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Foreword

This report is part of the *OECD Tax Policy Reviews* series. *OECD Tax Policy Reviews* are intended to provide independent, comprehensive and comparative assessments of OECD member and non-member countries' tax systems as well as concrete recommendations for tax reform. By benchmarking countries' tax systems and identifying tailored tax policy reform options, the objective of the Reviews is to enhance the design of existing tax policies and to support the adoption and implementation of tax reforms.

This project was led and written by Sean Kennedy with selective tax policy inputs from Bert Brys. The report was supervised by Bert Brys. Advice and comments related to the OECD Tax and Benefit Model TaxBen were provided by Olga Rastrigina from the OECD's directorate for Employment, Labour and Social Affairs.

The analysis in the report is primarily based on OECD statistics and OECD tax modelling tools. The microdata analysis is based upon a representative sample of the tax and benefit administrative data in 2019 provided by Lithuania for this project. Some of the results of Chapters 3 and 5 are based on simulations performed by the EUROMOD team of the European Commission's Joint Research Centre (JRC). EUROMOD is a tax-benefit microsimulation model for the European Union that is maintained, developed and managed by the Joint Research Centre (JRC) of the European Commission, in collaboration with Eurostat and national teams from the EU countries. This report makes use the beta-version of the model for Lithuania, based on version I3.0+, adapted to run on the input data derived from national administrative registers. This version is not available to the public. The authors are very grateful to Alberto Mazzon and Andrea Papini from the JRC and Louise Jensen from the Directorate-General for Structural Reform Support of the European Commission for their collaboration during the project.

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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.

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 arise 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 than 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 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

CIT regime and incomes	Unincorporated	Incorporated <i>Distribute all profits as:</i>	
		Dividends	Salary
Standard CIT rate	IA regime		
Low	-	+	
Mid	+		-
High		+	-
Reduced CIT rate			
Low	-	+	
Mid		+	-
High		+	-

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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2 Setting the scene for tax reform

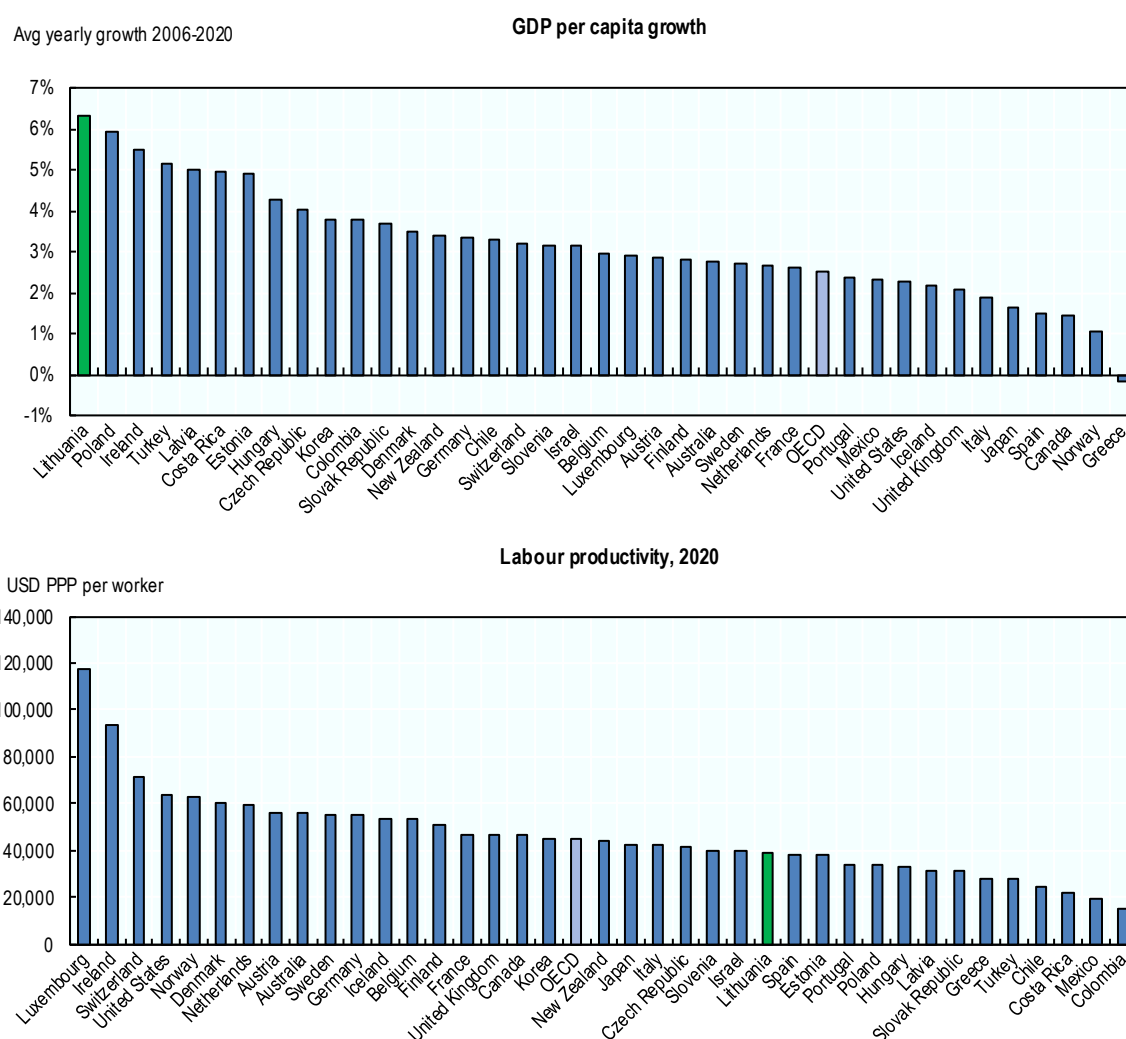
This chapter sets the scene for tax reform in Lithuania. The chapter reviews the economic, employment and inequality challenges facing the country. The chapter examines the wage income distribution and poverty risks with a focus on older workers. Finally, tax revenues and social spending are reviewed.

Lithuania's economy and labour market are recovering

This section provides observations and general economic reform options based on this Tax Policy Review. For a review of Lithuania's economy, see the *OECD Economic Survey of Lithuania 2022* (OECD, 2022^[1]).

The Lithuanian economy has successfully emerged from the COVID-19 crisis. Since the mid-2000s, Lithuania's per capita GDP growth has been above most OECD countries and other economies in the region (Figure 2.1). The COVID-19 pandemic hit a buoyant Lithuanian economy in 2020. Since then, GDP has rebounded rapidly and is projected to grow at 3.7% on average in 2022 and 2023 (OECD, 2021^[2]). Productivity measured as GDP per person has accelerated in recent years, reaching an indexed score of 119 in Q4 2021 against a benchmark of 100 in 2015.¹ However, labour productivity remains in the bottom third of OECD countries (Figure 2.1).

Figure 2.1. The economy has performed well but productivity remains low



Note: Labour productivity is measured in USD at current prices at current PPP per person employed. PPP measures the prices of the same basket of consumption goods in different countries.

Source: OECD compendium of productivity indicators.

The labour market is recovering. The unemployment rate has recovered in Lithuania following the COVID-19 pandemic (Figure 2.3). It gradually declined from a peak of around 9% in mid-2020 to 7% in spring 2022. The unemployment rate currently remains modestly above the OECD average. Labour force participation rates are forecast to increase from 71.8% in 2020 to 72.9% by 2023 (Figure 2.3). High and rising labour force participation is driven by various factors including immigration of skilled workers, both foreign and returning Lithuanian, in addition to the rising retirement age, low pensions and social support (OECD, 2018^[3]). The employment rate in Lithuania at 73.5% in Q4 2021 is relatively high, above the OECD average (68.7%) and between Latvia (70.2%) and Estonia (75.0%). Robust employment numbers are a contributory factor to wage growth in Lithuania (Figure 2.7).

Structural employment challenges remain

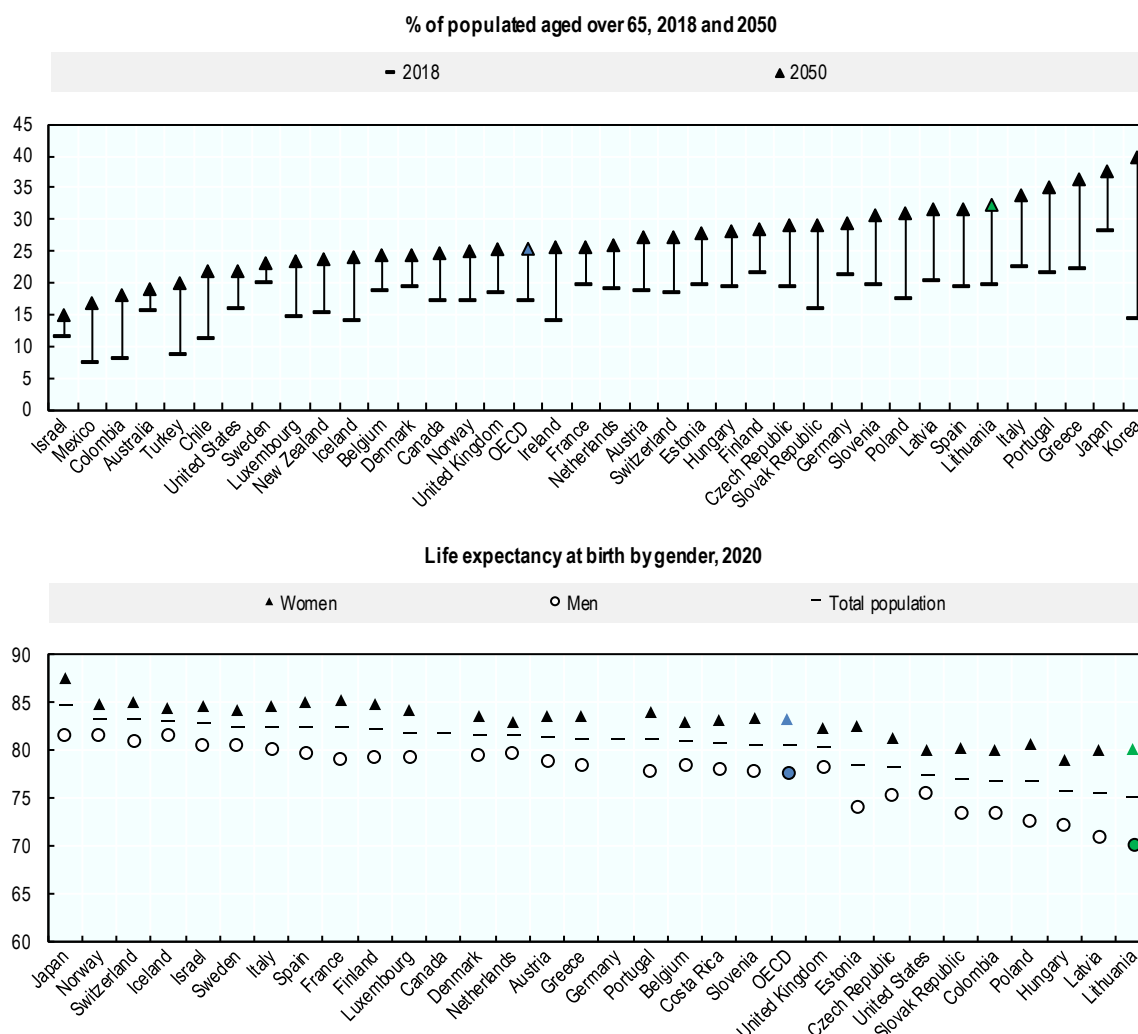
Lithuania's demographic challenges will amplify employment and fiscal challenges. The working-age population in Lithuania is declining at about 1% per year on average (Figure 2.3). At the same time, Lithuania's population is aging rapidly. Lithuania has a high 20% share of elderly persons (aged 65 and over) in 2018 against 17% in the OECD on average (Figure 2.2). The share of elderly persons is forecast to expand rapidly to 32% by 2050, which is among the fastest growth rates in the OECD (Figure 2.2). These structural developments imply that a growing retired population will be increasingly supported by a contracting working population. These trends will likely exacerbate labour shortages and the need for additional fiscal spending. In addition, labour tax revenues in Lithuania will be lower than otherwise as older workers have lower labour market participation rates than younger workers and because Lithuania does not levy PIT on pensions.

Poor health is a barrier to employment. Health limitations are among the most common obstacles to employment in Lithuania (Pacifico et al., 2018^[4]). While life expectancy has improved in recent years reaching 75 years of age in Lithuania 2020, it remains among the lowest in the OECD (Figure 2.2). Low life expectancy in Lithuania reflects poor health outcomes in the country more generally. For example, 15% of the population self-reported as being in poor health compared to 15% in Latvia, 13% in Estonia and 9% in the OECD on average (OECD, 2021^[5]). The life expectancy of Lithuanian women at 80 years of age is ten years above that of Lithuanian men, partly owing to better lifestyle choices among women (in a country where there are high proportions of daily smokers and high consumption of alcohol per capita).

Alcohol taxation has raised taxes and prevented avoidable illness. Alcohol consumption in Lithuania is among the highest in the OECD. Lithuania has increased excise taxes multiple times since 2009 and a further increase in 2017 when wine taxation doubled. Taxes on alcohol, wine and beer increased between 2009 and 2017. Some evidence exists that higher alcohol taxes led to a reduced disease burden and deaths (Rovira et al., 2021^[6]). The fear that alcohol would be bought instead in neighbouring countries does not seem to have materialised, despite high populations at the border regions.

Skill mismatches and an educational divide contribute to unemployment challenges. Under-qualification and field-of-study mismatches among employees are more common in Lithuania than in many other OECD countries. In 2016, 14% of Lithuanian workers were underqualified for the requirements of their job and 21% were over-qualified, against 19% and 17% in the OECD respectively. Furthermore, 35% of workers had a field-of-study mismatch in Lithuania (i.e. they were employed in a job that did not match their skills), compared to 32% on average in the OECD. The educational divide in Lithuania's labour market is large. The unemployment rate stood at 4% among highly educated 15 to 74 year-olds (with tertiary education) in 2021, whereas it was 9.3% among people with upper-secondary education and 16.6% among people with low (below upper-secondary) levels of education (according to data from Eurostat).

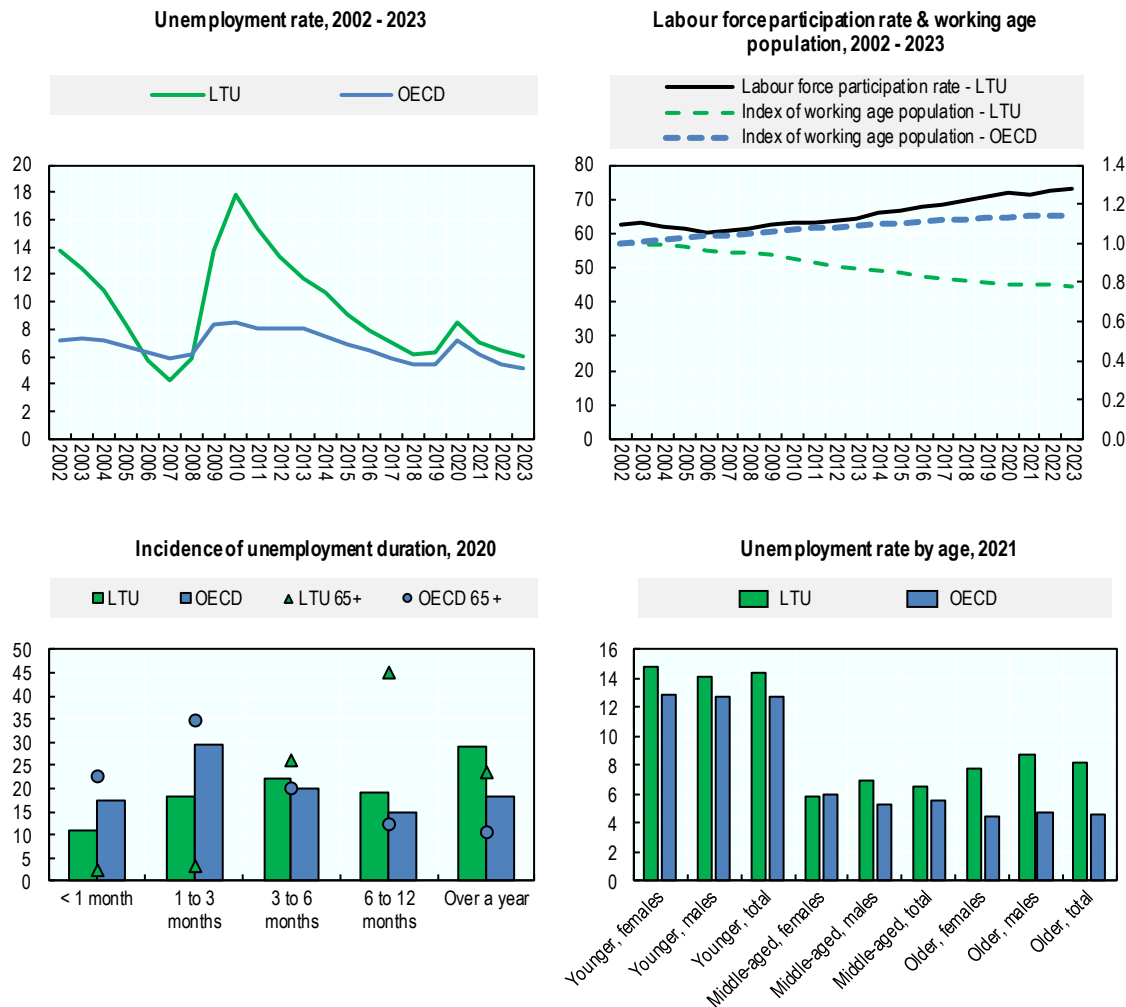
Figure 2.2. The population is aging rapidly and health outcomes are poor



is especially high among older Lithuanian men at 8.7% relative to Lithuanian women and relative to older men in OECD countries on average.

Figure 2.3. Unemployment is high among some groups

Labour market indicators



Note: The labour force is comprised of employed and unemployed persons but not inactive persons. Labour force participation is calculated as the labour force divided by the working-age population between 15 and 74. Working age population is defined as the share of those aged 15 to 74. Younger, middle-aged and older workers refer to those aged 15 to 24, 25 to 54 and 55 to 64 respectively.

Source: OECD Economic Outlook No 110.

Despite strong economic growth, long-term unemployment remains stubbornly high. The share of long-term unemployment (i.e. those unemployed for more than a year) was 29% in Lithuania in 2020 against 18% in the OECD and it has declined only modestly in Lithuania from 30% in 2019 (Figure 2.3). Although the share of long-term unemployment was higher following covid, these data point to the existence of a pool of vulnerable people facing employment difficulties. Since the chances of finding high-quality jobs diminish as people stay out of employment for longer, reconnecting the long-term unemployed

with jobs remains a major challenge. In addition, older individuals in Lithuania (aged 55 - 64) are also much more likely to be unemployed for 6 months or longer than for shorter periods (Figure 2.3).

Many long-term unemployed may be unable rather than unwilling to re-enter the labour market.

Unemployment benefit duration in Lithuania of 9 months (see section 3.3) and a high share of Lithuanians unemployed for over a year implies that many long-term unemployed are unable to find work before unemployment benefits expire. This is despite the strong financial incentives to find a job, specifically the large cuts in benefits as unemployed people transition to lower social assistance benefits (policy options for supporting the long-term unemployed are discussed later in section 3.3). High long-term unemployment including among older individuals despite strong economic growth and the financial incentive to re-enter work suggest that there are additional challenges faced by the unemployed in re-entering the labour force. These challenges include the aforementioned skill and qualification mismatches but also low formal incomes and potentially relatively high informal incomes (see Figure 2.4).

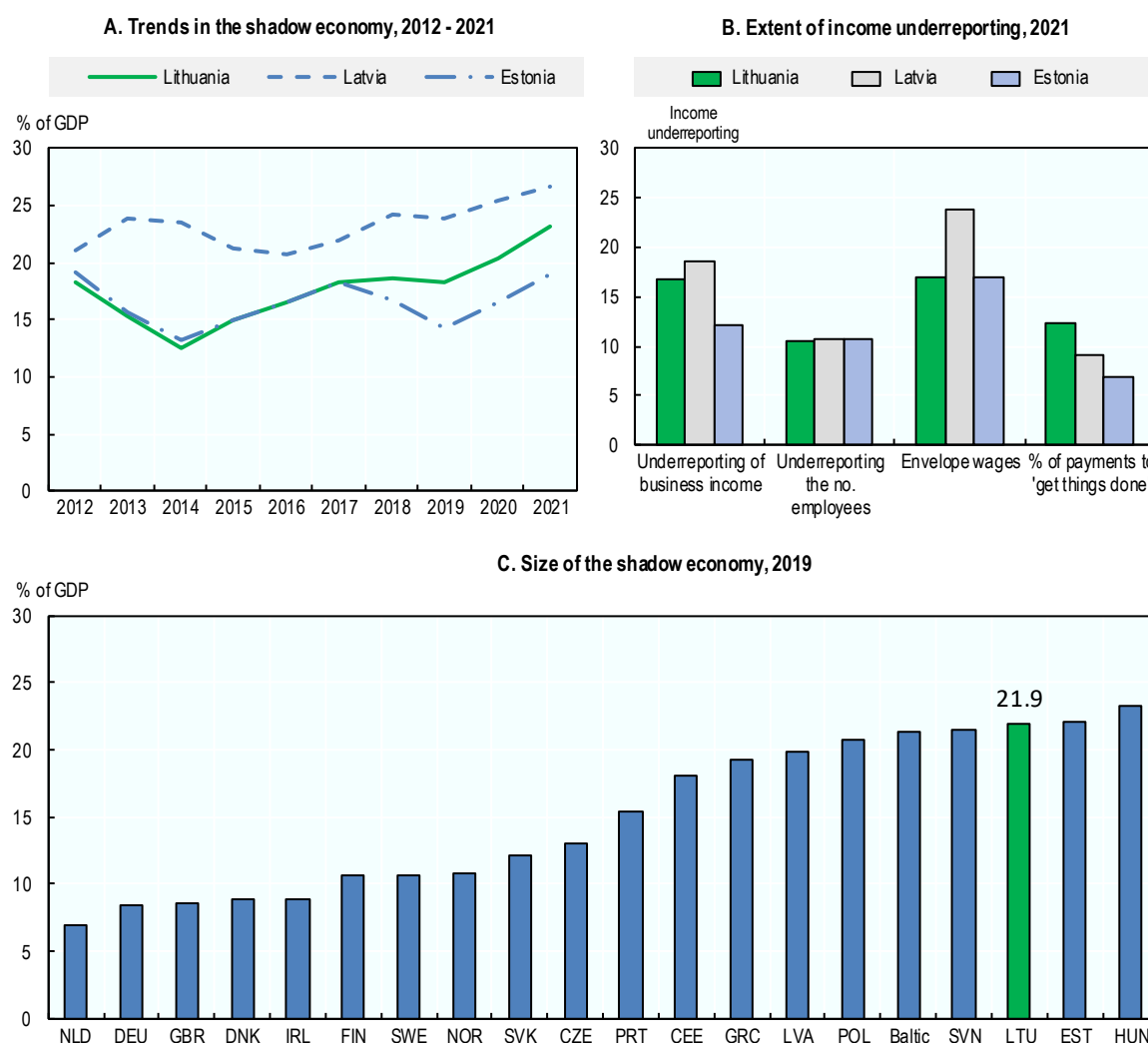
Despite a strong economy, informality is high

Informality is relatively high and has increased in recent years. Shadow economy generally refers to economic activity that should be reported to tax authorities but is not and therefore goes untaxed (OECD, 2017^[8]).² Measurement is notoriously challenging and estimates vary widely, ranging from 1 to 20% of GDP in OECD countries (OECD, 2017^[8]). Shadow economy as a share of GDP in Lithuania has been estimated at 22% in 2019 (Figure 2.4). The SEE Riga Shadow Economy Index estimates shadow economy in Lithuania at 23% of GDP in 2021, below that found in Latvia (27%) but above Estonia (19%) (Putniņš and Sauka, 2021^[9]) (Putniņš and Sauka, 2015^[10]). Despite strong wage growth (Figure 2.7), shadow economy as a share of GDP increased by 3% in Lithuania in 2020. While trends in shadow economy as a share of GDP in Lithuania and Estonia had moved together between 2012 and 2017, the relationship has diverged since with shadow economy as a share of GDP moving higher in Lithuania.

Informality in Lithuania is driven by several factors including relatively high taxes. Companies operate in the shadow economy in Lithuania for many reasons including relatively high taxes and uncertainty about regulatory policies (Putniņš and Sauka, 2021^[9]). Under-reporting of business income and so-called ‘envelope wages’ (i.e. a part of salary in the form of an undeclared cash payment) are of relatively greater concern in Lithuania compared to under-reporting of employees and payments to ‘get things done’ (Figure 2.4). Enhancements to tax enforcement and compliance by the tax administration must be part of the solution to addressing informality. Satisfaction with the performance of the tax administration in Lithuania has been improving (3.7 out of 5 in 2020 against 3.4 in 2019) and the perceptions of being caught for underreporting are high (44.3% believe there is a 76 – 100% chance of being caught for underreporting business profits) (Putniņš and Sauka, 2021^[9]).

