average. Education is focused on the general rather than the vocational track, resulting in labour market imbalances, as many graduates are not well matched to their jobs. Despite progress, adoption of digital technologies lags behind the levels of leading European countries. Increasing the labour market relevance of the tertiary system is important, in view of the shortages in ICT and ICT-related skills. A reason identified in the Development Program for the low participation of older people in the labour market is the lack of opportunities to participate in lifelong learning activities, especially in the development of competences in the field of information and digital technologies (UNECE active aging index 2018).

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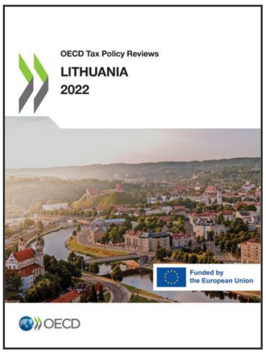

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