Informality may be higher in a low wage economy where taxes are less affordable. In economies with relatively lower take-home pay and higher informality like Lithuania (Figure 2.4), the financial incentives may be greater for households and businesses to purchase goods and services from the informal economy. Purchasing from the informal economy avoids paying labour taxes such as PIT and SSCs for employees and employers and indirect taxes such as VAT (which has a rate of 21%). In addition, in a relatively low wage economy (Figure 2.9), taxes may be less affordable which could encourage informal work. On the other hand, informality has increased in Lithuania over recent years during a period of rising wages and a growing economy more generally.

Figure 2.4. Informality appears to be high and rising



Source: Charts A and B are based on the SEE Riga Shadow Economy Index (Putniņš and Sauka, 2021^[9]). The Index is based on an annual survey of company owners in Estonia, Latvia and Lithuania. The surveys are conducted between February and April each year and contain questions about shadow economy in the two previous years. In 2022, 501 owners were interviewed based on a random stratified sampling approach. Underreporting of business income refers to the average share of revenue in % that companies conceal from government. Underreporting of number of employees refers to the average share of employees in % working without a contract. Envelope wages refer to the average share of salaries in % which is paid by the employers, but concealed from the government. % of payments to 'get things done' refers to the average percentage of revenue paid as 'bribes'. Chart C is based on Schneider, F. (September 2019), Latest developments of the shadow economy in the Baltic countries: What are the major causes and what could be done? University of Linz, Austria. In the analysis shown, shadow economy is defined as all legal production of goods and services that is deliberately concealed from public authorities.

Income inequality remains high

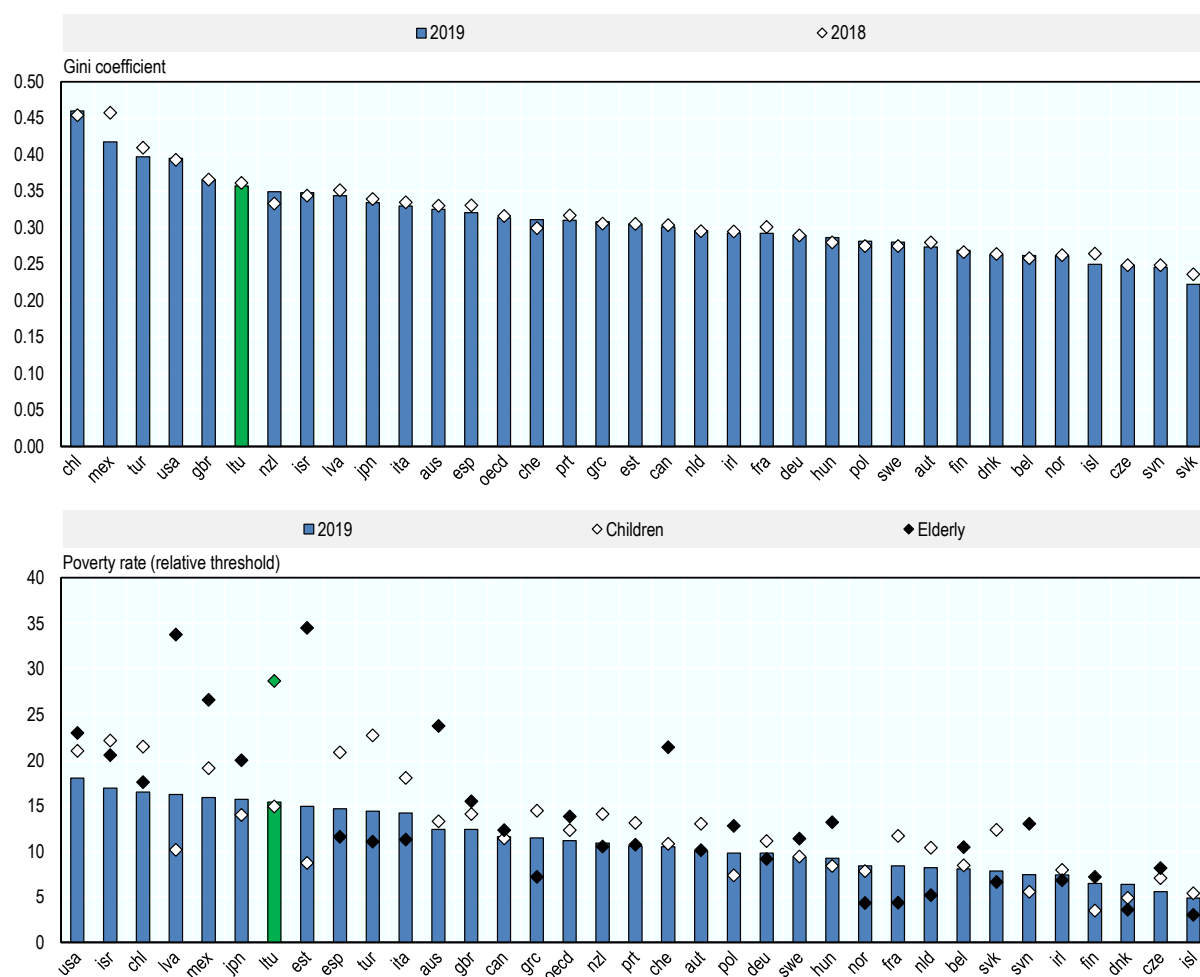
Disposable income inequality in Lithuania places among the top 6 OECD countries. In most OECD countries, the gap between the rich and poor is at its highest in many decades. In 2019, the latest year for which data are available, the Gini coefficient of disposable income (i.e. after the impact of taxes and benefits) in Lithuania was 0.357, down modestly from 2018 (when it was 0.361) but above the OECD average (0.313) and ahead of Estonia (0.305) and Latvia (0.344) (Figure 2.5). Lithuania places among the

top 6 OECD countries for income inequality in 2019. Rising income inequality is often a feature of rapidly growing economies such as Lithuania (Figure 2.1).

Relative poverty rates place among the top 7 OECD countries. The relative poverty rate in Lithuania, defined as the share living on less than half the median disposable income, was 15% in 2019. This poverty rate is above the OECD average (of 11%) but similar to Latvia and Estonia. Old-age poverty in Lithuania is the third highest in the OECD in 2019, below only Latvia and Estonia (poverty is discussed in more detail later, see Figure 2.11).

Figure 2.5. Disposable income inequality and poverty rates are relatively high

Inequality and poverty in Lithuania and OECD countries, 2019



Note: Data refer to the total population and are based on equivalised household disposable income, i.e. income after taxes and transfers adjusted for household size. The Gini coefficient takes values between 0 (where every person has the same income), and 1 (where all income goes to one person). The poverty threshold is set at 50% of median disposable income in each country. 2019 refers to the 2019 income year as opposed to survey year. Children refers to those aged 18 and under. Elderly relates to those aged 65 and over.

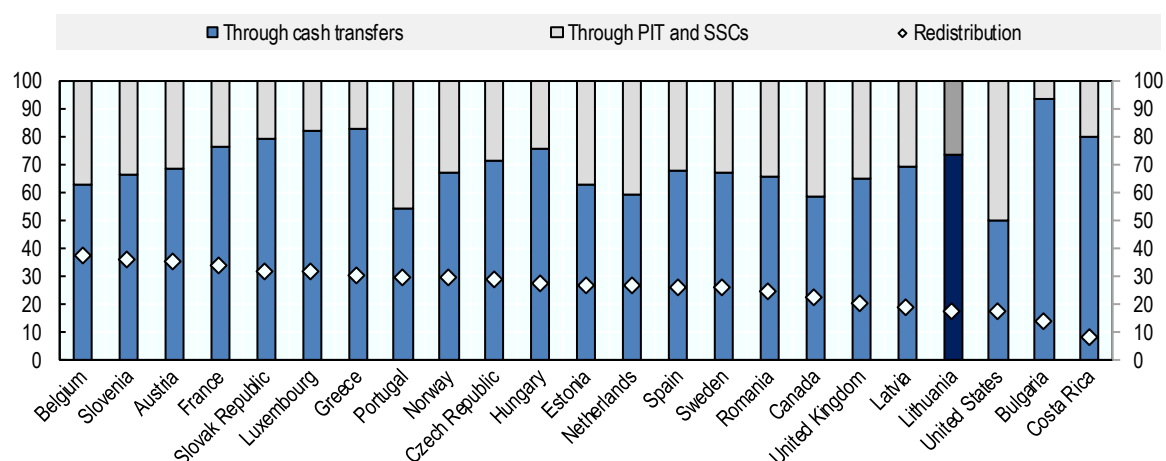
Source: OECD income distribution database.

The redistributive role of taxes and transfers is limited. An initial assessment of income redistribution can be given by computing differences between the share of cash transfers received net of PIT and SSCs (paid by households) at different points on the income distribution (Causa and Hermansen, 2017^[11]). In Lithuania, the market income Gini coefficient (inequality before taxes and transfers) is 42% in 2019 and the disposable income Gini coefficient (inequality after taxes and transfers) is 35%. Redistribution, defined as the difference between market and disposable income inequality as a share of market income inequality, is 17% in Lithuania 2019. The extent of redistribution in Lithuania is among the lowest in the OECD (Figure 2.6). This picture should be viewed with caution due to the absence of employer SSCs data and cross-country institutional differences in the design and funding of social security systems.

Taxes contribute less to reducing income inequality than transfers in Lithuania. 74% of the reduction in income inequality in Lithuania is due to transfers with the remaining 26% from taxes (PIT and SSCs). These shares are similar to the OECD average (Causa and Hermansen, 2017^[11]). Indeed, a greater role of transfers in redistribution is in line with cross-country empirical studies in other countries (Immervoll et al., 2005^[12]) (Joumard, Pisu and Bloch, 2012^[13]) (Brys et al., 2016^[14]).

Figure 2.6. The contribution of taxes and transfers to reducing inequality in Lithuania is low

The share of redistribution in Lithuania and OECD countries, 2019



Note: The redistribution figures shown are based on the working-age population from 18 to 65 because many pensioners will have no market income. Redistribution is defined as the difference between market income and disposable income inequality, expressed as a percentage of market income inequality. The new OECD income definition 2012 is used.

Source: OECD income distribution database.

Wages are growing rapidly

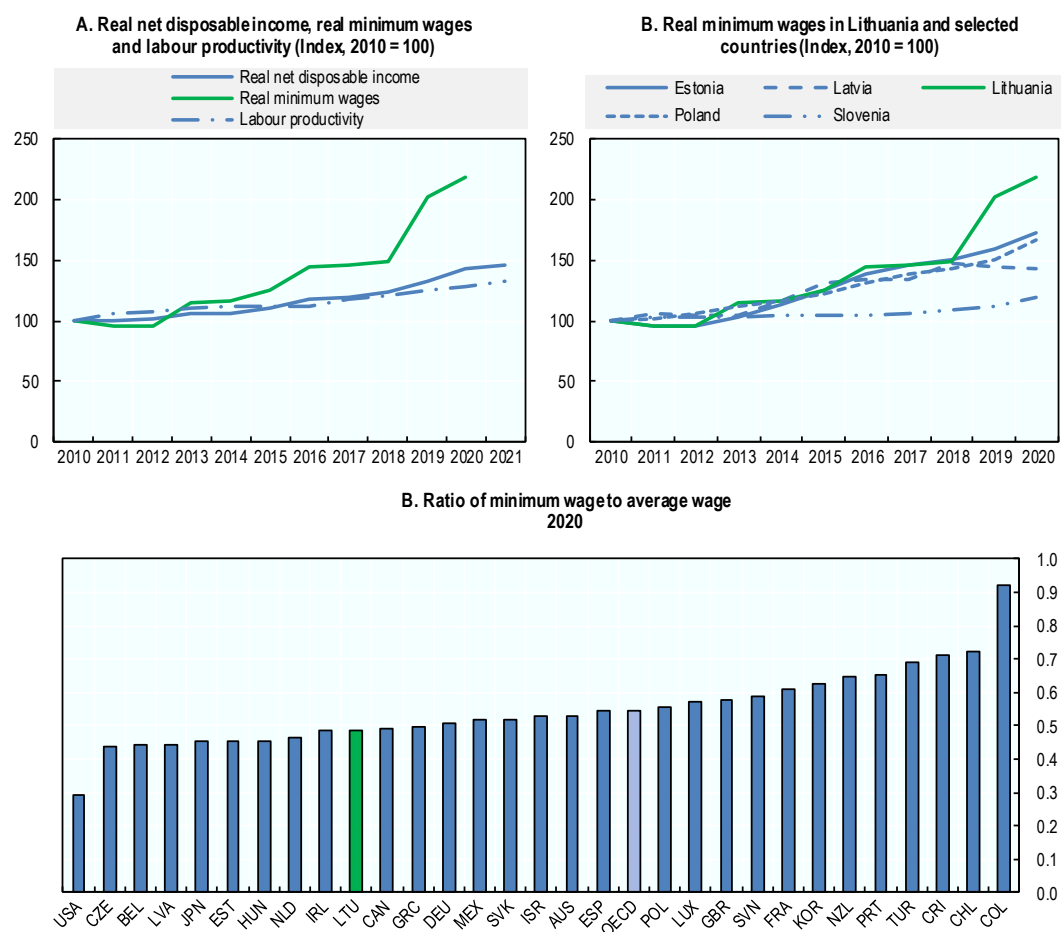
Wages have risen rapidly outstripping labour productivity but remain below the OECD average.

Real net disposable incomes in Lithuania were growing rapidly prior to the pandemic and have continued to rise since then, outpacing the growth in labour productivity (Figure 2.7, Panel A). Since 2010, average wages (in PPP) in Lithuania have increased by about 5% annually, reaching 65% of the OECD average in 2020. Average wages (in PPP) in Lithuania in 2020 were above Latvia, Estonia, Hungary and the Slovak Republic but below Poland and Slovenia.

The authorities have sharply raised minimum wages in recent years, but it remains low relative to average wages in international comparison. The minimum wage in Lithuania is set by the government taking into account several factors including current and previous wage levels in the economy and the

needs of workers and their families.³ In recent years, the government have steadily raised the minimum wage to support low-income workers and reduce income inequality. The minimum monthly wage (MMW) in Lithuania increased from EUR 555 in 2019 to EUR 730 in 2022. Since 2017, the MMW has almost doubled. Since 2010, real minimum wage growth in Lithuania has outpaced both real net disposable income growth in the economy (Figure 2.7, Panel A) and real minimum wage growth in other countries (Figure 2.7, Panel B). Eurostat data confirm that statutory minimum wages were raised more quickly in Lithuania than in most EU countries since 2017. Despite minimum wage growth, the ratio of minimum to average wages in Lithuania remains below the OECD average in 2020 (Figure 2.7, Panel C). Data from Eurostat confirm that the minimum wage as a share of gross earnings in Lithuania is not particularly high at 46% in 2020 and the ratio has remained broadly stable since 2017.

Figure 2.7. Despite rapid growth, minimum to average wages remain low



Note: Real net disposable income of households and non-profit institutions serving households. Real minimum wages are in 2020 constant prices at 2020 USD PPPs. Labour productivity refers to the total economy.

Source: OECD Labour Force Statistics; OECD Economic Outlook No 110.

There may be scope to continue to raise the minimum wage but informality risks must be tackled simultaneously

The minimum wage 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 average wage.

Setting higher minimum wages has the potential to increase the earnings of low-paid workers and support tax enforcement policy. National minimum wages are in operation in most EU Member States (21 out of 27) and aim to improve the income distribution by putting a floor on low wage earnings, thus making low-wage earners better-off and reducing the gap with high wage earners. However, minimum wages may come with efficiency loss if set at a level that reduces employers labour demand, especially in labour-intensive industries. In a review of the international evidence from the US, UK and other developed countries (Dube, 2019^[15]) find overall muted effects of minimum wages on employment but significant increases in the earnings of low paid workers. (ILO, 2021^[16]) find that improving the coverage, compliance and raising the level of the minimum wage up to two-thirds of the median have the potential to reduce income inequality. While minimum wage studies on Central Eastern and South Eastern European countries including Lithuania tend to find some disemployment effects, strong conclusions cannot be drawn (IMF, 2016^[17]). (Hazans, 2007^[18]) found that increases in the real minimum wages in Lithuania can have positive effects on labour force participation as it makes work pay. In a further paper on Lithuania, (Šuminas, 2015^[19]) found no effect of minimum wage on employment rates over the 2003Q1-2014Q1 period. Using a large wage hike in Latvia between 2013 and 2015, (Gavoille and Zasova, 2021^[20]) find that minimum wage hikes contributes to tax enforcement by pushing firms to covert part of the envelope to an official wage to stay under the radar of the authorities. Unreported wages then act as an employment buffer against minimum wage hikes in non-compliant firms. Unemployment can however fall in compliant firms employing minimum wage workers following a minimum wage hike.

However, setting higher minimum wages will not necessarily translate to better compensation for the low paid. First, even if compliance minimum wage regulation were perfect, the impact on take-home pay from a minimum wage hike will be somewhat blunted in Lithuania by relatively high SSCs at low incomes and the non-deductibility of SSCs from the PIT base. Second, compliance with minimum wages is unlikely to be perfect given informality (Figure 2.4). There is a body of empirical evidence for the 'lighthouse effect' whereby a statutory minimum wage acts as a signal to the informal sector so that wages in the informal economy increase following minimum wage hikes.⁴ The primary explanation for the effect is that minimum wages serve as a reference bargaining price for all workers in the economy (ILO, 2021^[16]). As a result, minimum wage hikes such as those undertaken in Lithuania in recent years may risk indirectly raising informal wages and therefore the relative attractiveness of informal work compared to formal work. For example, some employers might opt to offset higher minimum wages by reducing hours or making 'envelope payments' (i.e. a part of salary in the form of an undeclared cash payment) (see Figure 2.4). In both scenarios, this represents an effective increase in informal wages (i.e. the same wage with less hours or additional 'envelope wages'). In a study of several countries including Lithuania a negative correlation between the change in the minimum wage and changes in hours worked suggests that following minimum wage hikes, some employers pay the same but declare fewer hours (IMF, 2016^[17]).

Wages represent the bulk of total incomes

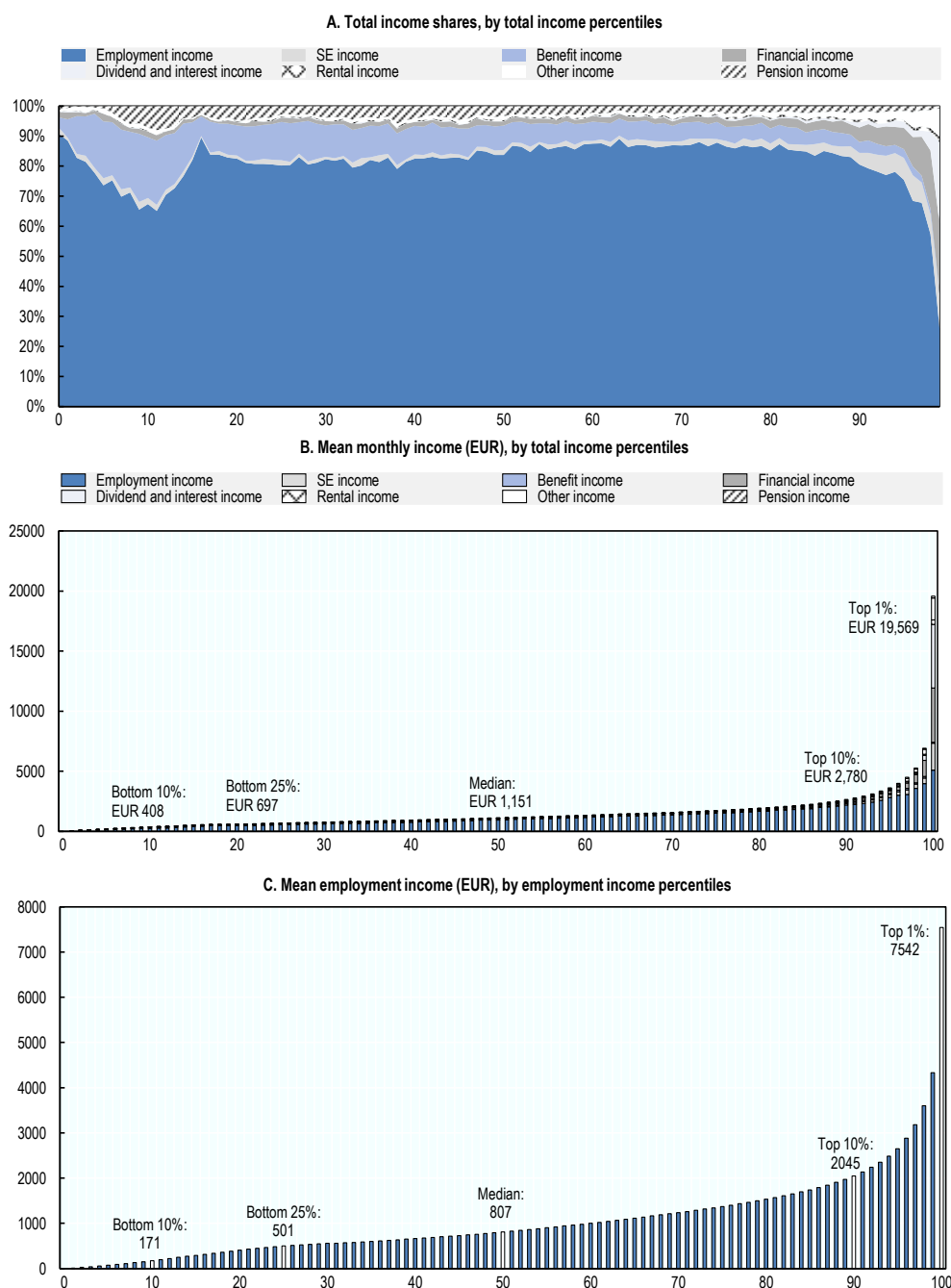
Employment wage income represents the largest share of total income at all total income percentiles, except for the top 1%. The employment income share represents 81% of total income on average across all percentiles (Figure 2.8 Panel A). The employment income share is lower in the bottom decile, mostly due to a higher benefit income share but also self-employment income. The employment income share is also lower in the top decile, representing 74% of total income on average (excluding the top 1%) due to higher shares of financial income, self-employment income, benefit income and dividend, royalty and interest income. Among the top 1% of total income, the largest share of income is derived from dividend, royalty and interest income (27%) followed by employment income (26%), financial income (23.0%) and self-employment income (11.4%).⁵

Capital income is concentrated among the very highest-income employees. Dividend income, financial income from the sale of real estate and financial assets and rental income from immovable property are highly concentrated among the highest income individuals. The total income held by the top 20% is 10.1 times that of the total income held by the bottom 20% (i.e. the S80/S20 ratio). This compares to an S80/S20 ratio of 8.3 for employment income, 3.5 for pension income and 1.9 for benefit income.⁶ The S80/S20 ratio for total income exceeds employment income due to the very high concentration in the top decile of certain incomes including dividend, interest and royalty income (96% of this income category is in the top decile), financial income (81%), rental income (62%) and other income (76%). These income categories are often largely comprised of a few specific income sources (see note in Figure 2.8 for income source components). Dividend, interest and royalty income mostly relate to dividend income (87%). Rental income mostly relates to rental income from immovable property (75%). Financial income is comprised of income from the sale of real estate – the sale of a residence (36%), income from the sale of real estate that is not a residence (28%) - and income from the sale of financial assets (19%). A significant component of the other income category relates to gifts from close relatives (31%). Among the top 1% of total income, more than half of all income is comprised of capital income (from dividends, interest, royalty, financial income and rental income).

Middle-income employment incomes are supplemented by additional income sources including benefit, financial and rental income. Mean monthly total income (and employment income) at P10, P50, P90 and P99 is EUR 408 (EUR 171), EUR 1 515 (807), EUR 2 780 (2045) and EUR 19 569 (EUR 7 542) respectively (Figure 2.8 Panels B and C).⁷ This demonstrates that average total incomes exceed average employment incomes significantly at mid-to-high incomes (i.e. by approximately 40% at P25, P50 and P90) and average total incomes are more than double average employment incomes at very high and low incomes (i.e. P10 and P99).

Figure 2.8. Wages represent the bulk of income at almost all income levels

Total income shares and average total and employment incomes (EUR), by percentile, 2019



Notes on income definitions: Total income is defined as employment income, self-employment income, pension income, benefit income, financial income, dividends, royalties and interest income, rental income and other income. Pension income includes contributory old-age pension and total private pensions (including abroad pensions). Self-employment income is largely comprised of individual-activity income and business certificate income. Rental income is comprised of rental income from immovable property and rental income from other wealth. Financial income includes income from financial instruments, transfers of wealth and transfers of real estate. Financial income is largely comprised of income from the sale of a residence, income from the sale of real estate that is not a residence, income from the sale of movable asset and income from the sale of financial assets. Benefit income includes a wide range of selected benefits including unemployment benefit, child benefit, child birth-related benefits, health benefit, contributory maternity benefit, paternity benefit, social assistance benefit and contributory disability benefit. Other income includes a wide range of miscellaneous income sources.

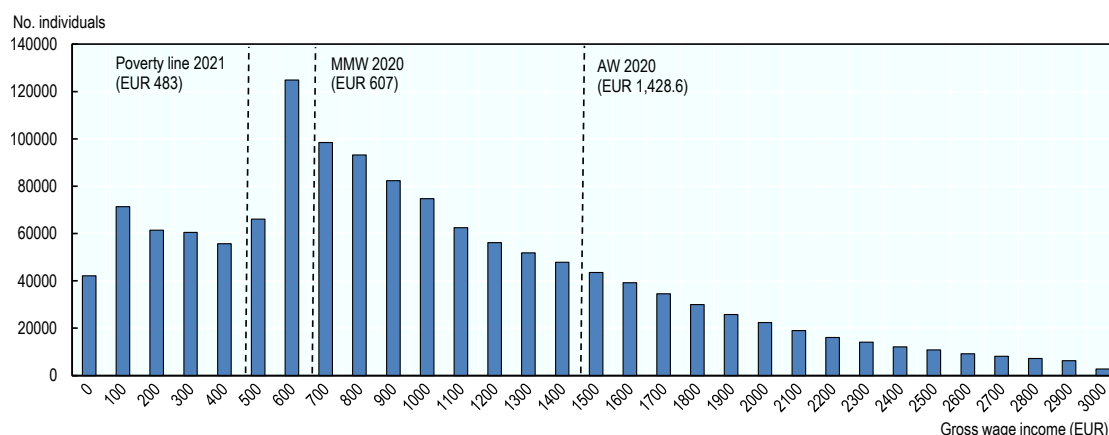
Source: OECD analysis of microdata 2019.

Wage income remains relatively low

Many employees earn low wages close to the minimum wage. 40% of individuals have monthly gross wage incomes of between EUR 500 and EUR 1,000 in 2020 (i.e. 35 – 70% of AW as calculated by Lithuania) (Figure 2.9). A high 9% report wages between EUR 600 and EUR 700 due to many workers earning the MMW. 29% have wages below the MMW. About 3 in 4 individuals earn wages below the AW, reflecting the positively skewed wage distribution and the wide gap between median and mean wages.

Figure 2.9. Many workers earn low wages

Monthly gross wage income distribution, 2020



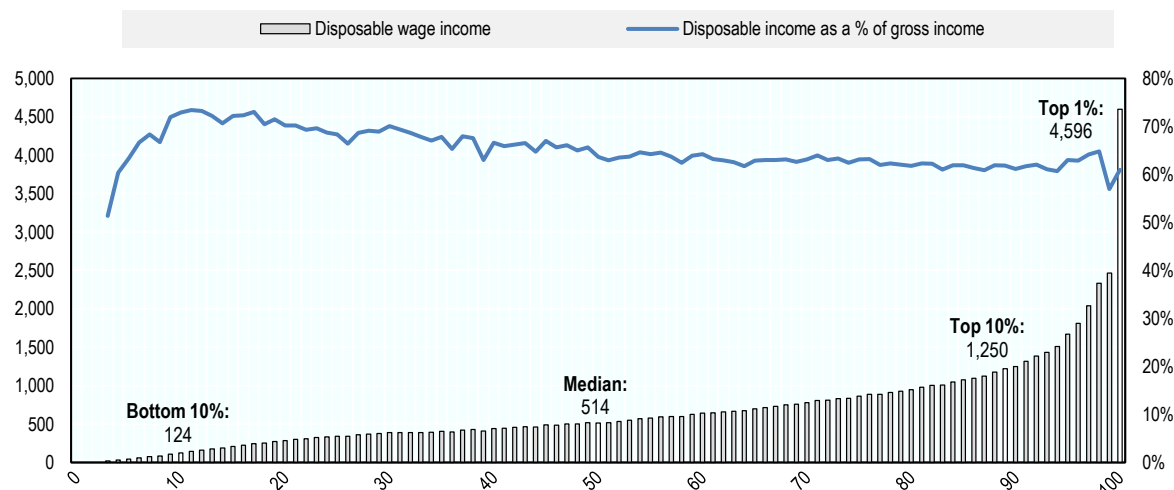
Note: The official average wage (AW) shown is calculated by Lithuania. Based on 1.35 million individual wage earners. Based on this distribution, the implied monthly mean, median, bottom 10% and top 10% wage incomes are EUR 1,029, EUR 902, EUR 235 and EUR 1 973 respectively. The share of individuals with wage income below the poverty line and AW can be approximately estimated by using the nearest EUR 100 distribution bin.

Source: OECD analysis of Lithuanian Ministry of Finance data.

Low disposable incomes are linked to high poverty. Disposable incomes are low and unequal. The median, top 10% and top 1% gross (and disposable) incomes are EUR 807 (EUR 514), EUR 2 045 (EUR 1 250) and EUR 7 542 (EUR 4 596) respectively (Figure 2.10). Disposable incomes are linked to poverty (see next section). The data imply a monthly disposable income poverty line of EUR 308 (based on 60% of the disposable median), which implies that employees below the 22nd employment income percentile face poverty risk (Figure 2.10). This poverty risk estimate aligns with household survey-based equivalised estimates in Lithuania which show that 24% of the population have an income below 60% of the median disposable income (see Figure 2.11). The microdata analysis should be interpreted with caution as taxpayers may have other income sources and benefits not included (e.g. self-employment income) and the data do not take account of indirect taxes such as VAT and excise.

Figure 2.10. Disposable incomes are low

Mean monthly disposable incomes (EUR), by employment income percentile



Note: Figures reported in the graph relate to disposable monthly wage income (i.e. gross wage minus PIT and SSCs). Mean employment wage income is calculated by employment income percentile. The total number of taxpayers with positive employment income is 46 389 in the sample microdata (i.e. employees).

Source: OECD analysis of microdata 2019.

Poverty risks are high for some groups

There are several ways to measure poverty. Poverty measurement generally assumes a well-defined notion of living standards, namely a poverty line, which must be reached if a person is not to be deemed poor (Forster, 2013^[21]). While there are several ways to measure poverty (such as absolute poverty and subjective poverty), relative poverty, which compares incomes relative to that of the population as a whole, can be usefully compared across countries (because they are independent of a specific country's definition of needs) and tends to reflect how most people assess their own conditions by comparing with others (Boarini et al. 2006).

In Lithuania, 1 in 5 people face relative poverty risk, living on less than EUR 430 a month. 21% of all households in Lithuania live in relative poverty in 2020 (Figure 2.11), broadly unchanged since 2019. Relative poverty is above the EU-27 on average (17%) but broadly similar to Estonia (21%) and Latvia (22%). Work and employment opportunities are important factors in shaping the risk of poverty across countries. In countries such as Lithuania where the share of the working-age population is lower (and declining, see Figure 2.3), poverty rates tend to be higher.

The elderly face the highest risk of poverty across the age groups, particularly older women. Lithuania has one of the highest old-age poverty rates among the European OECD countries, although it ranks below Estonia and Latvia (Figure 2.5). Retired persons face high poverty risks of 40% in Lithuania in 2020, a marked increase from 35% in 2019 (Figure 2.11). In 2020, 36% of older persons (those aged 65 and over) were at risk of poverty with older women facing a higher poverty risk (42%) compared to men (24%) (Figure 2.11). Higher poverty rates among older women than older men is common in many countries and can partly be explained by the lower pension income received by women. The average pension for women in Lithuania is about 22% lower than that for men, according to official estimates, reflecting lower lifelong earnings and shorter contribution periods due to the earlier statutory retirement age and career breaks.

Longer life expectancy among Lithuanian women means that older single women may be vulnerable to poverty risks. Single households in Lithuania are often comprised of older women (poverty rates are high for both groups separately and there is overlap between them). This is partly due to the old-age gender gap in Lithuania whereby the life expectancy of Lithuanian women is ten years above that of Lithuanian men (Figure 2.2). As such, Lithuanian women are expected to have 22 years in retirement compared to just 16 years for men (in the OECD, the expected number of years in retirement is 20 and 24 for men and women respectively). Given that incomes continue to fall in older age (Figure 2.12), women with longer retirements may be more exposed to poverty risks.

The incomes of elderly families could be investigated longitudinally in the microdata following the death of a spouse given the old-age gender gap and income cliff. The large old-age gender gap and income cliff in Lithuania imply that elderly women spouses may be at further risk of poverty if overall family income falls as a result of the death of a partner. A widower's pension of EUR 28.63 per month in 2021 is paid to the spouse of a deceased person with social insurance in Lithuania provided the deceased is of pension age.

Those hardest hit by poverty in Lithuania are the unemployed. More than half of the unemployed were at risk of poverty in 2020 (56%) (Figure 2.11). One contributing factor is limited unemployment benefit coverage, with only about one-third of the registered unemployed people receiving unemployment benefits, due to strict conditions (see section 3.3). Poverty rates among the unemployed increased by 2 percentage points between 2019 and 2020, which could partly be attributed to wages modestly outpacing unemployment benefits.⁸ Poverty risk for the unemployed is 7 times higher than for the employed in Lithuania. The difference is pronounced when comparing the unemployed groups with their peers in full-time and permanent jobs, supporting the view that good quality jobs is the best antidote to poverty (Causa and Hermansen, 2017^[11]). While the overall in-work poverty rate does not stand out in international comparison, part-time and temporary workers face high poverty rates. Given high poverty rates among the unemployed, participation tax rates that measure incentives to enter work from unemployment represent particularly important indicators for Lithuania and perhaps even more so than indicators that measure incentives to progress in work (see section 4.3).

Single persons and single parents in Lithuania face high poverty risks. 47% of single adults in Lithuania are at risk of poverty in 2020, broadly unchanged since 2019. In single households there is no partner to cushion the impact of temporary income shocks (Eurostat, 2019^[22]). Single-adult households can also be made up of jobless young people with low incomes (Koutsogeorgopoulou, 2020^[23]). Child poverty is closely related to vulnerability of the household. The well-being of children is linked to the structure and employment status of the household (Thévenon et al., 2018^[24]). Just under half of single parents with one child in Lithuania live below the poverty line (45% in 2020), which is also broadly unchanged since 2019. In addition, around a third of people with some or severe activity limitations live below the poverty threshold.

Figure 2.11. Poverty risks are high for the unemployed, single households and the elderly, particularly women

At-risk-of-poverty indicators in Lithuania and comparison countries, % of population



Note: At risk of poverty refers to 60% of median equivalised income after social transfers. *2 adults without children is abbreviated and refers to 2 adults, at least one 65+ years or over, without children. Employed persons, unemployed, retired persons and inactive persons refer to the at-risk-of-poverty-rate of persons aged 18 and older.

Source: Eurostat. Statistics Lithuania.

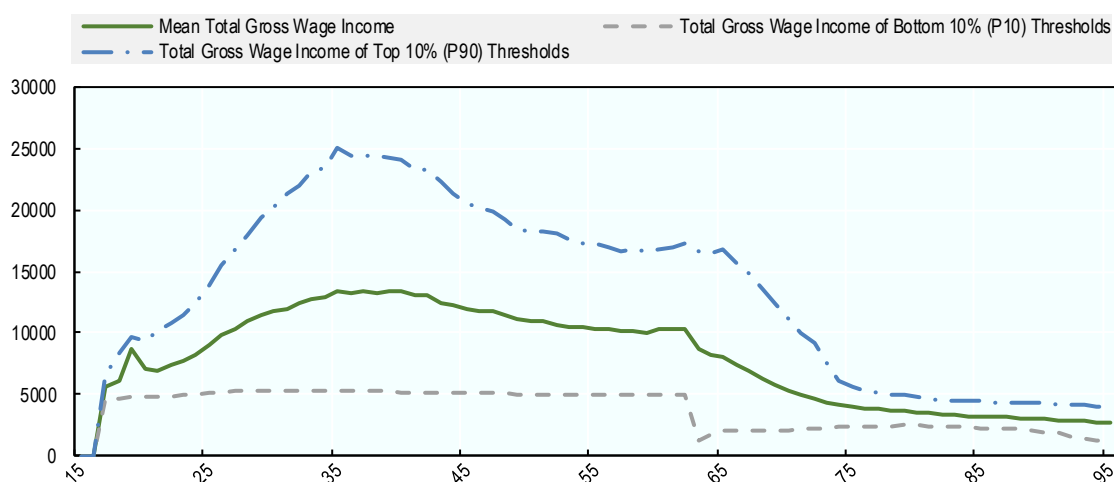
Two-adult families with three or more children face higher poverty rates than two-adult families with less than three children. Relative poverty also affects two adult households with one and two children (11.2% and 11.1% in 2020 respectively), but since 2019 the proportion at risk of poverty has increased for the former group (9.5% in 2019) but fallen significantly for the former (16.9% in 2019). Two adult families with three or more dependent children face a poverty rate that is 2.3 times greater than their counterparts with one dependent child.

Poorer workers transitioning to retirement face a sharp income cliff and low pension replacement rates

A decade after retirement, incomes decline by about half from an already low level and the decline is greater for the lowest incomes than the highest incomes. There is a significant ‘income cliff’ as workers transition from work to retirement. Incomes drop by about half 10 years after the retirement age (Figure 2.12). The decline is greater for those in the bottom 10% than for those in the top 10% (between the ages of 62 and 72, incomes declined by 55%, 57% and 47% for low, middle and high incomes respectively). Among higher earners, the decline in incomes happens later in retirement due partly to different jobs across incomes including that higher earners in office jobs can work for longer than lower earners in physical jobs.

Figure 2.12. Gross wage incomes fall by about half in the decade after retirement

Gross wage income in Lithuania by age, 2017



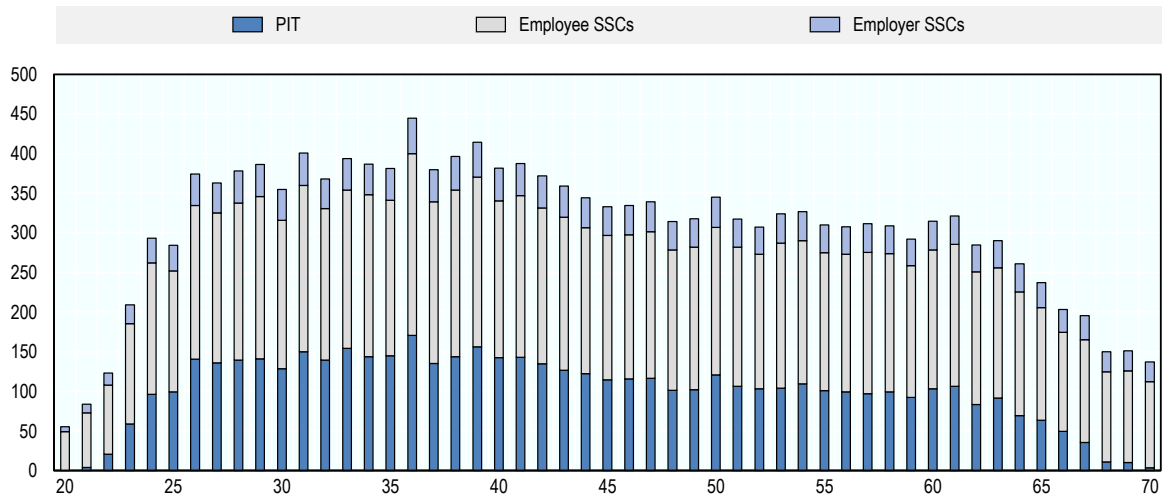
Notes: The data are for taxpayers on low incomes (the bottom 10% or P10), middle incomes (the average mean wage) and higher incomes (the top 10% or P90). The data are for the year 2017 (the statutory retirement age in Lithuania in 2017 was 63.5 years for men and 62 years for women). Some part-time workers are included (but part-time workers with no pension income are excluded). Gross wage income = gross taxable employment income + non-taxable employment income (e.g. earned and taxed abroad therefore not taxable in LT due to treaties for the avoidance of double taxation) + old age pension income. The total taxpayers represented are 1 588 568.

Source: OECD data provided by Lithuania as part of Working Party 2 in 2019.

The reduced wages of older employees is reflected in lower SSCs and PIT paid. The average PIT and SSCs paid by an employee falls by 18% between 40 and 60 and by a further 56% between 60 and 70 (Figure 2.14).

Figure 2.13. Older employees pay less taxes on average

Mean PIT and SSCs paid (EUR), by age



Note: The total number of taxpayers with positive employment income is 46 389 in the sample microdata (i.e. employees).

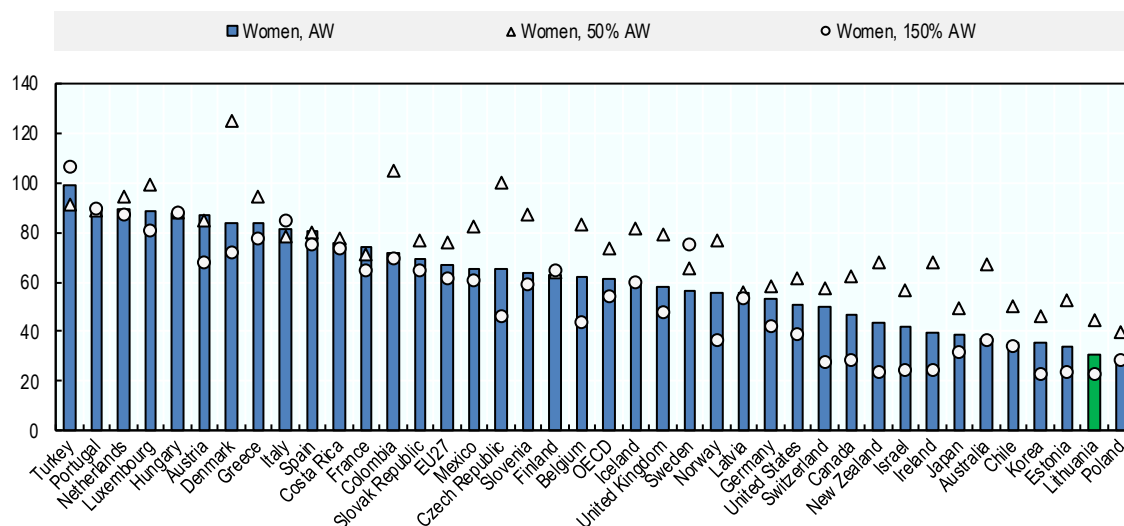
Source: OECD analysis of microdata 2019.

Net pension replacement rates in Lithuania are among the lowest in the OECD. Net pension replacement rates reflect the disposable income of individuals in retirement compared to when working. Net replacement rates in Lithuania at the AW are the second lowest in the OECD at 31% in 2020 (Figure 2.14) (net replacement rates in Lithuania are the same for men and women, see note). Net replacement rates in Lithuania are 11% higher than gross replacement rates due to the higher effective PIT and SSC rates on earnings than on pensions in retirement.

However, the pension system is redistributive. There is a wide difference between the replacement rates of high and low income earners. For those on lower incomes, replacement rates are higher (44%) than the average wage (31%) which are in turn higher than at higher incomes (23%). Despite a relatively redistributive pension system within Lithuania, net replacement rates for lower income individuals remain among the lowest in the OECD.

Figure 2.14. Net pension replacement rates are low

Net pension replacement rates at 50%, 100% and 150% of AW, OECD countries in 2020



Note: Replacement rates are shown for women since men and women have the same net pension replacement rates in Lithuania based on the OECD pension modelling. The net replacement rate is defined as the individual net pension entitlement divided by net pre-retirement earnings, taking into account personal income taxes and social security contributions paid by workers and pensioners. It measures how effectively a pension system provides a retirement income to replace earnings, the main source of income before retirement. This indicator is measured in percentage of pre-retirement earnings by gender.

Source: *Pensions at a Glance 2021*.

An increasing share of retired Lithuanian are working, in part to supplement low incomes. The employment rate among retired-age workers in Lithuania (aged 65 to 69) is 26% in 2020, up from 22% in 2018. It is above the OECD average in 2020 (23%) but below Estonia (34%) and Latvia (28%). Retired Lithuanians may have to work longer out of necessity rather than out of choice to supplement low retirement incomes and pensions (Figure 2.12 and Figure 2.14). Rising employment among the retired contributes to the high labour force participation rates in Lithuania (Figure 2.3).

Lithuania extended early retirement options in 2021 which may put pressure on the sustainability of the pension system. The extent of early retirement in Lithuania is reflected in the effective labour market exit age for men and women of 63.4 and 63.0 in 2020 respectively. The effective exit age for men and women are modestly below official retirement ages (64 and 63 in 2020), which is not uncommon in the OECD. However, Lithuania extended the options for early retirement in 2021. Retiring early in Lithuania remains possible up to five years before reaching the statutory retirement age and the associated penalty was reduced from 0.40% to 0.32% for each month of early claiming and made temporary for some workers (OECD, 2021^[25]).⁹ This policy will increase the incentives to retire early and have a negative impact on pension finances.

Encouraging early retirement could contribute to reducing already low pension incomes. Early retirement will reduce pension incomes directly through the aforementioned early retirement penalty system. To add to this, low income workers who opt to retire before the official retirement age and do not yet receive their pension face a significant income decline in Lithuania (a drop of 76%) in the first year of retirement (at age 63, see Figure 2.12). While such a decline is not uncommon (for comparative examples in Slovenia and Ireland, see (OECD, 2018^[26]) (OECD, 2019^[27]), it is significant and the income recovery in subsequent years is very modest.

Rising life expectancy will outpace increases in the retirement age. In Lithuania, life expectancy is projected to increase for men and women from 71 and 81 years of age in 2019 to 74 and 83 by 2030 (European Commission, 2021^[28]). The government plans to increase the retirement age for both genders to 65 by 2026. Consequently, the gap between life expectancy and retirement age will continue to widen in Lithuania despite increases in the retirement age. In this setting, even unadjusted pension benefits would imply greater redistribution of pension income to retirees at the expense of future generations who may ultimately have to pay the cost.

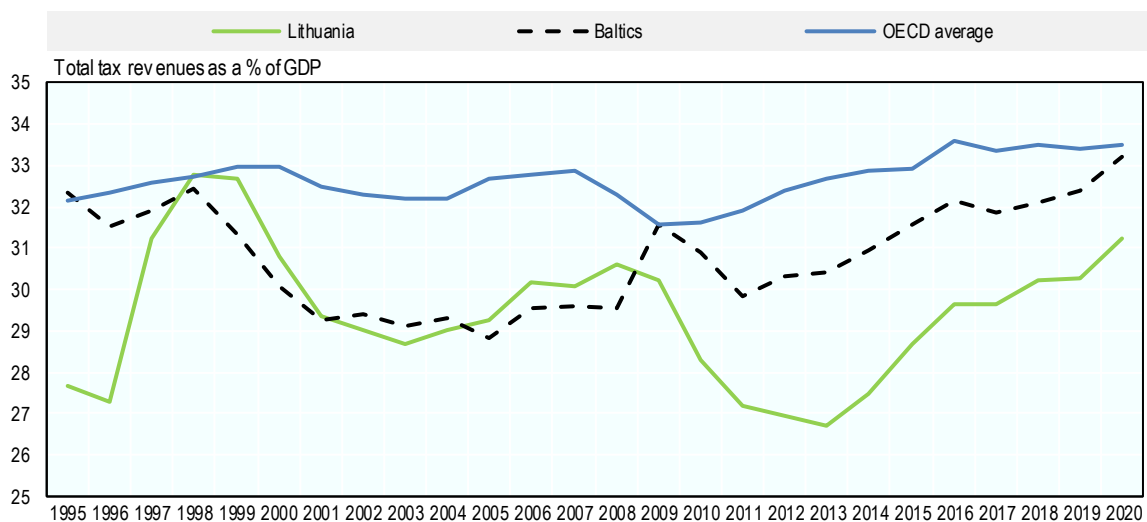
To support the sustainability and adequacy of the pension system, the government could consider establishing an automatic link between the retirement age and life expectancy when the pension age reaches 65. As life expectancy outpaces retirement age increases and the working-age population share declines (Figure 2.3), pension benefits will come under further pressure. Arguably the best way to at least maintain replacement rates while also improving the financial sustainability of the pension system without reducing pension adequacy is through an automatic adjustment mechanisms (AAM) that links the statutory retirement age to longevity trends (OECD, 2021^[25]). Seven OECD countries link the statutory retirement age to life expectancy (Estonia, Denmark, Finland, Greece, Italy, Netherlands and Portugal). In Estonia, Denmark, Greece and Italy, there is a one-to-one link between statutory retirement and life expectancy (OECD, 2021^[25]).

Despite a rising tax-to-GDP ratio, social spending remains low

Lithuania's tax-to-GDP ratio has increased rapidly in recent years, although it remains below the OECD and Baltic average. Lithuania's strong economic performance (Figure 2.1) has helped to bolster tax revenues. The tax-to-GDP ratio in Lithuania reached 31% in 2020 having risen rapidly in recent years from a low of 27% in 2013 (Figure 2.15). Much of the increase is attributable to rises in the PIT-to-GDP ratio (which rose from 3.6% in 2013 to 7.2% in 2019), which more than offset declines in the SSC-to-GDP ratio over the same period, and to a lesser extent increases in the VAT-to-GDP ratio (which rose from 10.7% to 11.6% between 2013 and 2019).¹⁰

Figure 2.15. Lithuania's tax-to-GDP ratio remains below the OECD

Tax-to-GDP ratio in Lithuania, OECD and comparison countries, 1995 – 2020



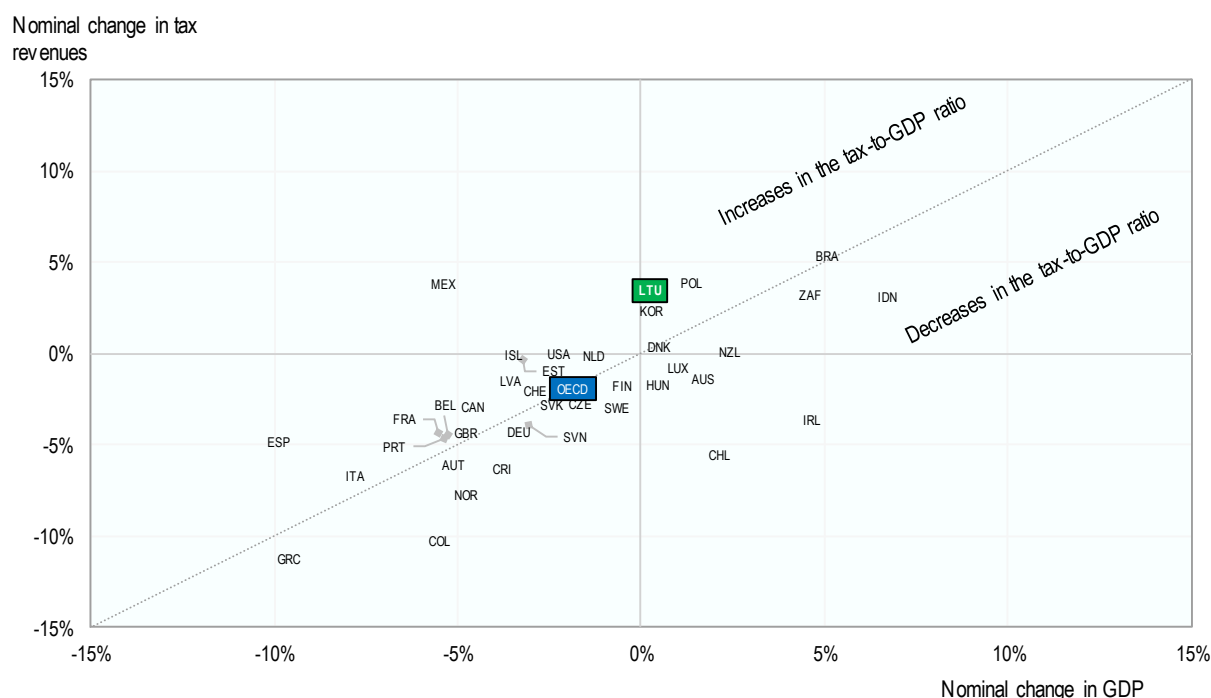
Note: Baltics refer to Estonia and Latvia.

Source: *Revenue Statistics 2021* (2021^[29]).

Lithuania is one of only a few countries to increase in tax revenues and GDP between 2019 and 2020. In OECD and partner countries, the higher share of taxes in total GDP in 2020 than in 2019 was generally the result of falls in GDP rather than tax revenues during the COVID-19 crisis. Lithuania is one of only five OECD countries that recorded an increase in both tax revenues and GDP along with Denmark, Korea, Poland and Turkey (Figure 2.16). In addition, Lithuania increased its tax-to-GDP ratio by almost 1 percentage point between in 2020, among the highest year-on-year changes in the OECD and most of the increase in Lithuania is attributable to an increase in the SSC-to-GDP ratio.

Figure 2.16. Lithuania increased both GDP and tax revenues during covid

Year-on-year change, percentage



The diagonal line across the graph represents the point at which the change in tax revenues and in GDP were of the same magnitude and therefore the point at which the tax-to-GDP ratio remained unchanged. Countries above the diagonal line had increases in their tax to GDP ratios; countries below it, had falls. Argentina and Turkey have not been included in this figure due to the distortive impact of high levels of inflation on nominal tax revenue and GDP data. Data for Australia, Brazil, Indonesia, New Zealand, and South Africa show the change between the fiscal years 2018 and 2019; data for Japan are not included as data on SSC revenues is not available.

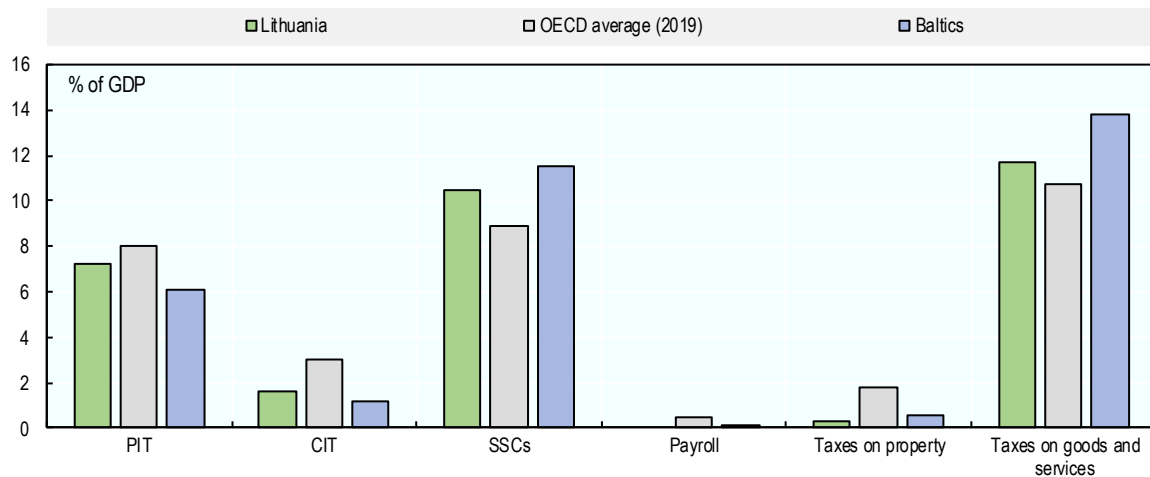
Source: *Revenue Statistics 2021* (2021^[29]).

Lithuania's tax structure is relatively concentrated in taxes on goods and service and labour taxes.

Lithuania's tax mix is concentrated in indirect taxes and labour taxes (Figure 2.17). Compared to the OECD average, Lithuania's tax mix is tilted towards goods and services (11.7% vs 10.8%) and SSCs (10.4% vs 8.9%) and to a lesser extent towards PIT (7.2% vs 8.0%) and CIT (1.6% vs 3.0%). Total labour taxes in 2020 as a share of GDP are broadly similar in Lithuania, the Baltics and the OECD average (17.6%, 17.6% and 17.4% respectively)¹¹.

Figure 2.17. Lithuania's tax mix is concentrated in taxes on goods and services and SSCs

Taxes as % GDP, 2020



Notes: OECD average data is for 2019. Baltics refer to the average of Estonia and Latvia. PIT refers to taxes on individuals (OECD code 1100). CIT refers to taxes on corporate (1200). SSCs refers to total social security contributions (2000). Taxes on property and taxes on goods and services refer to codes 4000 and 5000 respectively.

Source: *OECD Revenue Statistics 2021* (2021^[29]).

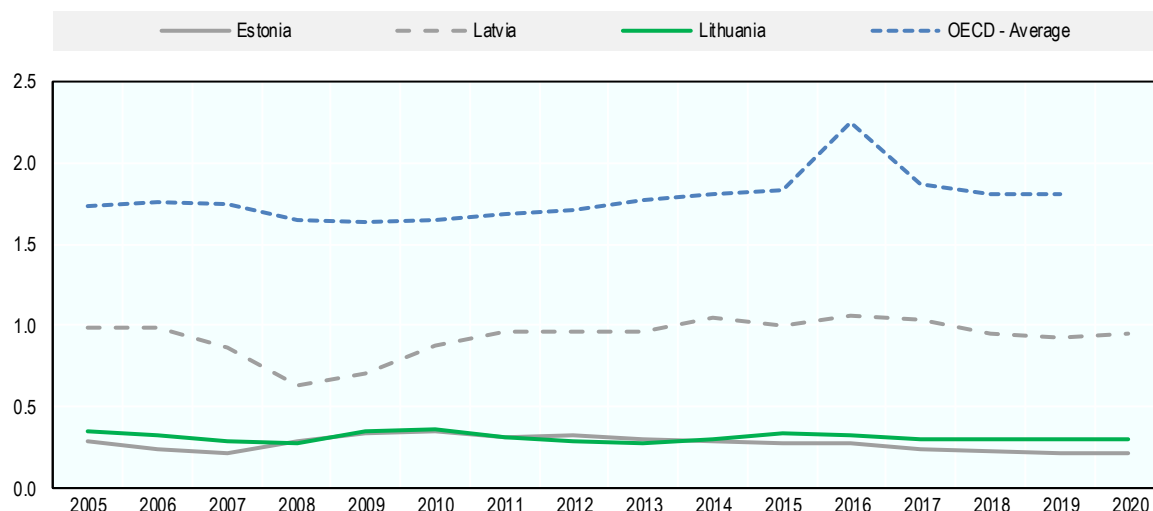
Lithuania's tax mix could be more conducive to economic growth. Taxes can be grouped based on their potentially distortive effects on growth (OECD, 2010^[30]). Less distortive taxes include consumption taxes (which are high in Lithuania), recurrent taxes on immovable property and inheritance taxes (which are low), while CIT, PIT and SSCs tend to be more harmful for economic growth. In Lithuania, the sum of the distortive taxes accounts for 62% of total tax revenues in 2020¹². This is high relative to the sum of the same set of distortive taxes in Estonia (60%) and Latvia (53%).

Property taxes are among the least harmful taxes for growth, but they play a minor role in Lithuania.

In OECD countries, empirical analysis concluded that recurrent taxes on immovable property, in particular when owned by households, were the least damaging tax for long-run economic growth, compared to consumption taxes, personal income taxes and corporate income taxes (Johansson et al., 2008^[25]). Recurrent taxes on immovable property can be efficient because the tax base is immobile (which limits the behavioural response to the tax) and visible (which makes it harder to evade). Designed correctly, recurrent taxes on immovable property can enhance fairness by for example exempting a certain amount of residential property wealth from tax. In Lithuania, property tax revenues are low representing 0.3% of GDP in 2020 against 0.2% in Estonia, 0.9% in Latvia and 1.8% in the OECD on average in 2019 (Figure 2.18). Revenues from taxes on property have also remained broadly stable in recent decades.

Figure 2.18. Tax revenues from property are low

Revenues from taxes on property as % of GDP, 2005 - 2020



Note: Property taxes code 4000 in OECD revenue statistics.

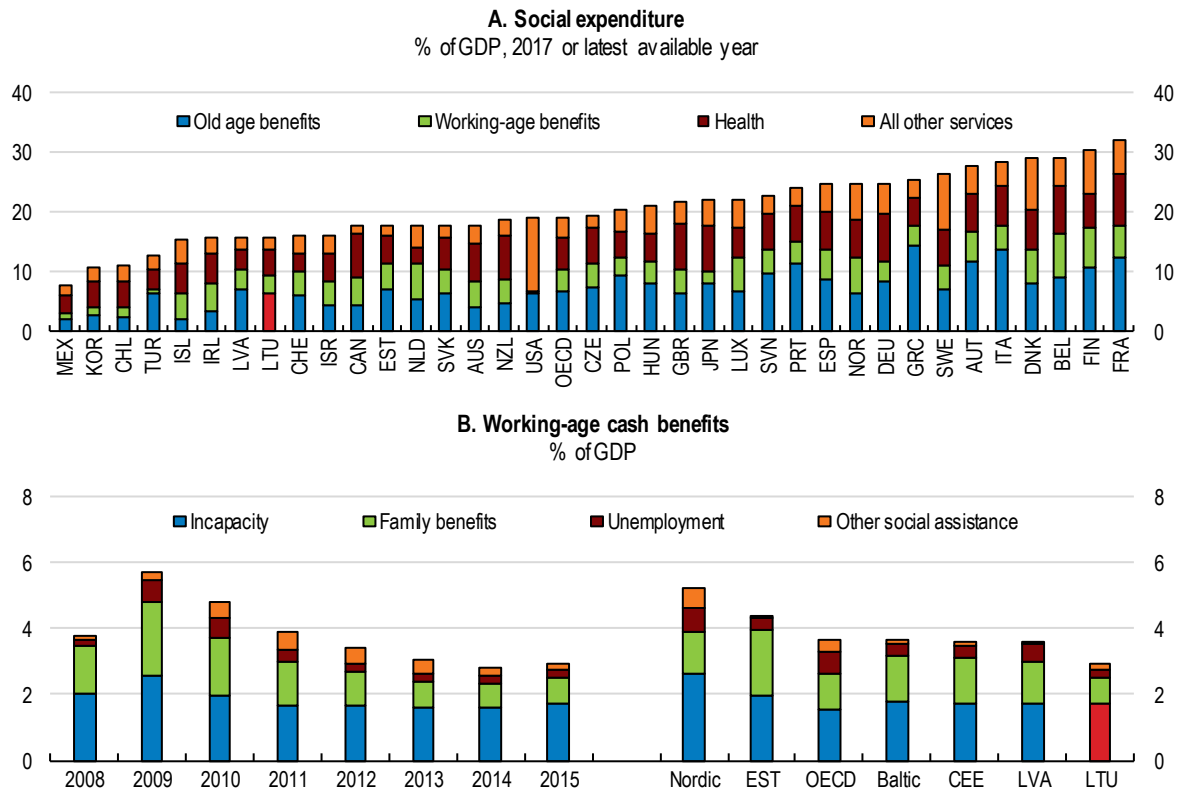
Source: *Revenue Statistics 2021* (2021^[29]).

Despite rising tax revenues, social spending is low in international comparison, although it has increased in recent years. Social expenditure as a share of GDP in Lithuania is 16.7% in 2019, above Latvia (16.4%) but below Estonia (17.7%) and the OECD average (20.0%). A decomposition of social expenditure in 2017, which does not take account of the generosity of benefit increases in recent years, shows that the level of spending in health may be low in the context of the ongoing challenges (Figure 2.2) and the level of working-age benefits are low relative to the need to support inclusivity given rising wages for some. In addition, social spending as a share of GDP in Lithuania on old-age benefits, active labour market programmes and unemployment were 6.1%, 0.3% and 0.2% in 2017, all of which were below the OECD average.

Developing and upgrade low skills. Lithuania's spending on education is modest in international comparison both in terms of per student spending and as measured in terms of GDP (OECD, 2021^[31]). The OECD skills strategy (2021) made a number of recommendations to enhance skills in Lithuania. These included increasing labour market relevance of tertiary education given ICT shortages, making vocational and higher education skills more responsive to labour market needs and strengthening foundational skills (literacy, numeracy and problem solving) and education and training among older adults (OECD, 2021^[31]).

Figure 2.19. Social spending is low

Social expenditure and working-age cash benefits in Lithuania and selected OECD countries, 2017



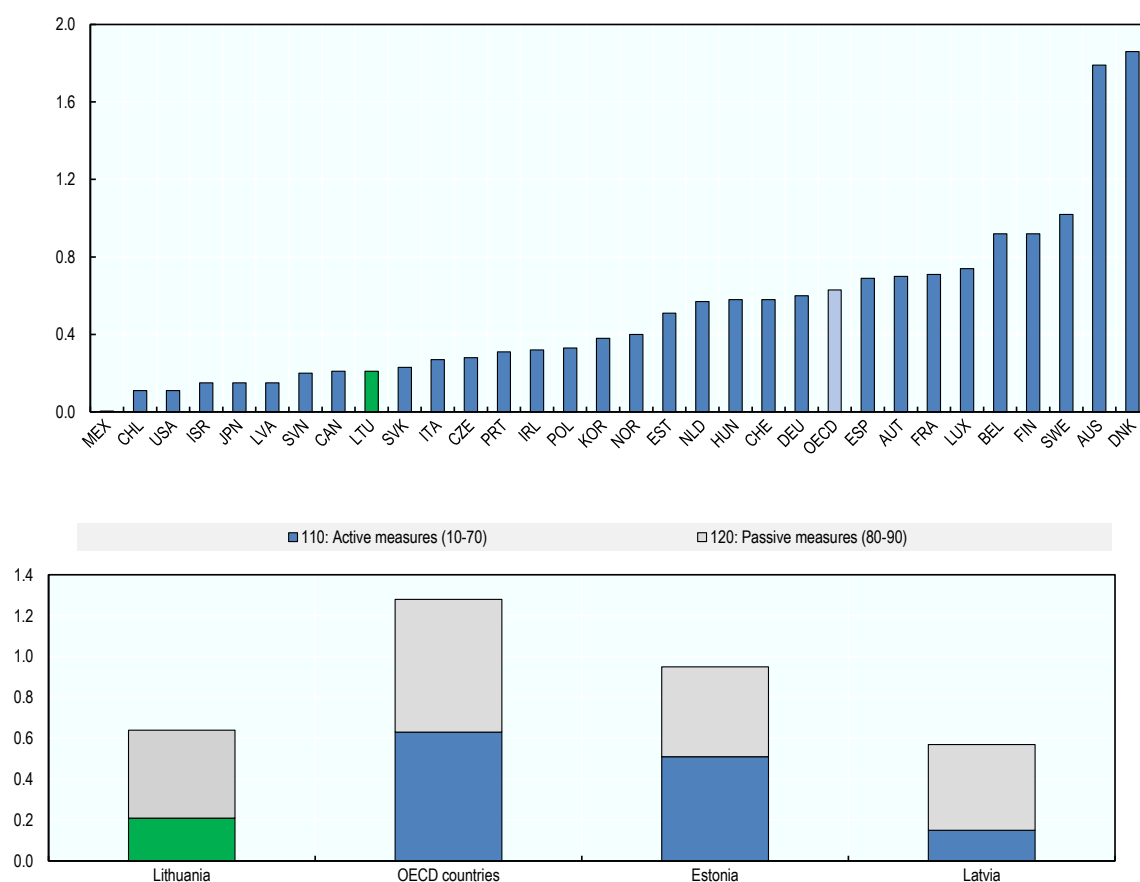
Note: Panel A: Working-age benefits includes spending on unemployment, family benefits, incapacity, and other social assistance. Panel B: Only cash benefits are included (i.e. excludes in-kind benefits). Average groups are as follows: OECD-EU: EU countries who are OECD members; EU27: European Union members; Baltic: Estonia, Latvia, and Lithuania; Nordic: Denmark, Finland, Iceland, Norway, and Sweden; CEE (Central European Economies): Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia. International comparison data refer to 2017 or the latest available year. Data for LTU and OECD average are for 2015.

Source: OECD social expenditure database (OECD, 2020^[32]).

Active labour market spending is low. Lithuania's active labour market programme (ALMP) spending as a share of GDP is among the lowest in the OECD in 2019. This is partly due to relatively low active labour market spending on employment incentives and training. Passive labour market measures are mostly comprised of out-of-work income maintenance and support. According to recent OECD research on training and unemployment subsidies for the unemployment (OECD, 2022^[33]), Lithuania needs to make further efforts to make ALMPs more effective, more available, and to target them more to people who need them the most. The findings included increasing spending on ALMPs, with an emphasis on programmes that support upskilling and reskilling and promote employment in the primary labour market. The OECD research also recommends expanding upskilling and reskilling opportunities, particularly for people who need them the most and for whom the social returns in terms of achieving a more inclusive labour market may be greatest, notably older jobseekers aged 50 and above, low-skilled persons and long-term unemployed.

Figure 2.20. Active labour market policies could be strengthened

Active labour market policy spending, % of GDP, 2019



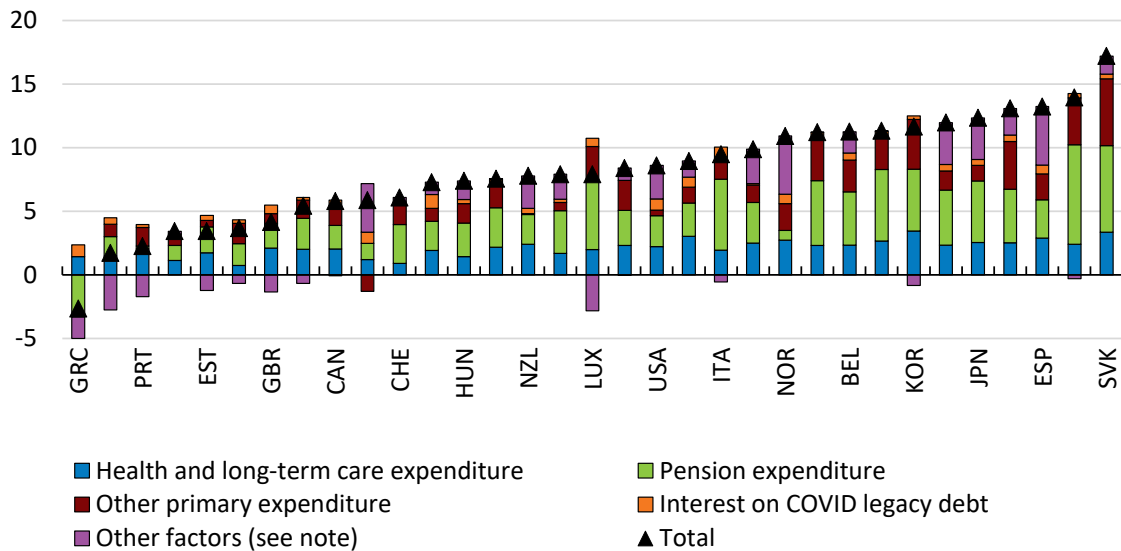
Notes: 10: PES and administration. 20: Training. 40: Employment incentives. 50: Sheltered and supported employment and rehabilitation. 60: Direct job creation. 70: Start-up incentives.

Source: OECD labour market statistics database.

Long-run fiscal sustainability in Lithuania is favourable due to a relatively strong fiscal position, low spending and high employment. Much research has demonstrated that fiscal sustainability is a concept fraught with uncertainties (Blanchard, Leandro and Zettelmeyer, 2021^[34]). To quantify long-run fiscal sustainability, OECD research uses an indicator of long-run fiscal pressure that is premised on the idea that governments would seek to stabilise public debt ratios at projected 2022 levels by adjusting structural primary revenue from 2023 onward (Guillemette and Turner, 2021^[35]). This approach shows that the potential future fiscal pressure to keep the public debt ratio at current levels in Lithuania is relatively low. Lithuania would need to increase the structural primary revenue by 2 percentage points of GDP between 2021 and 2060 compared to 8 percentage points for the median country (Figure 2.21). There are at least three reasons for this. First, the structural fiscal position in Lithuania is better to begin with (i.e. just before Covid) so there is less need for adjustments, reflected in the negative ‘other factors’ category. Second, initial spending is lower in Lithuania than in other countries so even proportionate increases translate to smaller increases as a percentage of GDP. The projection does not however account for countries expanding coverage and generosity of spending over time. Third, employment rates are high and rising in Lithuania which projected in the future imply higher revenue and reduced spending all else equal.

Figure 2.21. The potential future fiscal pressure to keep the public debt ratio at current levels in Lithuania is relatively low

Change in fiscal pressure between 2021 and 2060, % pts of potential GDP



Note: The chart shows how the ratio of structural primary revenue to GDP must evolve between 2021 and 2060 to keep the gross debt-to-GDP ratio stable near its current value over the projection period (which also implies a stable net debt-to-GDP ratio given the assumption that government financial assets remain stable as a share of GDP). Expenditure on temporary support programmes related to the COVID-19 pandemic is assumed to taper off quickly. The necessary change in structural primary revenue is decomposed into specific spending categories. The component 'Interest on COVID legacy debt' approximates the permanent increase in interest payments due to the COVID-related increase in public debt between 2019 and 2022. The component 'Other factors' captures anything that affects debt dynamics other than the explicit expenditure components (it mostly reflects the correction of any disequilibrium between the initial structural primary balance and the one that would stabilise the debt ratio).

Source: (Guillemette and Turner, 2021^[35]).

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Notes

¹ Seasonally adjusted. Based on OECD productivity database, productivity and unit labour costs.

² A proposed OECD definition is as follows: Economic activities, whether legal or illegal, which are required by law to be fully reported to the tax administration but which are not reported and which therefore go untaxed unlike activities which are so reported.

³ The government sets the minimum wage based on the recommendation of the Tripartite Council of the Republic Lithuania.

⁴ Much of the evidence for the ‘lighthouse effect’ comes from countries with high levels of informality, particularly countries in Latin America.

⁵ Self-employment income is largely comprised of individual-activity income (75%) followed by business certificate income (24%).

⁶ Pension income mostly relates to the contributory old-age pension income (96%).

⁷ Note that total income percentiles are used for total income and employment income percentiles are used for employment income.

⁸ Gross average wages grew 9.4% between Q1 2020 and Q1 2019 compared to unemployment benefits which grew 9.2% between January 2021 and January 2020.

⁹ Note that reductions are not applied for workers with long social insurance records of 40+ years and receiving early retirement pensions for less than 3 years.

¹⁰ The ratio of SSCs-to-GDP declined from 10.8% to 9.6% between 2013 and 2019.

¹¹ Total labour taxes refers to PIT, SSCs and payroll taxes combined.

¹² PIT, CIT and SSCs represent 23.0%, 5.1% and 33.4% of total tax revenues respectively.

3

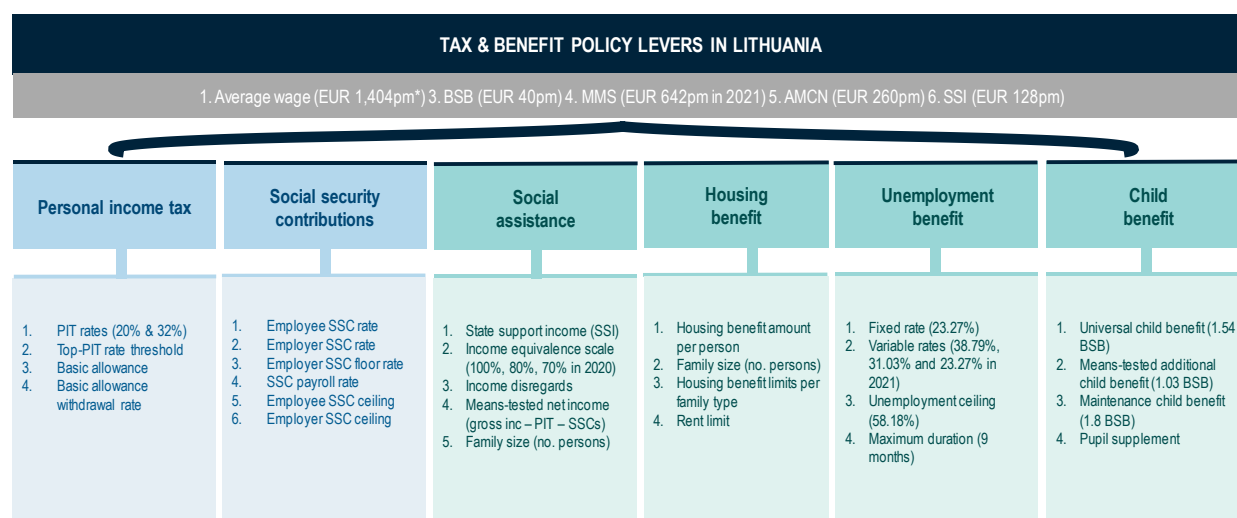
The design of the tax and benefit system in Lithuania

This chapter is divided in two parts. In the first part, it assesses and provides reform options for the design of the tax system including the design of the personal income tax, the basic tax allowance and social security contributions. An assessment of the sustainability of the social security system is also included. In the second part, the chapter assesses and provides reform options for the design of the benefit system including unemployment benefit, housing benefit, social assistance benefit and child benefits.

Introduction

Lithuania has a range of interacting policy levers that influence the tax and benefit system. The purpose of the policy lever map is to provide an overview of the various policy levers that are available to Lithuania to make adjustments to the tax and benefit system (Figure 3.1). The map highlights interactions within the system, for example that social assistance benefit is means-tested according to net income which is in turn reduced by the PIT and SSC rates. Similarly, the number of persons in a family can determine both the amount of social assistance benefit and housing benefit. The structure of this chapter covers each tax and benefit policy lever in turn.

Figure 3.1. A tax and benefit policy lever map for Lithuania



Note: Some other targeted benefits such as pensions and sickness and disability benefit are not included. Housing benefit here is shown only for rent. Compensations for heating costs, drinking water costs and hot water costs are not included (*Būsto šildymo, geriamojo ir karšto vandens išlaidų kompensacijos*), which covers a larger share of households-house owners. This benefit is outside the scope of OECD TaxBen model as the model considers only households-renters. Average wage refers to OECD secretariat calculations for 2020 (see Taxing Wages 2021). Figures are for 2021 unless otherwise stated. BSB refers to basic social benefit. MMS refers to minimum monthly wage. AMCN refers to amount of minimum consumption needs. SSI refers to state supported income.

Source: OECD analysis adapted from OECD Tax-Benefit Model for Lithuania 2020 and 2021.

Lithuania introduced a wide-ranging labour tax reform in 2019. The stated rationale for the reform was to make social insurance clearer, more attractive, to reduce the tax burden on labour and to make labour taxation the most competitive in the Baltic States (Government of the Republic of Lithuania, 2018). The reform included a number of changes to taxes and benefits including the following:

- The introduction of a progressive PIT-rate system (with two PIT rate brackets) from a flat PIT-rate system.
- Shifting SSCs from employers to employees.
- A mechanical upward compensation adjustment in gross wages.
- The introduction of employee and employer SSC ceilings.
- An increase in the basic allowance and adjustment to the basic allowance withdrawal rate.
- Increases in universal child benefit and additional child benefit.

Since the reform, a range of further tax and benefit policy changes were made in 2020 and 2021 including:

- Increases in the top-PIT rate.
- Cuts in the top-PIT rate threshold.
- Cuts in the employee SSC ceiling.
- Cuts in the employer SSC ceiling followed by abolition.
- Part of the SSCs previously used to cover social insurance pensions was shifted to general taxation.
- Further increases in, and a redesign of, the basic allowance.

Box 3.1. Labour tax reforms in Romania and Latvia

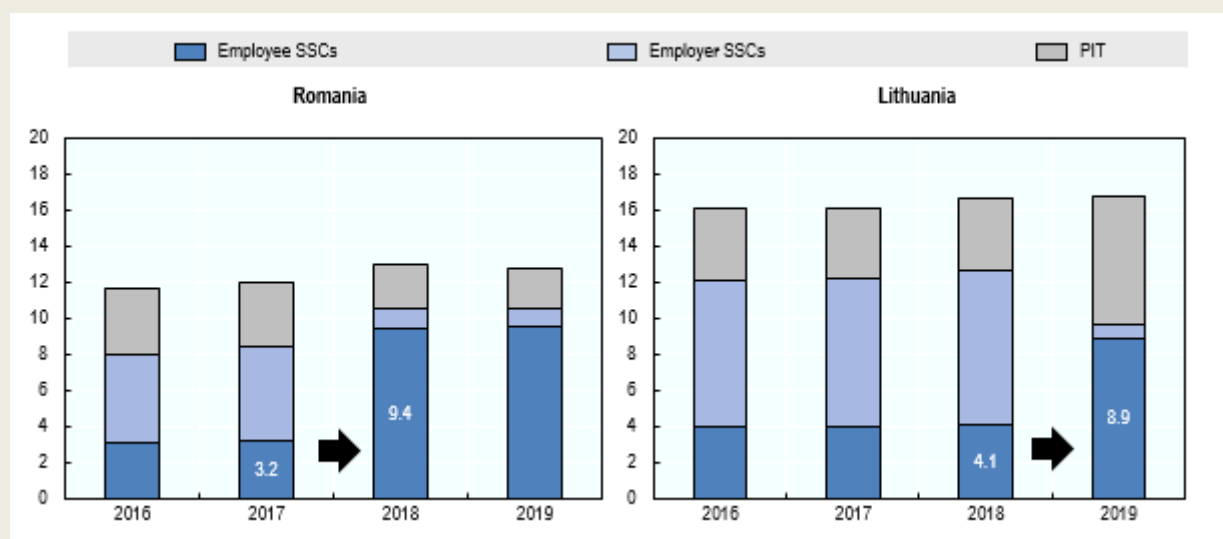
I. Romania undertook a tax reform that shifted almost all employer SSCs to the employee

In 2018, one year before Lithuania's labour tax reform, Romania undertook a labour tax reform that similarly shifted almost all employer SSCs to the employee. Unlike Lithuania which reduced total SSC rates to 20.97% in 2019 (by cutting employer SSC rates by more than it increased employee SSC rates), Romania kept total SSC rates about the same at 37.25% in 2018. Romania increased employee SSC rates by 19pp to 35% in 2018 (up from 16% in 2017) while employer SSC rates were cut by a similar 20.5pp to 2.25% (down from 22.75% in 2017). Lithuania increased employee SSCs by 10.5p.p. to 19.5% in 2019 (up from 9.0% in 2018) but cut employer SSCs by a significantly greater 29.03p.p. to 1.47% in 2019 (down from 30.5% in 2018).

Romania's reform increased tax revenues, unlike Lithuania's which was broadly neutral. Employee SSC revenues in Romania rose markedly from 3% to 9% of GDP in 2018. This was partly offset by declines in employer SSCs and PIT, which fell to 1% (from 5%) and 2% (from 4%) of GDP respectively. Total labour taxes increased by 1% reaching 13% of GDP following the reform. In Lithuania, increases in employee SSC revenues (from 4% to 9%) and PIT revenues (from 4% to 7%) were offset by reduced employer SSCs (from 9% to 1%).

Romania employed a different wage strategy to Lithuania, but gross wages still rose. Lithuania increased gross wages mechanically in January 2019 so that net disposable income for most workers remained unchanged. Statistics Lithuania data show that average monthly earnings by 30% in Q1 2019 compared to Q4 2018, suggesting that Lithuanian firms compensated workers with even higher gross wages than required by the mechanical adjustment. Average monthly earnings have continued to grow in Lithuania since then up to the latest data in 2022, albeit more slowly. In Romania, while no such mechanism was employed and instead wage bargaining occurred between employees and employers, gross wages increased steadily in the years after 2018 and up to 2022¹. Gross wages likely increased in Romania as the shift in SSCs from employer to employee allowed firms to increase gross wages without further increasing total compensation of employees and, at the same time, workers demanded higher gross wages to compensate for higher employee SSCs (European Commission, 2019^[1]) (For a discussion of employer and employee SSC incidence see Box 3.2).

Figure 3.2. Taxes as a % of GDP in Romania and Lithuania, 2016 - 2019



Note: PIT refers to taxes on individual or household income including holding gains. Employee SSCs refer to compulsory social contributions by households. Employer SSCs refer to social contributions by employers. Employee SSCs in Romania are comprised of 25% general health SSC and 10% health SSC in 2018 (which were previously 10.5% and 5.5% respectively in 2017). An employee SSC for unemployment was also abolished in 2017.

Source: Data on Taxation, European Commission.

II. Latvia introduced a tax reform that included transitioning to a progressive PIT system

Latvia introduced a labour tax reform in 2018. The reform had several aims including strengthening tax wedge progressivity and reducing the tax burden on low-income earners with no dependents.

As part of the reform, Latvia transitioned to a progressive PIT rate system. A flat 23% rate was replaced with three PIT rate brackets of 20%, 23% and 31.4%. To support the financing of healthcare services, the SSC rate increased by 1 p.p. from 34.09% to 35.09%, shared equally between employers and employees (employer SSC rate increased 0.5 p.p. and employee SSC rate increased 0.5 p.p.).

Following the reform, tax revenues remained broadly similar and the impact on progressivity was limited. After the reform, SSCs-to-GDP increased from 8.4% to 9.2% while PIT-to-GDP fell from 6.6% to 6.0%. The decline in PIT-to-GDP was partly due to a relatively large proportion of taxpayers in the lower tax bracket that pay PIT at the lower rate. Overall, PIT and SSC revenues as a share of GDP remained broadly unchanged at 15.1% in 2018 (in 2019, PIT and SSCs both increased to 9.6% and 6.5% as a share of GDP respectively). The directionality of these PIT and SSCs changes had been anticipated by the authority's pre-reform. Some evidence has pointed to a relatively limited impact on inequality following the reform as the progressive PIT schedule tended to benefit middle-income earners and was less well targeted at poorer households (Ivaškaitė-Tamošiūnė et al., 2018^[2]).

The design of the tax system

Lithuania operates a worldwide personal income tax system. Lithuanian residents are taxed on their worldwide income while non-residents are taxed on the basis of the territoriality principle and, as such, are only taxed on income from Lithuanian sources. Worldwide taxation for personal income is more prevalent around the world than territorial taxation (Shum, Fay and Lui, 2017^[3]).

A new rule in 2022 requires employers to pay all employment-related payments into employee bank accounts. Lithuania is a relatively high cash economy according to survey data from the European Central Bank. 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.

SSCs are not deductible from the PIT base, which is atypical among OECD countries. A common form of interaction between PIT and SSCs in OECD countries is the full or partial deductibility of SSC payments from the PIT base. For example, in Estonia, employee SSCs for unemployment insurance are deductible from PIT as a standard tax relief. In Poland, an allowance is provided for all social insurance contributions paid by the taxpayer and a tax credit is available for health insurance contributions. In Germany, SSCs are deductible up to specific ceilings. In Lithuania however, SSCs are not deductible from the PIT base.

Non-deductible SSCs imply lower disposable incomes. As SSCs are deductible from the PIT base in most OECD countries, SSC rate hikes narrow the PIT base and mechanically reduce effective PIT rates. As SSCs are not deductible in Lithuania, workers face relatively higher marginal and average PIT rates and have less disposable income relative to allowable SSC deductibility. The non-deductibility of SSCs in Lithuania support the case for not taxing future SSC pension benefits under the PIT as they have effectively already been taxed through higher PIT. Similarly, while shifting from employer to employee SSCs would mechanically reduce PIT revenues to some degree in most OECD countries due to lower taxable personal income (given constant total labour costs for the employer), it would not do so in Lithuania.

Lithuania transitioned to a progressive personal income tax system. Lithuania transitioned from its flat 15% PIT rate system to a progressive PIT rate system in 2019 with a lower 20% rate and an upper 27% rate. In 2020, the top-PIT rate was increased to 32% and the lower PIT rate remained the same (Table 3.1, Table 3.2).

Table 3.1. The PIT rate schedule

Monthly taxable income bracket (EUR)	Marginal tax rate in 2020
Up to 8 690	20%
Above 8 960	32%

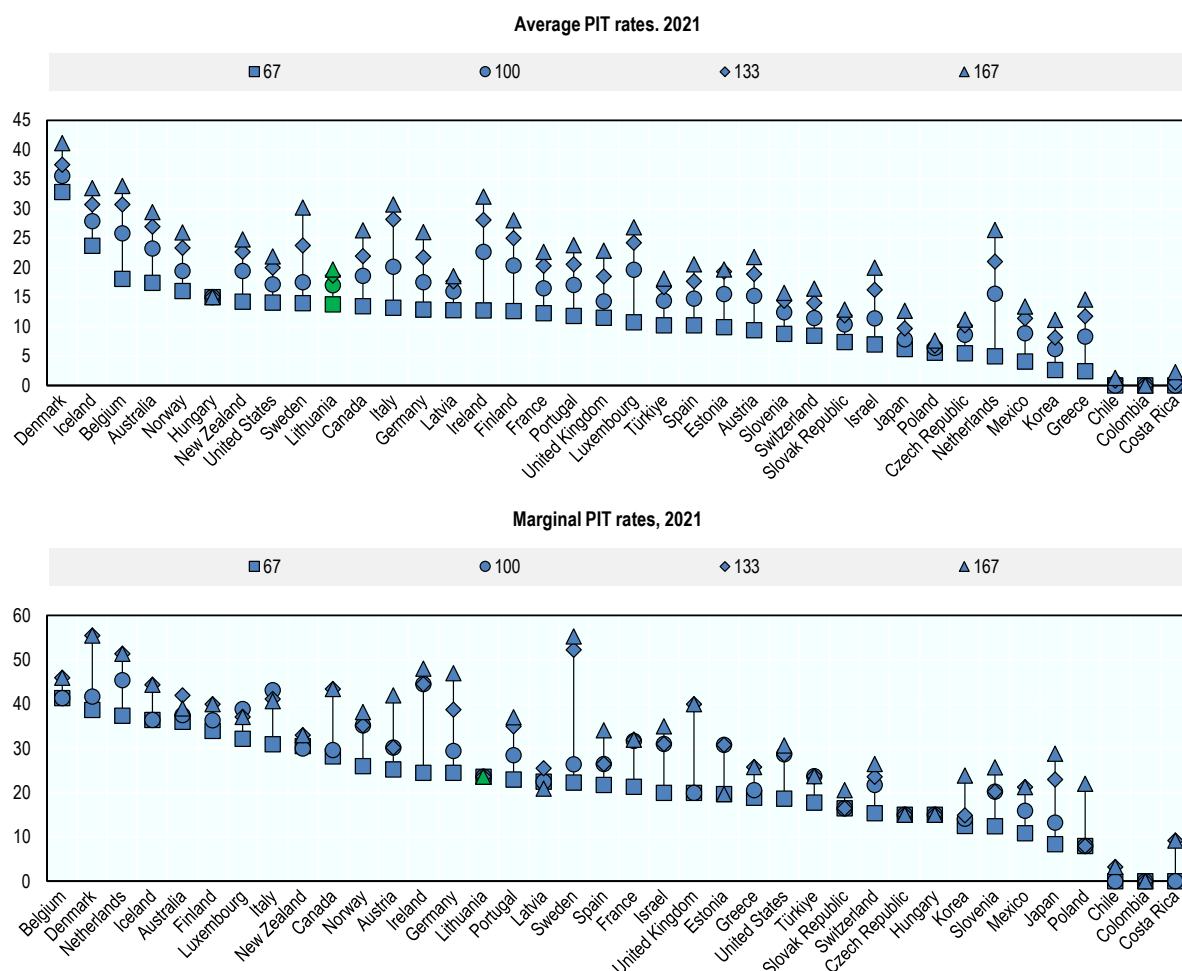
Note: In 2020, a 20% PIT rate applies to taxable income up to EUR 104 278 per year (EUR 8 698 per month) or 84 average wages (AW) and the PIT rate for the part exceeding this limit is 32%.

Source: OECD analysis.

Average and marginal PIT rates are relatively compressed. At lower incomes (67% of AW), average PIT rates in Lithuania rank among the top 10 OECD countries (Figure 3.3). Relatively high PIT rates at low incomes contribute to the work disincentive in Lithuania (see chapter 4). At higher incomes (AW and 133% of AW), average PIT rates are in the middle of OECD countries. Average PIT rates are relatively compressed ranging from 14% to 20%, indicating relatively little PIT progressivity. Marginal PIT rates in Lithuania are in the middle of OECD countries. Marginal PIT rates are the same for the income levels shown, again reflecting not much progressivity.

Figure 3.3. PIT rates are relatively compressed

Marginal and average PIT rates in OECD countries, 2021



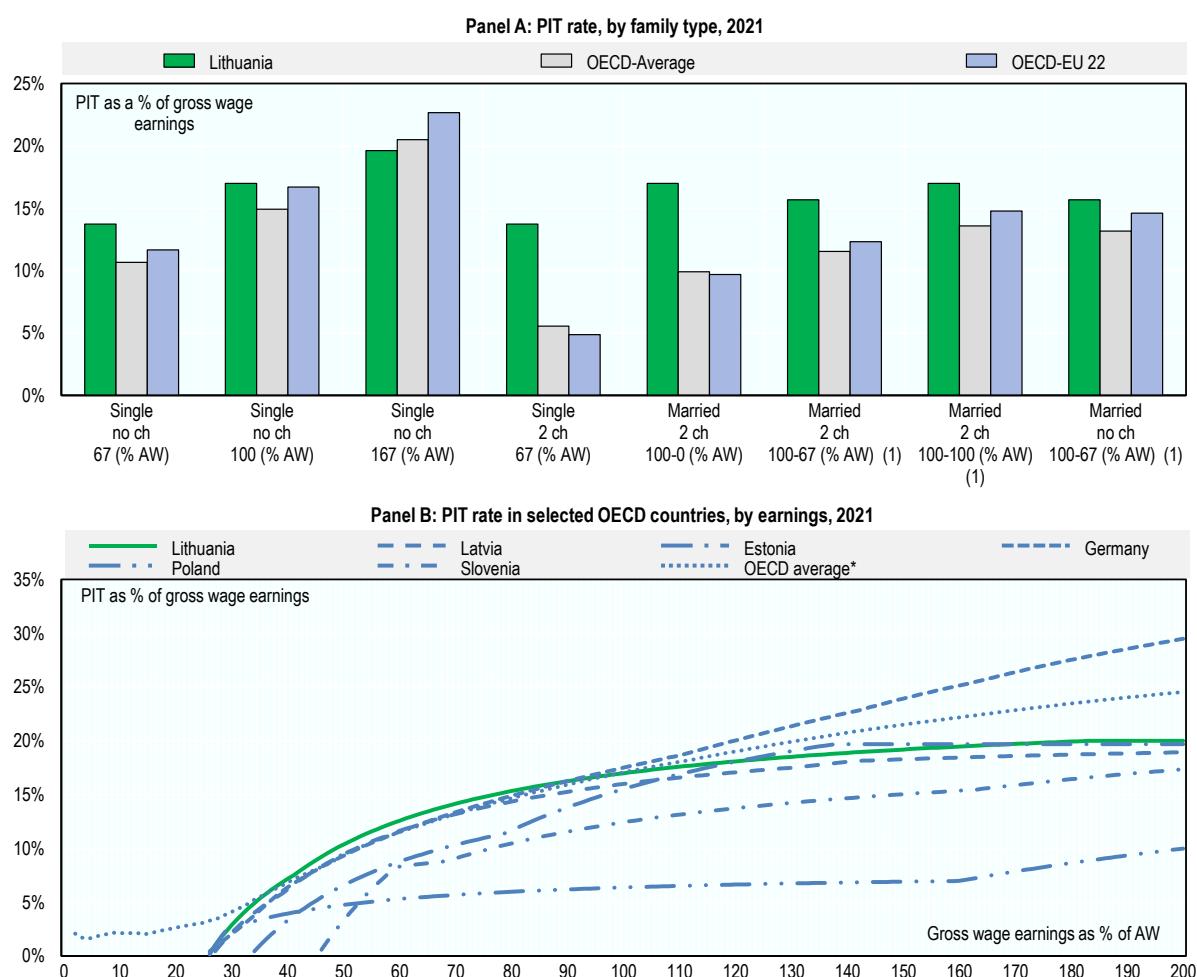
Note: Analysis relates to an average single individual without children. The marginal rates are expressed as a percentage of gross wage earnings.

Source: OECD tax database.

Average PIT rates are quite high at incomes below the average wage. Average PIT rates for single individuals in Lithuania are above the OECD average at lower incomes (below the AW) but below the OECD average at higher incomes (167% of AW) (Figure 3.4 Panel A). Single and couple Lithuanian parents with two children have markedly higher average PIT rates than the OECD average. The average PIT rate in Lithuania is above the OECD average and several peer countries between about 1/3 of the AW and the AW (Figure 3.4 Panel B). Above the AW, the average PIT rate in Lithuania remains flat while the OECD average PIT rate rises.

Figure 3.4. Average PIT rates are quite high at low incomes

Average PIT rates, 2021



Note: In panel A, ch = children. 1 = two-earner couple. In panel B, data refers to a single individual with no children. In panel B, OECD average refers to an unweighted average of the average PIT rate by percentile in 29 OECD countries for which data are available.

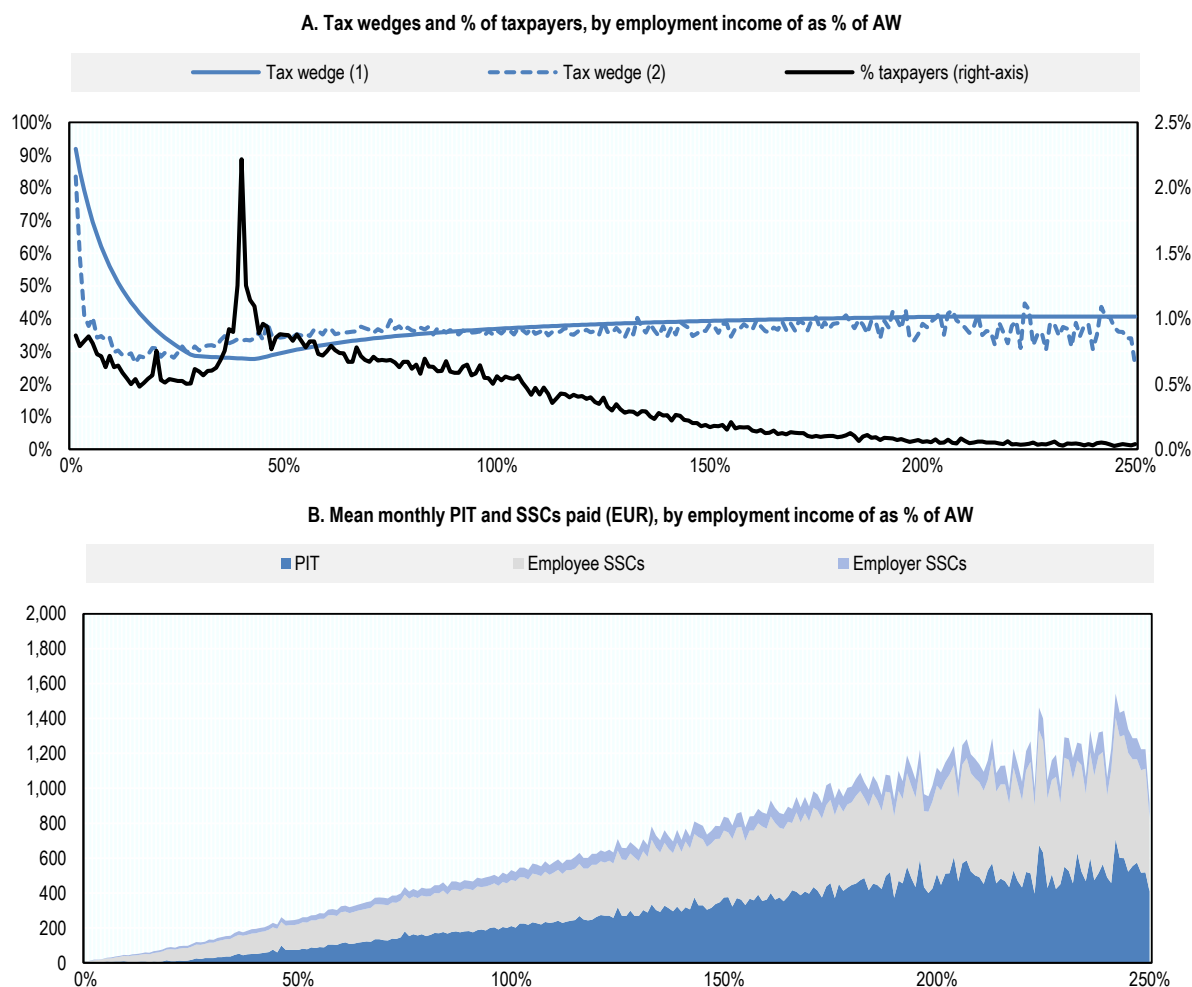
Source: OECD tax-benefit model. Model version 2.4.0. *Taxing Wages 2022*.

Microdata analysis confirm that many lower income employees face relatively high tax burdens.

Over 1/3 of employees earn below half the AW (Figure 3.5, Panel A). The average backward-looking tax wedge by percentile calculated using the microdata (i.e. tax wedge 2 in Figure 3.5, Panel A) and the hypothetical tax wedge (i.e. tax wedge 1 in Figure 3.5, Panel A) highlight a relatively flat tax burden across the employment income distribution and high tax burdens at low incomes (due to the employer SSC floor) (Figure 3.5, Panel A). In addition, mean PIT and SSCs paid by employment income in the microdata are consistent with the tax rules (Figure 3.5, Panel B) - the PIT share rises over time because the PIT rate rises steadily as the BA is tapered and the SSC shares are flat due to the flat employee and employer SSC rates.²

Figure 3.5. Many lower income employees face high tax burdens

Tax wedges, share of taxpayers and taxes paid, by total income as % of AW



Note: Tax wedge (1) is based on the OECD Taxing Wages model in 2021 for a single employee using the same AW. Tax wedge (2) is the mean backward-looking tax wedge by percentile calculated using the microdata in 2019. The total number of taxpayers with positive employment income is 46 389 in the sample microdata (i.e. employees). The microdata is for the year 2019. Some key tax rules have changed since 2019. In 2019, the BA was EUR 3 600 for annual incomes up to 12 MMS (EUR 6 660). The lower PIT rate was 20% (up to 120 AW i.e. EUR 136 334) and the upper PIT rate was 27%. In 2021, the BA had increased to EUR 4 800 up to 12 MMS (i.e. EUR 7 704). The lower PIT rate is 20% (but up to 60 AW i.e. EUR 81 162) and the upper PIT rate increased to 32%. The employee and employer SSC rates of 19.5% and 1.47% remained the same. In 2021, the employee SSC ceiling was cut to 60 AW and the employer SSC ceiling was abolished.

Source: OECD analysis of microdata 2019.

Lithuania has halved the top-PIT rate threshold in recent years but it remains high. Lithuania has cut the top-PIT rate threshold (i.e. the income level at which the top-PIT rate starts to apply) from about 10 to 5 annual AWs between 2019 and 2021 (Table 3.2).³ The top-PIT rate threshold as a share of the gross wage in Lithuania has gone from being one of the highest among OECD countries to converging towards the average in OECD countries (Figure 3.6). However, the top-PIT rate threshold remains high at EUR 8 698 in 2020 relative to the monthly average wage of EUR 1 400 (OECD estimate⁴) and the monthly minimum wage (MMW) of EUR 1 400. The cuts to the top-PIT rate threshold between 2019 and 2021 (which increase the tax burden on higher earners) should be considered in the context of employee and

employer SSC ceilings, which were jointly reduced to the same AW multiples during that period (which reduce the SSC burden on higher earners, see Table 3.8 in the SSC section).

Table 3.2. Lithuania has cut top-PIT rate thresholds and increased top PIT rates

PIT rates and higher PIT-rate thresholds in Lithuania, 2018 - 2021

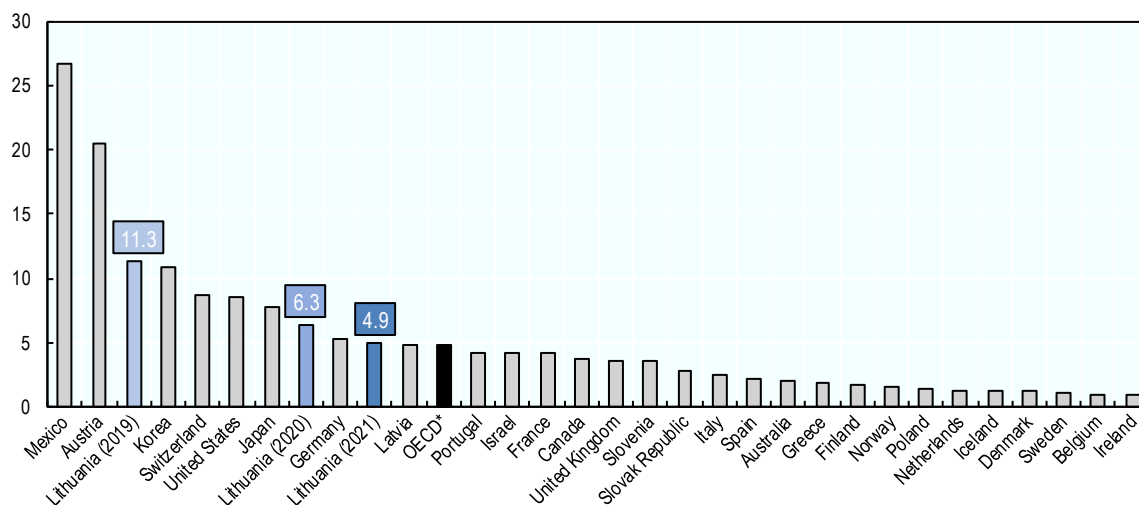
	2018	2019	2020	2021
PIT rates	15%	20% and 27%	20% and 32%	20% and 32%
Top-PIT rate threshold (as a multiple of annual AW)	none	10	7	5

Notes: Monthly AW are converted to annual AW by dividing by 12. In 2021, 60 * EUR 1 352.70 = EUR 81,162 per year. In 2020, 84 * EUR 1241.4 = EUR 104 277.60 per year. In 2019, 120 * EUR 1,136.2 = EUR 136,344.

Source: OECD analysis.

Figure 3.6. The top-PIT rate threshold has converged towards the OECD average

Top PIT thresholds as a share of gross wages in Lithuania and selected OECD countries, 2020



Note: Gross wages incomes are based on OECD secretariat calculations from *Taxing Wages 2021* publication. In Lithuania, the average wage is EUR 12 095 in 2019 and EUR 16 426 in 2020. Average wage in Lithuania in 2021 is assumed to be the same as 2020. *OECD refers to an weighted mean average for the selected countries shown.

Source: OECD tax database; *Taxing Wages 2021*.

Developments in labour tax revenues

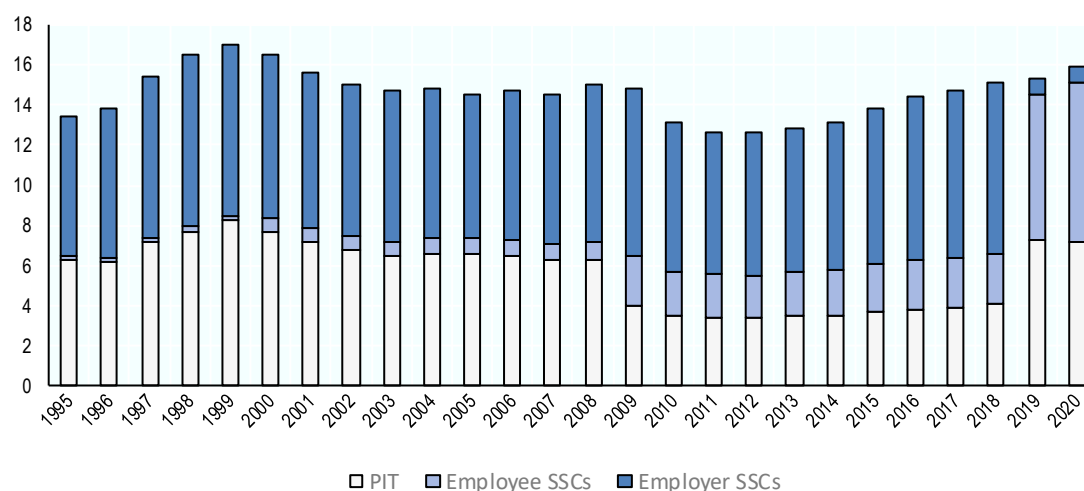
In 2019, the year of the labour tax reform, labour tax revenues remain broadly unchanged. PIT and total SSC revenues as a share of GDP increased only modestly in 2019 (Figure 3.7). This occurred because the PIT-to-GDP ratio and the employee-SSCs-to-GDP ratio rose from 4.1% to 7.2% and 2.5% to 7.3% respectively, but they were mostly offset by the employer-SSCs-to-GDP ratio decline from 8.5% to 0.7%. After that in 2020, employee-SSCs-to-GDP increased while employer-SSCs-to-GDP and PIT-to-GDP remaining broadly unchanged.

The reform involved the most significant reshuffling of the labour tax mix in decades. Employee SSC revenues as a share of GDP have gone from playing a minor role in 1995 to a major role in 2020 and vice versa for employer SSC revenues (Figure 3.7). To explore the consequences of this SSC reshuffling,

Box 3.2 considers the role of the tax incidence concept for employee and employer SSCs. Box 3.1 examines the case study of Romania in 2018 which also shifted most of its SSCs from the employer to the employee.

Figure 3.7. Labour taxes were broadly unchanged in 2019

Labour tax revenues as % of GDP, 1995 - 2020



Note: PIT relates to incomes and profits of individuals (code 1110). Employee and employer SSCs relate to OECD revenue statistics codes 2100 and 2200 respectively.

Source: *Revenue Statistics 2021* (2021_[4]).

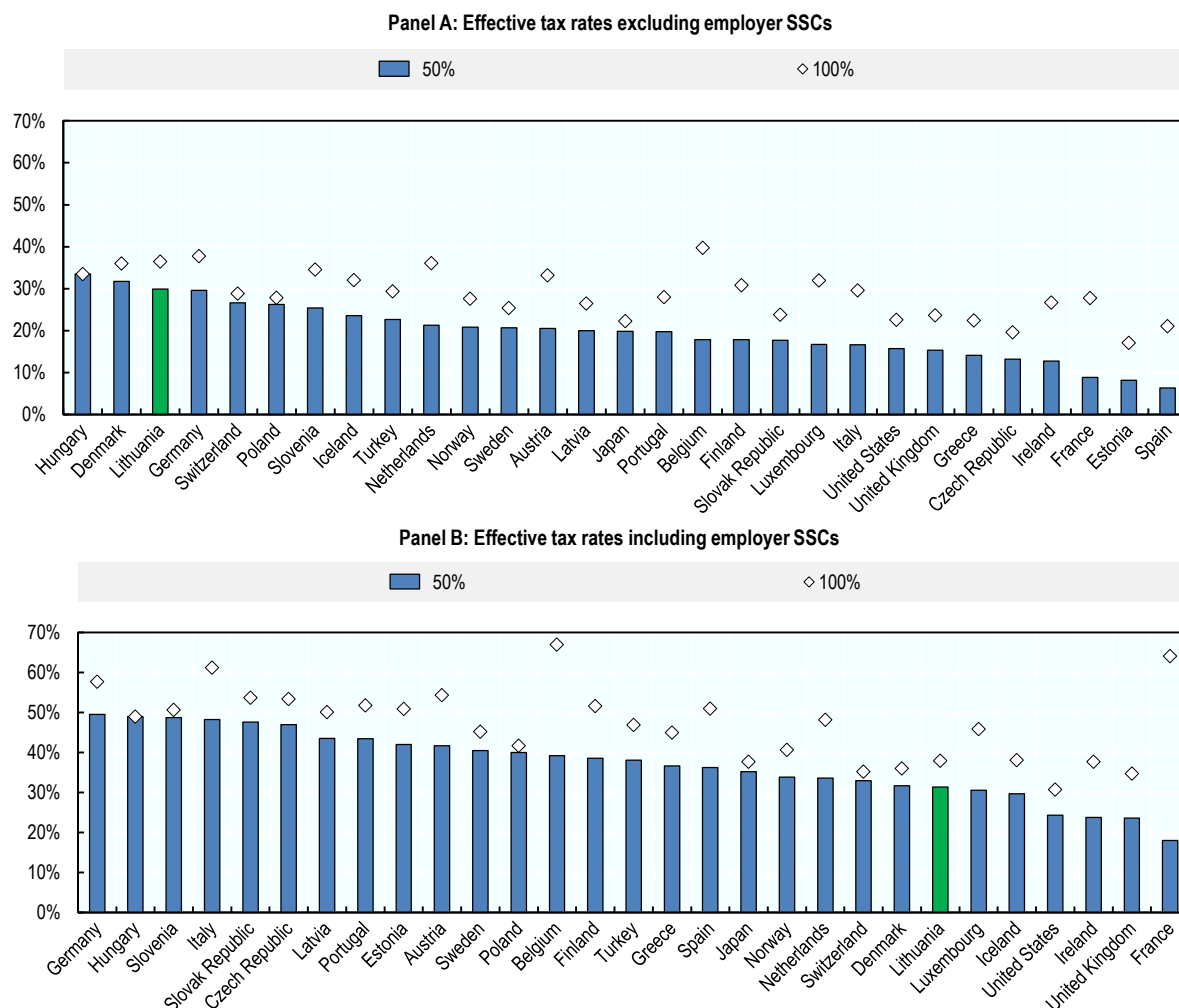
The personal income tax system could be more progressive at the top

The effective tax rate is high in international comparison but low when employer SSCs are included.

Average effective tax rates (AETRs) for a single individual with no children in Lithuania in 2021 are the third highest in the OECD at low and middle incomes (50% and 100% of the AW respectively) (Figure 3.8 Panel A). AETRs at low incomes are driven mostly by employee SSCs (see section 3.2). When employer SSCs are included in the ETRs (which is not a typical measure used in OECD Taxing Wages that brings the calculation closer to a tax wedge type measure), Lithuania's AETRs do not change by much (Figure 3.8 Panel B). Lithuania's AETRs are now lower when compared to other OECD countries because the AETRs of other countries have increased by more (due to Lithuania's relatively lower employer SSCs). A similar trend occurs at high incomes. At 200% of AW, measured without employer SSCs, AETRs in Lithuania are the 8th highest in the OECD countries shown in 2021. A single individual with no children at 200% of the AW in Lithuania faces a lower AETR than in Germany but higher than in Estonia, Latvia and Poland (Figure 3.9). However, when employer SSCs are included, a single individual earning 200% of the AW in Lithuania is then ranked the 4th lowest among the OECD countries shown in 2021.

Figure 3.8. Effective tax rates in international comparison

Effective tax rates including and excluding employer SSCs, single individual with no children earning 50% and 100% of the AW, 2021



Source: *Taxing Wages* 2022 tax decomposition data. OECD tax benefit model 2021.

AETRs in Lithuania are relatively flat at higher incomes. AETRs in Lithuania are compressed, ranging from 30% at low incomes (50% of the AW) to 40% at high incomes (250% of the AW) (Figure 3.9). AETRs at high incomes (above the AW) are also quite flat. In these two respects, Lithuania's ETR structure is not dissimilar to Germany. In addition, the PIT rate on low-incomes (67% of AW) as a share of the PIT rate on high-incomes (167% of AW) is the fifth-highest in the OECD at 70% in 2021, indicating relatively little PIT progressivity. Including employer SSCs in AETRs makes Lithuania's ETRs comparatively lower but the ETR structure remains quite compressed and flat.

Figure 3.9. Effective tax rates are not very progressive at the top

Effective tax rates, single individual with no children, gross income as % of AW, 2021



Note: The effective tax rate is the share of gross income that is due to the government as income tax and employee social-security contributions, minus social benefits received. The effective tax rate including employer SSCs is calculated by adding employer SSCs as a share of gross wage earnings to the effective tax rate.

Source: *Taxing Wages 2022* tax decomposition data. OECD tax benefit model 2021.

Rapidly rising wages may induce bracket creep. Rapidly rising inflation and nominal wage growth in Lithuania (Figure 2.7) means that taxpayers will reach the higher marginal tax rate more quickly than previously (i.e. bracket creep). Consequently, the non-indexation of PIT brackets (i.e. PIT brackets are not systemically increased to account for wage growth or inflation) effectively increases the tax burden.

The introduction of a middle PIT rate bracket could be considered

Few employees face the top PIT rate due to the high top PIT rate threshold. Despite the top PIT rate threshold being cut from 10 to 5 annual AW between 2019 and 2021 (i.e. to EUR 81 162),⁵ it remains high in the context of the employment income distribution. To be liable for the top PIT rate, employees would need to earn in the top 1% of employment income as measured by employment income percentiles (i.e. the average employment income in the top 1% is EUR 7 542 per month or EUR 90 501 per year) (Figure 2.7, Panel C). The top PIT rate threshold is also high in a total income distribution context as it is similar to the mean total income of the top 2% of employees as measured by total income percentiles (i.e. EUR 83 122, see (Figure 2.8, Panel B).

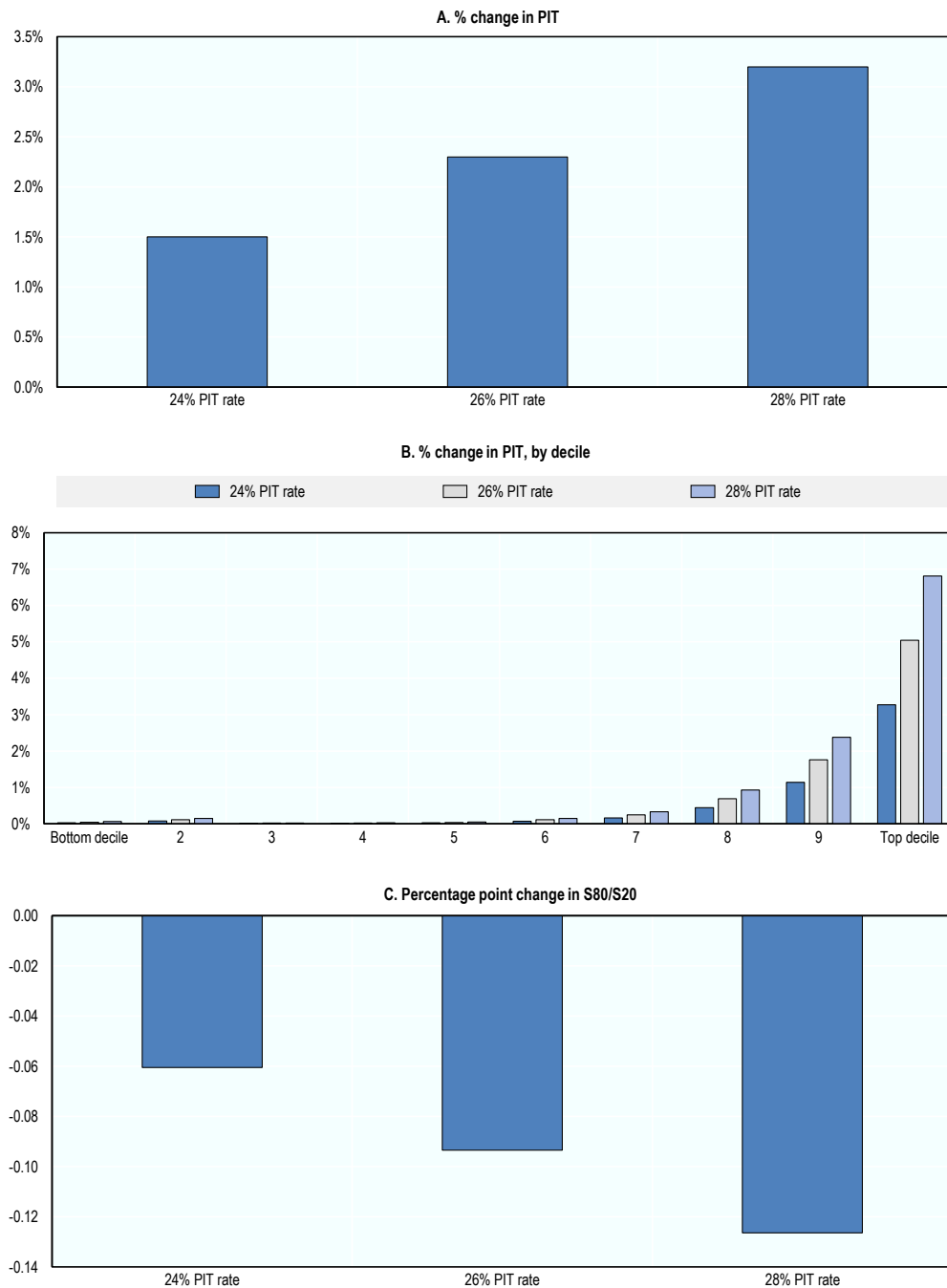
A new middle PIT rate bracket could be considered. The introduction of a third middle PIT bracket could be considered which would effectively act as a de facto top PIT bracket if the current top PIT rate bracket were retained (given that so few employees face the current top PIT rate). Some combination of a reduced top PIT rate threshold and the introduction of a third middle PIT bracket could also be envisaged. A PIT rate threshold targeted at the top 10% and 5% of employees (rather than the current top PIT rate which targets only the top 1%) would correspond to a top PIT rate threshold of about 1.5 and 2.0 times the annual AW (instead of the current 5 times the AW) (Figure 2.8, Panel C).

Introducing a middle PIT rate bracket would raise PIT revenues. The introduction of a middle PIT bracket at 2 annual AW at PIT rates of 24%, 26% and 28% would raise PIT revenues by 1.5%, 2.3% and 3.2% respectively (Figure 3.10, Panel A). Almost all of the additional PIT would be raised from employees in the top income quintile and particularly in the top decile (Figure 2.8, Panel B). The introduction of a middle PIT bracket would lead to a modest reduction in income inequality as measured by the S80/S20 ratio (Figure 3.10, Panel C). Setting the middle PIT rate threshold at 1.5 annual AW could also be considered. The simulations in Figure 3.10 are based on EUROMOD, which is a tax-benefit microsimulation model for the European Union that is maintained, developed and managed by the Joint Research Centre (JRC) of the European Commission (see the note in Figure 3.10 for details).

Cutting the top PIT rate and simultaneously aligning the SSC ceiling with the top PIT rate threshold would reduce overall PIT and SSC revenues. Cutting the top PIT rate threshold from 5 to 4 annual AW and simultaneously aligning the SSC ceiling with the PIT rate threshold would raise PIT revenues but reduce SSC revenues. Overall PIT and SSC revenues would decrease modestly and income inequality would increase modestly (the S80/S20 ratio would increase by 0.0023 percentage points from 10.7604 to 10.7627).

Figure 3.10. The introduction of a new middle PIT rate bracket would raise PIT revenues and reduce inequality

Simulating the introduction of a middle PIT bracket, 2 annual average wages



Note: EUROMOD is a tax-benefit microsimulation model for the European Union that is maintained, developed and managed by the Joint Research Centre (JRC) of the European Commission, in collaboration with Eurostat and national teams from the EU countries. This report makes use the beta-version of the model for Lithuania, based on version I3.0+, adapted to run on the input data derived from national administrative registers. This version is not available to the public. The tax-benefit system simulated in the baseline scenario refers to the one in force in 2022. The underline input data come from national administrative registers for year 2019. Uprating factors are used to bring the income values from the income reference period to the policy year, in this case from 2019 to 2022. Simulations provide static results, as no labour supply or general equilibrium effects are estimated in EUROMOD.

Source: Simulations performed by the EUROMOD team of the European Commission's Joint Research Centre (JRC).

Box 3.2. Employer and employee SSC incidence

The theoretical literature argues that formal tax incidence (who legally is obliged to pay tax) is irrelevant for effective tax incidence (who eventually bears the burden of the tax), at least in the long run. This line of argument suggests that the same given increase in employee SSCs or employee SSCs is immaterial of who the tax burden falls on. The effective tax incidence (i.e. who eventually pays the tax or is 'out-of-pocket', irrespective of who has paid the cash) of an SSC increase is ultimately borne by the employee, typically through the mechanism of reduced wages, and this occurs regardless of whether the tax is paid by employers (through an employer SSC increase) or employees (through an employee SSC increase). In standard economic theory, this occurs because employees are more inelastic than employers to SSC changes. In this context, inelasticity means that workers have few good alternatives to work because they have to 'pay the bills' somehow and are unlikely to have sufficient capital to live off that exclusively. By contrast, employers have more good substitutes – they can swap labour for capital or relocate to where labour is cheaper. For example, in a meta-analysis, Melguizo and Gonzalez-Paramo (2013) find that two-thirds of the incidence of labor taxes generally fall on employees, albeit there is a very wide range of estimates.

The empirical literature finds that, in general, SSC cuts lead to higher employee wages but also that the tax incidence may vary across different settings (e.g. short run versus longer run, SSC rate increases versus decreases, changes in employee versus employer SSCs, etc.). While relatively few studies directly examine the incidence of employer and employee SSCs, some of the more recent and empirically rigorous studies indicate that there is relatively limited shifting of SSCs to employees in the form of changed wages. A number of studies use macroeconomic evidence based on cross-country regressions (such as (Arpaia and Carone, 2004^[5]) find evidence that the incidence differs in the short-term (perhaps reflecting short-term stickiness of nominal wages). There are also a number of quasi-experimental studies. (Gruber, 1995^[6]) finds evidence that a decrease in pension SSCs in Chile led to an equivalent increase in wages that is consistent with the full incidence of SSCs on employees. (Anderson and Meyer, 1997^[7]) find that companies with larger employer SSC reductions increase employee earnings roughly one-for-one (and employment is unaffected). They interpret this as evidence that the incidence of employer SSC is largely or fully on workers. Their finding may also, at least in part, be explained by behaviour shifts (i.e. employees working harder due to a SSC cut, which induces employers to increase salaries). For example, using three large increases in SSCs in France between 1976 and 2010, (Bozio, Breda and Grenet, 2017^[8]) find very limited shifting of SSCs to employees in the form of lower wages. They interpret this as wage stickiness prevents employer SSCs from being shifted to employees in the short-term. (Adam, Phillips and Roantree, 2019^[9]) find that statutory incidence matters for the short-term economic effects of SSCs in the UK. They interpret their findings as evidence that employees change their hours in response to SSCs, but that in the short to medium term at least, the formal incidence of SSCs can matter for their behavioural impacts and economic incidence. (Bozio, Breda and Grenet, 2019^[10]) find that the tax incidence falls on employers for reforms that have no tax-benefit linkage whereas the incidence of SSCs falls on employees in reforms with strong tax-benefit linkages. A tax-benefit linkage distinguishes SSCs from other labour income tax. If workers incorporate in their labour supply decisions not only net wages but also expected benefits, behavioural responses may be reduced (because workers have even less incentive to shift to alternatives). In that case, SSCs with strong tax-benefit linkages are expected to be fully shifted to workers.

The design of the basic allowance

Lithuania increased the basic allowance in recent years. A personal basic allowance (BA) (i.e. a tax-exempt amount) is applied to employment income in Lithuania to calculate taxable income. The BA was EUR 350 per month in January 2020, the max BA was available up to EUR 607 per month and a tapering equation was applied thereafter (Table 3.3). In response to the COVID-19 pandemic, the BA was increased to EUR 400 in July 2020 and the withdrawal rate was modestly increased. This change was applicable for the whole of 2020. In 2021, the BA threshold was increased to EUR 642 and the withdrawal rate was modestly decreased. In 2022, the BA was increased to EUR 460 and the number of ‘break points’ was increased from one to two. Between 2019 and 2020, the rate of increase in the BA in Lithuania of 13% was higher than the rate of increase in some other OECD countries (including Canada +5.0%, Germany +3.6% and United Kingdom +0.6%).

The basic allowance as a share of the average wage is not dissimilar to that found in some other OECD countries. The maximum BA increased in Lithuania represented 27% of the AW in 2022. In Slovenia, Latvia, the Slovak Republic and Estonia, the BA represented 17%, 28%, 33% and 36% of the AW respectively in 2020.

Table 3.3. Lithuania has increased the basic allowance in recent years

	2020	2021	2022
Max BA (per year / per month)	400	400	460
Max BA income threshold(s) (EUR):	607	642	730 & 1 678
BA formula(s) above threshold:	$400 - 0.19 \cdot (\text{inc} - 607)$	$400 - 0.18 \cdot (\text{inc} - 642)$	<p>Between MMW – 1 678: $460 - 0.26 \cdot (\text{inc} - 730)$</p> <p>Above 1 678: $400 - 0.18 \cdot (\text{inc} - 642)$</p>
Max BA as a % of AW	29%	26%	27%

Notes: 2020 refers to the basic allowance introduced in July 2002. ‘inc’ refers to individual gross income. If the BA as calculated by the formula is negative, it is assumed equal to zero. In 2022, there are two thresholds with two different associated BA formulas. AW for 2020 Jan, 2020 July, 2021 and 2022 are based Statistics Lithuania average gross monthly earnings for 2020Q1, 2020Q2, 2021Q1 and 2021Q4 2021KQ (latest available data), which are EUR 1 381, EUR 1 398.5, EUR 1 517.4 and EUR 1 679.3 respectively. MMW refers to minimum monthly wage. Source: OECD analysis.

Lithuania operates a basic tax allowance withdrawal system, which is common in OECD countries. The withdrawal rate determines both the rate at which the BA is decreased for higher incomes above the maximum BA threshold and the income level at which the BA is no longer received at all. As incomes start to increase above the BA threshold, the amount withdrawn increases. Withdrawal-type systems are operated in different forms in several OECD countries including Slovenia, the Slovak Republic and Latvia.

The BA withdrawal rate can be used to increase the progressivity in the middle part of the income distribution. Since the withdrawal rate starts at the max BA threshold and ends when the BA is fully withdrawn, the withdrawal rate targets tax burden adjustments in the low to middle part of the income distribution. A withdrawal rate of zero implies no withdrawal and the BA becomes a flat amount that all taxpayers benefit from irrespective of their income. A withdrawal rate close to one implies a rapid rate of BA reduction so that effectively only low incomes can benefit from it. The increase in the withdrawal rate from 17% in 2020 to 26% in 2022 contributed to increased PIT 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 incomes rise. The BA 2022 reduces the PIT burden at low incomes and supports progressivity, reflected in the downward shifted PIT curve (Figure 3.11). An employee at 50% of the AW has seen their PIT fall from 11% to 9% to 7% in 2020, 2021

and 2022 respectively (Figure 3.11). Compared to the 2021 BA design, the 2022 BA design has a first 'break point' with a steeper slope and a second 'break point' that matches the 2021 BA design at higher incomes. The first 'break point' tapers more quickly than the 2021 taper rate as incomes are increased beyond the BA max threshold. The second 'break point' occurs at 118% of the AW and slows the rate of the BA taper to match that of the 2021 design.

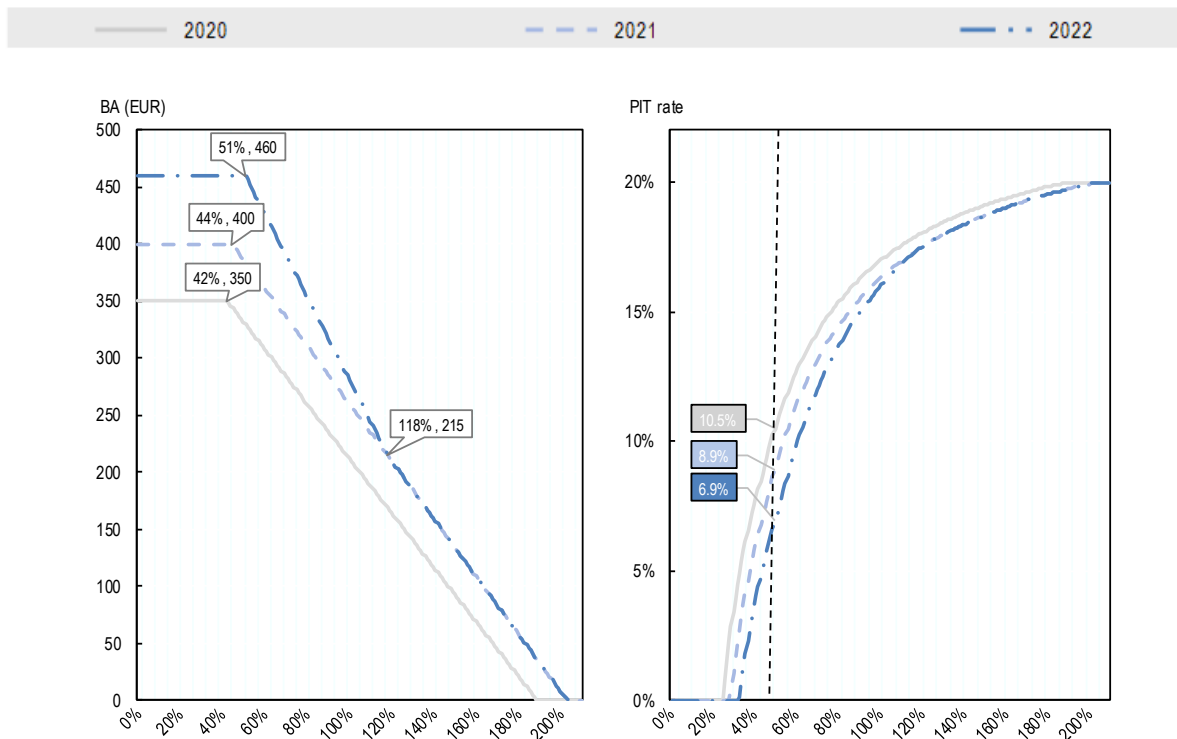
Limitations of the basic allowance

The basic allowance is somewhat untargeted. While the BA is and has been an overall effective way to produce PIT progressivity in Lithuania, it is somewhat untargeted. Compared to the 2020 BA, the 2022 BA is withdrawn at a higher income, which may benefit some higher earners. As a result of the BA increase between 2020 and 2022, a high earner (150% of the AW) saw a modest average PIT rate cut from 19.1% to 18.7%. The BA is fully withdrawn at 189% of the AW in 2020 and at 203% of the AW in 2021 and 2022, after which point the average PIT rate converges to the 20% marginal PIT rate (and at higher incomes to the 32% PIT rate).

Most of the basic allowance benefit went to workers earning between the minimum and average wage. The large share of Lithuanian workers with wages between the MMW and the AW (Figure 2.9) led to this cohort receiving the largest share of the BA benefit. 57% of the BA in 2020 went to individuals earning between the MMW and the AW despite that the cohort represented only 44% of individuals. 29% went to those below the MMW (Figure 2.9). Therefore, the structure of the wage distribution contributed to most of the BA benefit going to middle rather than lower wage earners.

Figure 3.11. The 2022 basic allowance has a higher amount and a faster tapering rate

The amount of the basic allowance (EUR) and the percentage PIT rate in Lithuania, 2020 – 2022



Note: A caveat to the analysis shown is that the BA is examined in each year in nominal terms using the average wage in 2020 (on the x-axis) but the real BA value is declining given inflation and rising wages in Lithuania

Source: OECD analysis.

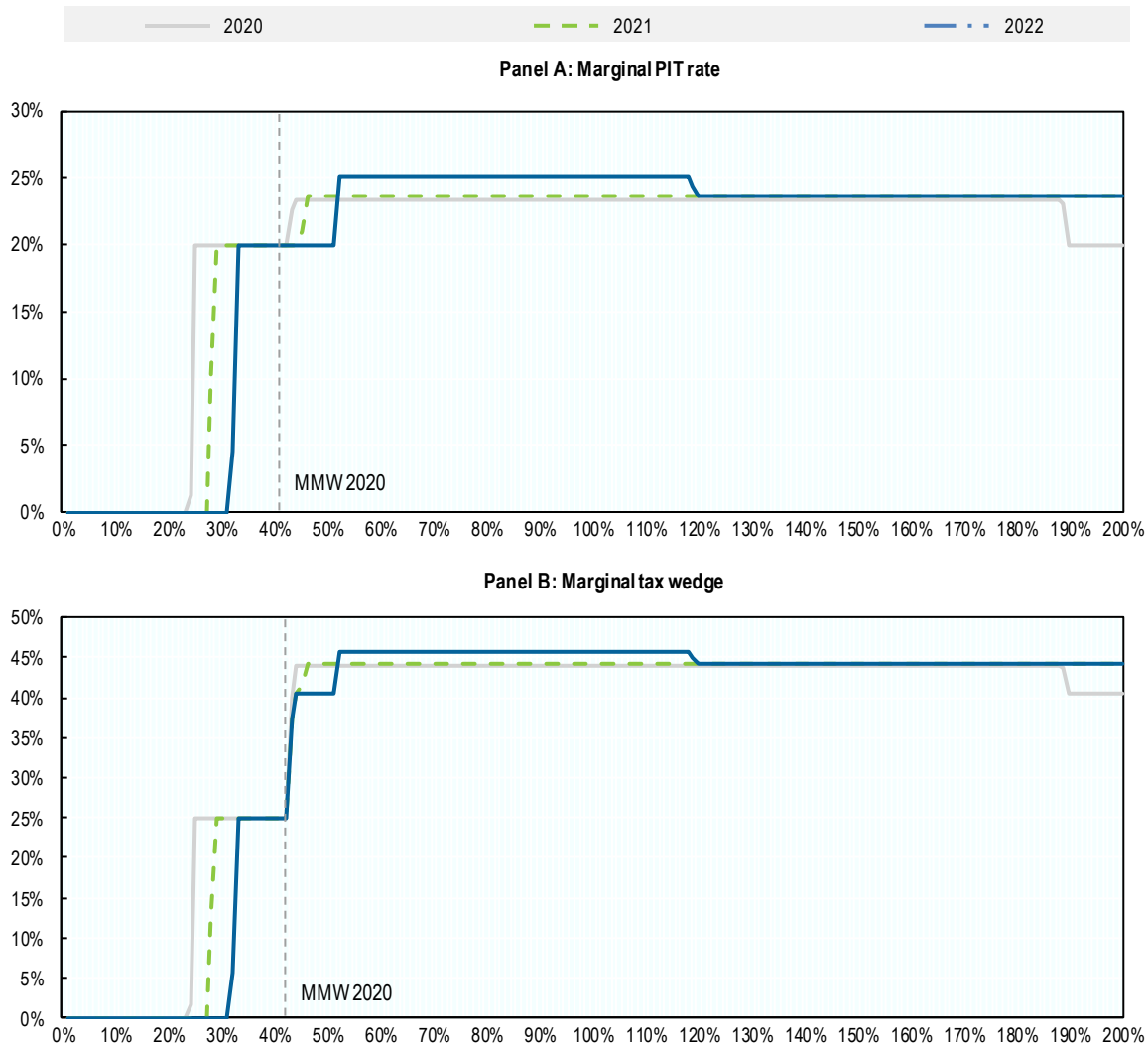
The basic allowance design in 2020 and 2021 produce some marginal PIT rate spikes at low incomes close to the minimum monthly wage. The marginal PIT rate patterns in 2020 and 2021 are broadly similar (Figure 3.12, Panel A). The first spike in the marginal PIT rate occurs as employees first start to pay PIT (at 31% of the AW in 2021, slightly above the level of 2020 due to the greater BA). The second spike occurs as the max BA starts to be tapered out (at about the MMW in 2020). The marginal tax wedge is higher than the marginal PIT rate but follows a similar pattern (Figure 3.12, Panel B).

The 2022 basic allowance design produces even higher marginal PIT rates spikes than in previous years. For the 2022 BA design, the first spike in the marginal PIT rate is the same magnitude as in 2020 and 2021 but it occurs at a higher income due to the higher BA amount. The second spike occurs after the max BA threshold and is larger in magnitude than in previous years due to the more rapid BA tapering.

The basic allowance design may produce modest poverty traps but for many workers. For both the marginal PIT rate and the marginal tax wedge between 2020 and 2022, spikes in the marginal tax rates occur at about 1/3 and 1/2 of the AW. A large share of Lithuanian employees earn wages at these incomes. These spikes could reduce the incentives for low-income employees to earn more income, to work more hours or to work harder beyond these thresholds (to avoid additional tax burdens). Modestly high marginal tax rates could also make working extra hours in the informal economy more attractive, which is not low or decreasing in Lithuania (Figure 2.4). The extent to which employees 'bunch' below these marginal tax rates should be examined further in the tax record data.

Figure 3.12. The basic allowance produces marginal tax rate spikes at low income levels

Marginal PIT rate and marginal tax wedge, based on basic allowance in 2020, 2021 and 2022



Note: The basic allowance amounts in EUR are set at 350, 400 and 460. The basic allowance thresholds in EUR are set at 607, 642 and 730 (and 1,678). The AW is set at the 2020 level of EUR 16,844 as calculated by the OECD secretariat and the MMW in 2020 is 607.

Source: OECD modelling.

Rising wages reduce the value of the basic allowance. Rising wages driven by inflation undermine the value of the BA. As wages rise, the max BA threshold is reached at a lower income of 44% of AW instead of 51%, implying higher effective PIT burdens on employees (Figure 3.13). Similarly at 50% and 100% of the AW, higher wages imply higher PIT rates of 9% vs 7% and 17% vs 16% respectively.

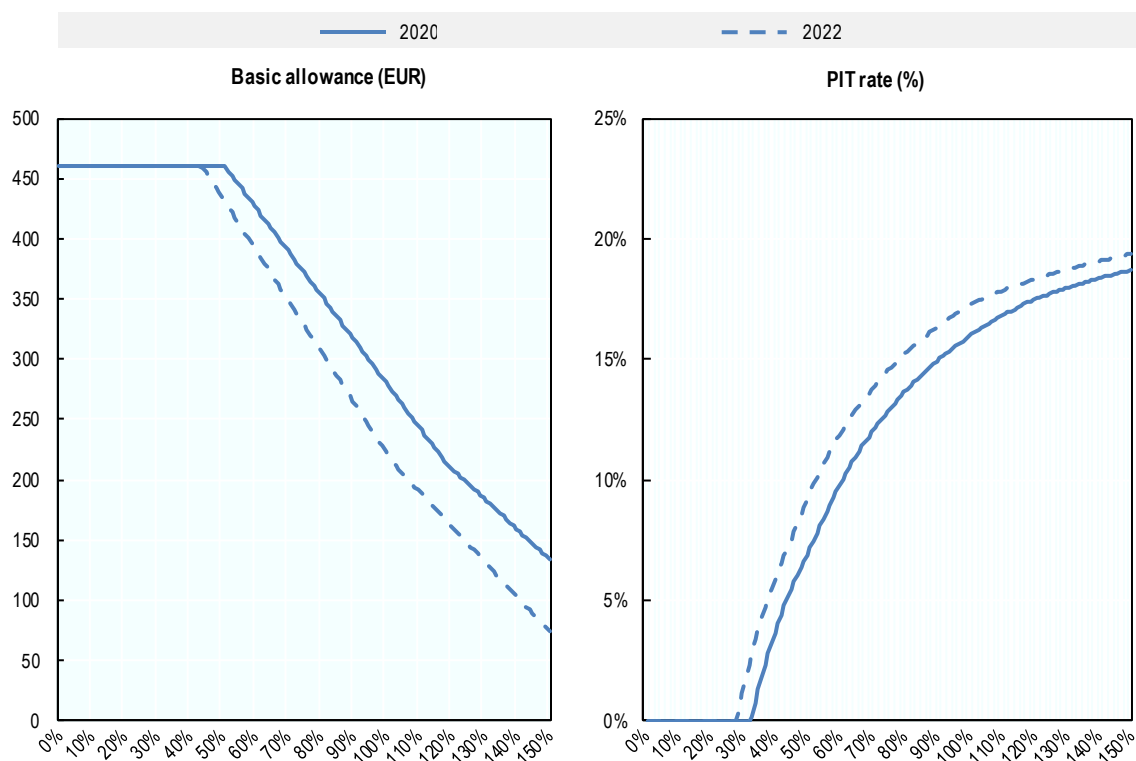
The basic allowance should be inflation-linked. The BA is not formally indexed to inflation. It is however set annually by the government informed by the increase in the MMW (the MMW is in turn set by the government, unions and employers indexed based on the MMW as a share of the forecast AW). Indexing 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 rise with inflation, it follows that the BA should also be inflation-linked. Inflation in Lithuania was reported as among the highest in the OECD. The CPI reached

19% in May 2022. Linking the BA to inflation in Lithuania would maintain its value in real terms including for low-income workers.

Whether the basic allowance should be linked to wage growth is a policy choice, but it could come with PIT revenue risks. Linking the BA to a measure that might outgrow inflation, such as the MMW or the AW, is a policy choice. The purpose of a BA and a progressive PIT system is partly that a growing economy with rising wages will translate to higher PIT revenues. However, by linking the BA to increases in wages instead of inflation, a relatively larger share of workers could be exempt from paying any PIT when wages outpace inflation. It may be preferable from both a compliance and PIT revenue perspective that low-income workers pay a small PIT amount rather than none at all.

Figure 3.13. Rising wages reduce the relative value of the basic allowance and increases average effective PIT rates

The basic allowance and the average PIT rate, based on a simulated AW in 2020 and 2022



Note: 2020 average wage is based on the OECD secretariat calculations. This is increased by 9.9% in 2021 and a further 5.3% in 2022 based on Statistics Lithuania average wage increases in 2021. Note that in 2022 wages increased even more quickly.

Source: OECD analysis.

The design of the basic allowance may be contributing to income bunching

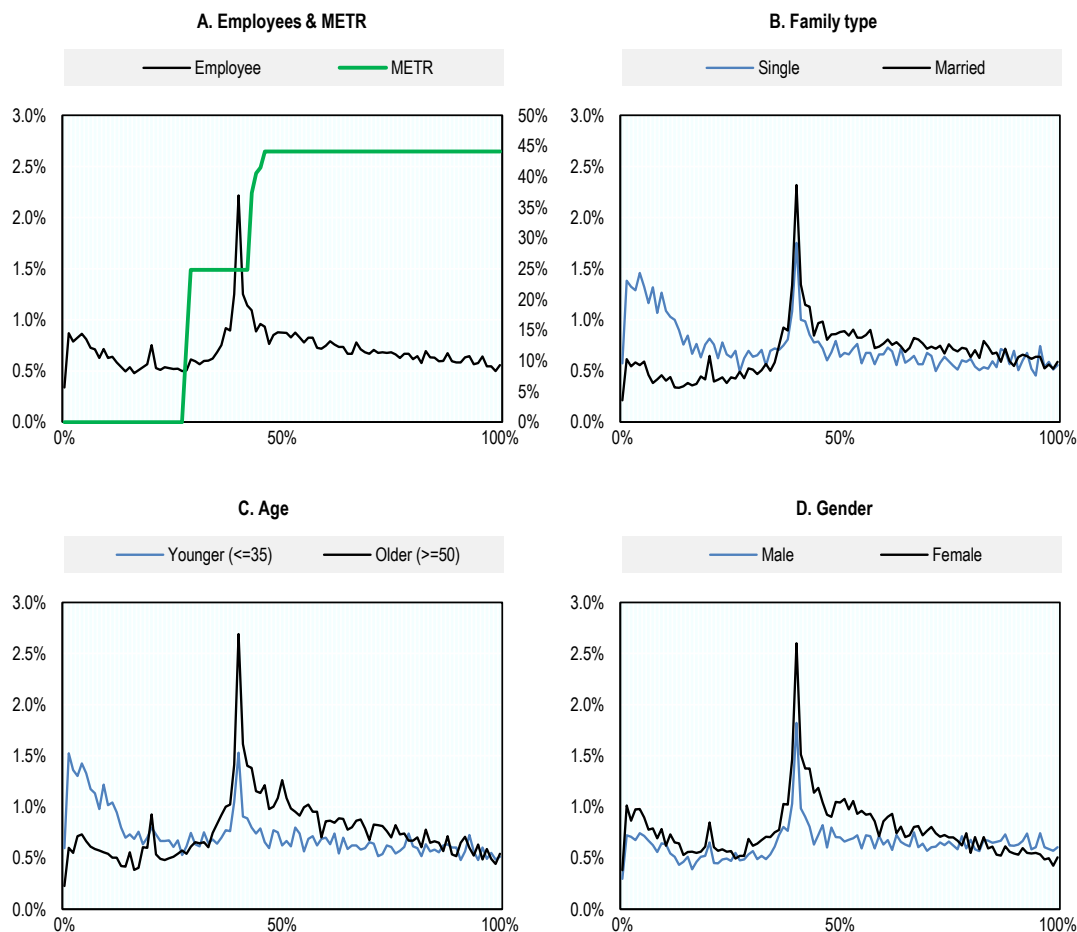
There is evidence of employee income bunching at the minimum monthly wage, particularly among older, married and female employees. The MMW is the most commonly reported employment wage income among employees (i.e. EUR 555 in 2019). 4.7% of employees report an income between 39% and 41% of AW (Figure 3.14, Panel A). Income bunching is higher for different employee types. In the

aforementioned 39% to 41% of AW income range, income bunching is higher for married couples vs single individuals (5.0% vs 3.8%), for older employees aged over 50 vs employees aged under 35 (5.7% vs 3.5%) and for female vs male employees (5.6% vs 3.8%) (Figure 3.14, Panels B, C and D). Income bunching is particularly high for employees that are aged above 50, married and full-time employees (6.4%). Single and younger workers under the age of 35 are more likely to report income at very lower incomes between 0 – 5 of the AW ((Figure 3.14, Panels B and C).

Income bunching at the minimum wage coincides with a jump in the METR due to the loss of the maximum basic allowance as incomes rise. While much of the income bunching is likely due to the MMW itself, the sharp distributional spike in the share of employees reporting an income at the MMW occurs just before a spike in the METR, which is partly driven by the tapering of the max BA.⁶ Therefore, employees may be responding to this jump in the METR by reporting incomes below it at the MMW (i.e. ‘income bunching’) partly to benefit from the max BA and so as not to lose the BA at higher incomes. If this were the case, the greater degree of income bunching among older employees, married couples and women could suggest that these groups are particularly responsive to increased METRs.

Figure 3.14. There is evidence of employee income bunching at the minimum monthly wage

Bunching of employees at the MMW, % of employees, by employment income as % of AW



Note: Analysis based on 43,389 individual taxpayers with positive employment income. Of these, 55% are married and 29% are single. 33% are younger (i.e. 35 years of age or younger) and 34% are older (i.e. 50 years or older). 50% are female and 50% are male.

Source: OECD analysis of microdata 2019.

Medium-term PIT reform options

- **The introduction of an in-work benefit could be investigated further as part of future work**

An in-work benefit could be envisaged. In-work benefits are welfare schemes designed to provide income supplement to needy families or individuals on the condition that they work (OECD, 2005^[11]). In-work benefits (IWB) typically involve tax reductions or cash transfers that are conditional on labour market participation. The value IWBs, such as an earned income tax credit (EITC), commonly depend on the recipient's earned income. The value of the credit increases gradually with income (phase-in) until it reaches a maximum credit amount (plateau). Beyond a certain earned income threshold (the phase-out threshold), the value of the credit is gradually reduced to zero. IWBs are typically means-tested and may be targeted at specific groups. When designed correctly, the IWBs have the potential to alleviate in-work poverty and increase work incentives and labour market participation for lower income workers (OECD, 2011^[12]). Table 3.4 outlines selected advantages and limitations of introducing an IWB in Lithuania.

In-work benefits tend to help the unemployed find jobs and the unemployed face high poverty rates.

High and rising poverty rates among the unemployed (Figure 2.11) suggest that disincentives to enter work or inability to work may be a more pressing policy concern for Lithuania than disincentives to progress in work. Most evidence suggests that IWB have positive employment effects when moving from unemployment to work (Chetty, Friedman and Saez, 2013^[13]) (Blundell and Shephard, 2012^[14]). This occurs because the substitution effect (workers can gain more per hour worked with an IWB) tends to outweigh the income effect (workers reduce hours as IWB raise disposable income). With regard to progressing in work, the evidence is more mixed and the effects tend to be smaller (OECD, 2011^[12]). However, this may be less of a concern in Lithuania given high employment and participation rates and relatively lower poverty among the employed (Figure 2.3).

An in-work benefit could compensate for relatively high PIT and SSCs faced by low income workers. A refundable in-work benefit that reduces with income could support formal work incentives among low-income workers by compensating for modestly high average effective PIT rates and high and less progressive employee SSCs. The phase-in region of an EITC in-work benefit typically incentivises labor supply increases at the intensive margin (i.e. longer hours) as the tax credit amount increases with gross earnings.

The merits of an in-work benefit programme are stronger in individual-based tax systems such as in Lithuania. In an individual-based tax system such as in Lithuania, IWB work incentives are stronger relative to IWB in a household-based tax system (which depends on household size and is mean-tested) as it may reduce incentives for the second earner to enter work (Bargain and Orsini, 2004^[15]).

In-work benefits are typically costly. Spending on the EITC programmes in the United States and the United Kingdom ranges from 0.4 to 0.5% of GDP (OECD, 2020^[16]). However, these costs are at least partly outweighed by lower welfare payments since some jobseekers find a job as a result of the IWB. This in turn helps to broaden in the tax base. EITCs can be financed with PIT revenues rather than SSC revenues so that there is no loss to SSC funds.

A challenge for designing an EITC in Lithuania is that it could add to an already complex tax and benefit system. The complex structure of the EITC and its interaction with the rest of the tax and benefit system make its impact on labour supply dependent on its design and on household characteristics, such as marital status and number of children (Liebman, 1998^[17]); (Eissa and Williamson Hoynes, 2004^[18]). Estonia introduced a non-payable tax credit for low-income earners in 2016 and abolished it a year later in 2017, reflecting the challenges of adding additional complexity to the tax system. An EITC would increase marginal tax rates, which are already high for low income workers over the income range where the BA is tapered out.

Table 3.4. Selected advantages and limitations of in-work benefits

Advantages	Limitations
<ul style="list-style-type: none"> - IWBs have positive employment effects at the extensive margin and the unemployed in Lithuania face high poverty rates. - IWBs could help to compensate for relatively high PIT and SSCs faced by low income workers. - Work incentives are stronger in an individual-based tax system such as in Lithuania. - Supports redistributes to lower-income households and reduces poverty if labour supply is increased and workers are sufficiently responsive at the extensive margin. - May support women through its interaction with the gender income gap and due to a high share of single women households facing poverty at low incomes. - Encourages second earners to enter work that have low work incentives in Lithuania at short unemployment durations. - Encourages single parents to enter work, especially when economy is strong, as is currently the case in Lithuania. - Complementary to Lithuania's active labour market programmes that promotes jobs and enhances skills. 	<ul style="list-style-type: none"> - IWBs are relatively costly. - Adds to Lithuania's already complex tax and benefit system. - May interact with other out-of-work benefits such as social assistance and unemployment benefits. - Mixed evidence of positive labour market effects at the intensive margin (i.e. number of hours worked). - Mixed evidence of poverty reduction, which depends on the IWB design. - May reduce work incentives to work longer hours or work more for those already in work. - Employers may cut wages in response to the IWB. - Are relatively ineffective in weak labour markets.

Source: OECD analysis. (Saez, 2002^[19]) (OECD, 2005^[11]) (Vandelannoote and Verbist, 2020^[20]).

- 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. In-work social assistance (IWSA) is provided to out-of-work individuals that move into employment. The scope of IWSA is by definition narrower than in-work benefit, which is usually available to a broader group of low-income workers (only about 2 000 individuals currently receive IWSA). To be eligible for IWSA, taxpayers must meet several eligibility criteria including the following. First, recipients must be receiving SA benefits (i.e. qualify for the income means-test and other SA eligibility conditions for at least one month). Second, once in work, recipients must earn income of at least the MMW or the minimum hourly pay (thus part-time workers are included provided they earn at least the minimum hourly pay). IWSA is based on a person's income before they enter work. It is not means-tested against current income. Third, recipients must be registered with the employment service for at least 6 months. The former two criteria are likely to significantly limit eligibility while the latter registration with the employment service is unlikely to disqualify many taxpayers (since it is a standard mandatory requirement for receiving SA by working-age adults).

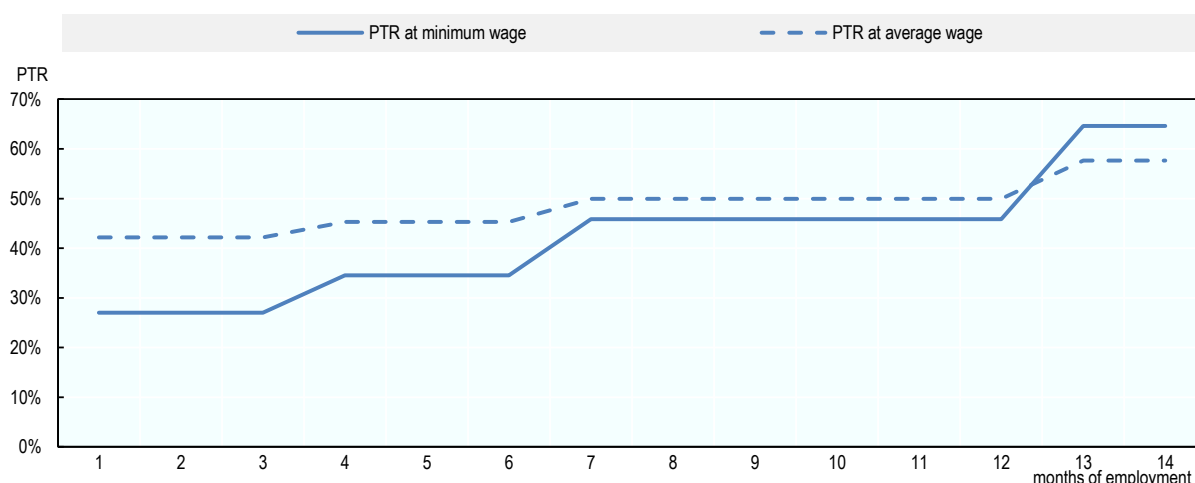
In-work social assistance was reformed in 2020. To encourage social benefit recipients to enter the labour market, eligibility for IWSA was simplified in June 2020 by removing the condition on the upper wage limit, which was of approximately the AW. The amount of IWSA was doubled and the amount was set to decline with duration. For 1 to 3 months, the amount of IWSA is set at 100% of previous SA (paid during the last 6 months prior to employment). For 4 to 6 months and 7 to 12 months, the IWSA falls to 80% and 50% of the previous SA respectively. After 12 months, IWSA is no longer available.

The amount of IWSA depends on employment duration but not on current income. The reform in 2020 implies that the effect of IWSA on work incentives is the strongest at the beginning of employment spell. The PTR of entering work at the minimum wage is 27% with full IWSA (i.e. at one month of employment) and increases to 65% after 12 months of employment when the IWSA expires (Figure 3.15).

Similarly, the PTR of entering work at the AW is 42% with full IWSA and 58% after IWSA expires (Figure 3.15). Since the IWSA upon entering work equals the previous SA out-of-work, initial IWSA removes all disincentives to work associated with the loss of means-tested SA. Work disincentives in the first 3 months of employment are produced only by SSCs and PIT.

Figure 3.15. In-work social assistance falls with longer employment duration

PTR for a single parent with two children starting work at the minimum and average wage, 2021



Source: OECD Tax and Benefit model TaxBen (version 2.4.1).

Redesigning the in-work social assistance with in-work benefit characteristics could improve work incentives but it would not be without challenges. Unlike an in-work benefit (IWB), the IWSA reduces with duration rather than with income (i.e. it is not means-tested with income), it has strict eligibility criteria and it is time-limited (Table 3.5). Some of the IWSA criteria could be redesigned to be more similar to an IWB to increase the incentives to work while also retaining its current SA function. However, such a redesign would not be without challenges. Setting the amount and taper rate of an IWB is perhaps the most challenging but important aspect of its design. Setting the amount depends on several factors including the difference between out-of-work income and in-work work income, the level of income support relative to the MMW, the cost of the programme (and how it could be funded) and the numbers of workers earning income at the income levels where the benefit is tapered. Additionally, sufficient time would need to be provided to induce wage progression given that most studies show wage progression at 3–4% per year (OECD, 2005^[11]).

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. Several OECD countries have adopted social assistance-related measures that support incentives to enter work (Table 3.6). Slovenia's Financial Social Assistance implies that those who work more hours have higher SA relative to those who work fewer hours (Table 3.6). This means a person entering work becomes eligible for higher SA, which is then tested against their current income. However, such a design has drawbacks as, apart from being relatively costly, it increases income at particular hour thresholds and may prevent work progression beyond these thresholds. A wider set of policies that increase work incentives for new employees in selected OECD countries is shown in Table 3.6.

In-work social assistance eligibility criteria could be eased and the duration of assistance could be extended to improve work incentives. Given the challenges of redesigning the IWSA so that it tapers

with income like an IWB, a relatively more straightforward redesign option that has the potential to improve incentives to work include adjusting the eligibility criteria and time duration. IWSA could be broadened by reducing the requirement time to register with the employment services from 6 months to e.g. 3 months. The IWSA could be extended by increasing the current retention of 100% of the IWSA for 3 months for a longer duration such as 6 months.

Table 3.5. Comparing Lithuania's in-work social assistance with an in-work benefit

Policy	Characteristics
Lithuania's in-work social assistance programme	<ul style="list-style-type: none"> - Main purpose is social assistance / poverty alleviation and providing stronger work incentives for those on social assistance - Conditional on labour market participation (i.e. starting a new job) - Reduces with time but not dependent on current earnings - Strict eligibility criteria & limited reach - Conditional on already receiving social assistance - Time-limited (i.e. can only be received for 12 months) - Means-tested on income before moving into work - Somewhat limited targeting at specific groups (e.g. greater assistance for larger families)
In-work benefit programmes	<ul style="list-style-type: none"> - Dual purpose of labour market participation and in-work poverty alleviation - Conditional on labour market participation - Increases as incomes rise (phase-in) up to a maximum (plateau) before declining gradually to zero (phase-out) - Often widely available to low-income workers - Sometimes time-limited - Means-tested (depends on earned income) - Often targeted at specific groups (e.g. older workers with low skills, individuals with poor health and single mothers)

Source: OECD analysis.

Table 3.6. Various policies that increase work incentive for new employees in selected OECD countries

Country	Social assistance-related measures	Tax design rules
Slovenia	Financial social assistance	<ul style="list-style-type: none"> -The first adult or single person who is working between 60 and 128 hours per month receives 126% of the basic minimum income (BMI). -The first adult or single person who is working more than 128 hours per month receives 151% of the basic minimum income (BMI).
Croatia	SSCs	<ul style="list-style-type: none"> - Employers do not have to pay health insurance contributions for a period of 5 years if taxpayers are younger than 30 years, if a job contract was closed for a continuous period and for the first time with that person.
Poland	PIT	<ul style="list-style-type: none"> -The government introduced 'PIT Zero' for young adults under 26 years. It provides a full exemption of income tax for wages coming from either standard employment or non-standard employment, unless gross earnings exceeds a threshold.
Poland	Activation allowance	<ul style="list-style-type: none"> -If an unemployed person finds a job before exhausting the unemployment benefit, the unemployed can receive an activation allowance. This is a standalone benefit, whose eligibility depends on previous entitlement to the unemployment benefit. -In 2022, Poland expanded PIT zero to a broader set of employees including Polish citizens returning from abroad to work in Poland, families with 4+ children and working seniors over the age of 60 (women) and men (65).

Slovakia	Activation allowance	-Monthly allowance for household members that have earned income of at least the minimum monthly wage.
Austria	In-work benefit	-The amount of the benefit is individually calculated by raising the unemployment benefit or unemployment assistance by 45%, 55% or 60% depending on the working hours. -The maximum duration of the benefit receipt is one year.

Source: OECD TaxBen country reports available at <http://oe.cd/TaxBEN>.

The design of social security contributions

Most employer SSCs were shifted to the employee. With regard to SSC rates in 2019, employer SSC rates were cut (from 30.5% to 1.47%) and employee SSC rates were increased (from 9.0% to 19.5%) (Table 3.7). Consequently, total SSC rates (employer and employee) were cut by almost half in 2019. Between 2019 and 2021, SSC rates remain unchanged.

To compensate employees for higher employee SSCs, gross wages were adjusted upwards. The authorities increased gross wages mechanically by 28.9% in January 2019 in an attempt to keep the disposable incomes of employees unchanged. In 2018, the employer SSC rate was 30.5%, of which 28.9% was shifted to employees in 2019. The breakdown of the 28.9% included pension insurance of 22.3%, health insurance of 3%, and sickness insurance of 1.4% and maternity insurance of 2.2%.

Table 3.7. SSC rates in Lithuania, 2018 - 2021

	2018	2019	2020	2021
Employee SSC rates	9.0%	19.5%	19.5%	19.5%
Employer SSC rates	30.5%	1.47%	1.47%	1.47%
Total SSC rates	39.50%	20.97%	20.97%	20.97%

Note: Employer SSC rates are comprised of 1.31% unemployment social insurance and 0.16% accidents at work and occupational diseases social insurance. Note that this is a general rate - In practice four categories of rates of insurance contributions for accidents at work and occupational diseases are applied, depending on company's risk profile. Note that employer SSC ceiling has been abolished in 2021.

Source: OECD analysis.

Employer SSCs in Lithuania are comprised of three components.

- First, the employer SSC rate in Lithuania of 1.47% in 2020 is comprised of:
 - 1.31% for unemployment insurance, and
 - 0.16% for insurance from accidents and work and occupational diseases.
- Second, the employer payroll SSC rate of 0.32% in Lithuania is comprised of:
 - 0.16% of gross wage for the Guarantee fund, and
 - 0.16% of the gross wage for the Long-term employment benefit fund (to pay severance pay for the damage caused by occupational accidents or diseases).
- Finally, an employer floor or minimum amount was introduced in 2018.

Lithuania does not levy SSCs on pensions, similar to about half of all OECD countries. PIT and SSCs play an important role in old-age income support. 21 out of 38 OECD countries levy SSCs on pensions (OECD, 2021^[21]). Among OECD countries that levy SSCs on retirees, the SSC rate is always lower for retirees than for workers. In most OECD countries, pensions are not typically subject to pension SSCs or unemployment SSCs but they are sometimes subject to health SSCs (OECD, 2021^[21]), which older individuals disproportionately use and benefit from.

The cuts to employer SSC rate and total SSC rates may have induced employers to raise employee wages to offset the decline in disposable incomes. Following the shifting of SSCs from employers to employees, employees are *prima facie* worse-off and employers better-off. The incidence of the change in

the SSC mix generally falls on the employee (for a discussion of SSC incidence see Box 3.2) because there are few good alternatives to work for most people. Given that the evidence in the research literature for differential labour supply effects in employee and employer SSCs is scarce and weak (Box 3.2), it may be reasonable to assume that the labour supply effect of increases in employee SSC and employer SSCs are similar. Under this assumption, the labour supply effects of employee and employer SSCs can be usefully considered together (i.e. total SSCs). In Lithuania, total SSCs as a share of gross income have declined in Lithuania in recent years (Figure 3.16). Economic theory predicts that in the long-term (when the effective tax incidence becomes predominant) the incidence will largely fall on the employee through higher wages than would be the case otherwise. This occurs partly because employers must increase wages to offset the decline in disposable incomes for employees. The studies of (Gruber, 1995^[6]) and (Anderson and Meyer, 1997^[7]) show that employer SSC rate cut can lead to one-for-one increases in employee wages, which suggests that employer SSC incidence falls fully or mostly on workers. Average gross monthly earnings increased by 30% in Lithuania in Q1 2019 compared to the previous quarter, indicating that companies compensated workers with even higher wages than the 28.9% required by the upward mechanical adjustment. A similar wage increase in Romania following its shifting of SSCs from the employer to the employee (see Box 3.1).

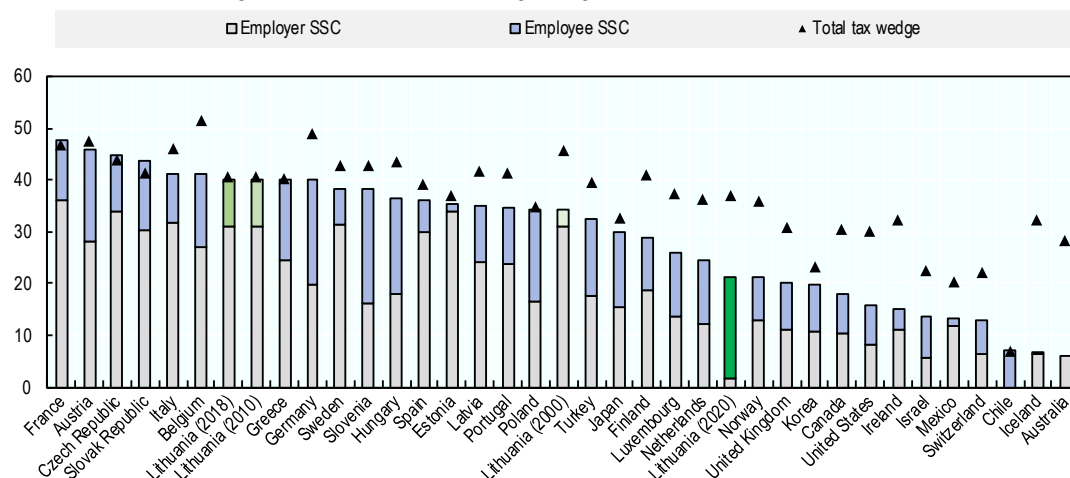
SSC rates and revenues

Total SSC rates are somewhat low in international comparison but employee SSCs are among the highest in the OECD. Lithuania's employee SSC rate of 19.5% is the third highest in the OECD, behind only Slovenia and Germany. The ratio of employee-to-employer SSCs in Lithuania is by far the highest in the OECD (Figure 3.16). Total SSC rates in 2020 are historically low in Lithuania. They are lower in 2020 than in any year going back to 2000. In addition, total SSC rates are lower than in Latvia and Estonia, where the total SSC rate is about 35% in both countries in 2020.

The shifting of virtually all employer SSCs to the employee in 2019 represented a significant departure from the SSC rate mix over the past two decades (Figure 3.16). As discussed previously in the PIT section (Figure 3.7), this shift was reflected in reduced SSC revenues (i.e. employee SSCs increased but were outweighed by employer SSC declines) and broadly revenue-neutral labour taxes (due to a compensating increase in PIT revenues). In 2020 however, while PIT revenues remain stable, total SSC revenues increased sharply to 8.7% of GDP from 8.1% in 2019. This increase moved Lithuania's total SSC revenues from being below the OECD average to above it (total SSCs as a share of GDP are 8.4% in the OECD in 2019).

Figure 3.16. Total SSC rates are somewhat low in international comparison

Total SSC rates and tax wedge as a share of the average wage in 2020



Note: Analysis is for an individual at 100% of the AW.

Source: OECD tax database.

SSC ceilings

Since their introduction in 2019, SSC ceilings have been steadily cut. SSC ceilings were simultaneously introduced for employees and employers (excluding health insurance contributions) for incomes above 10 annual AW in 2019. The rationale for the SSC ceilings was partly to compensate for the higher PIT burden associated with the introduction of the progressive PIT rate system (discussed previously, see Table 3.2). In 2020, the employee and employer SSC ceilings (excluding insurance contributions) were reduced to 7 annual AW. In 2021, the ceiling for employee SSCs was further reduced to 5 annual AW and the employer SSC was abolished. From 2021, the employee SSC ceiling only applies to employees overall employment income (combined from all employers, as opposed to each employer individually as was previously the case).

Table 3.8. SSC ceilings have been steadily cut

SSC ceilings and top-PIT rate threshold, in annual AW, 2019 - 2021

	Employee SSC ceiling	Employer SSC ceiling
2019	10	10
2020	7	7
2021	5	Abolished

Note: An SSC ceiling is the income level above which additional income is not subject to SSCs. Monthly AW are converted to annual AW by dividing by 12.

Source: OECD analysis.

SSC ceilings remain high in international comparison. The employee SSC ceiling of 5 times the annual AW in 2021 is high in international comparison. In OECD countries, the ceiling usually applies to wage levels higher than 1.67 of the AW (OECD, 2021^[22]). Lithuania's high employee SSC ceiling imply that high earners make a financial contribution to the funding of the social security system.

SSC ceiling cuts in recent years reduced the SSC burden on higher earners. The introduction of the SSC ceilings in 2019 reduced the SSC burden on high earners. Subsequent cuts to the SSC ceiling in 2020 and 2021 further reduced the SSC burden for higher earners. The abolition of the employer SSC ceiling in 2021 increased the SSC burden on higher income employers, albeit the increased SSC burden is small owing to the low employer SSC rate. The top-PIT rate threshold was also reduced jointly with the employee SSC ceiling between 2019 and 2021 (Table 3.8) and will have increased the PIT burden on middle and higher earners. The threshold values for both the PIT and SSCs is dependent on the size of the AW set by law each year which is in turn set based on actual wages in the economy.

The abolition of the employer SSC ceiling in 2021 increased the tax wedge on higher earners, but only modestly. The tax burden on high earners has increased with the abolition of the employer SSC ceiling in 2021 compared to when the ceiling was in place. However, the impact of abolishing the employer SSC ceiling on the tax wedge is limited by the low employer SSC rate and it only starts to take effect at high income levels (Figure 3.17).

Figure 3.17. The abolition of the employer SSC ceiling will modestly raise taxes on high earners

Tax wedge in Lithuania with and without the employer SSC ceiling, 50% - 800% of AW



Note: Compares employer SSC ceiling reduction to the same level as that of the employee SSC ceiling in 2021 (i.e. EUR 6 674 or 60 AW) with the abolition of the employer SSC in 2021. Given that the ceiling is adjusted annually to take account of wage changes, gross wage labour income is estimated by the OECD secretariat of EUR 16 426 in 2020 is used in the analysis (*Taxing Wages 2021*). A 2021 gross wage labour income could be estimated by increasing the figure by 9.9% (based on Statistics Lithuania wage growth) but this has little impact on the results. Source: OECD analysis; *Taxing Wages 2021*; Statistics Lithuania.

The merits of raising the employee SSC ceiling depends on several factors including the extent of SSC revenues that could be raised, arbitrage opportunities and equity considerations. For schemes such as health insurance, which are relevant given aging and relatively poor health outcomes in Lithuania (Figure 2.2), contribution ceilings imply that high-income earners do not participate with their full earnings in the redistributive scheme, which may not conform to the principle that people should contribute according to their financial capacity to do so. If Lithuania wished to generate additional resources to finance the social security system, particularly in healthcare where the benefit entitlements are mostly independent of the level of contributions paid, it could consider reinstating higher employee SSC contribution ceilings. The additional resources could help to reduce SSC contribution rates. The capacity for Lithuania to support income inequality by raising the employee SSC ceiling depends on several factors, some of which may need further empirical examination. The potential SSC revenue that could be raised by increasing the employee SSC ceiling will be limited by a relatively small number of high incomes (so revenue costing is needed). From an efficiency perspective, high-income earners could respond by leaving the country and working abroad. There may also be arbitrage opportunities for employees to switch to more lightly taxed income sources. From an equity perspective, raising the employee SSC ceiling weakens the link between SSC contributions paid and SSC benefits received. Raising the 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.

Table 3.9. SSC and top-PIT rate threshold policy options

Policy	Policy objective	Impact on tax burden & tax revenues	Selected risks
Cut employee SSC ceiling (undertaken in 2020 & 2021)	- Offset higher PIT burden associated with progressive PIT system - Reduce high SSC ceilings	Reduce SSC burden on higher incomes & reduce associated SSC revenues	- May increase income equality - Reduces SSC revenues
Cut top-PIT rate threshold (undertaken in 2020 & 2021)	- Raise PIT revenues - Reduce income inequality	Increase PIT burden on higher incomes & raise associated PIT revenues	- PIT revenue raised may be small given small number of high incomes - Risk employees may switch to more lightly taxed income sources - Risk employees leave the country to work abroad
Increase employee SSC ceiling (not undertaken)	- Raise SSC revenues - Reduce income inequality	Increase SSC burden on higher incomes & raise associated SSC revenues	- SSC revenue raised may be small given small number of high incomes - Weakens link between capped SSC benefits & capped contributions

Source: OECD analysis.

High SSCs discourage work and encourage informality

High employee SSCs may reduce labour supply while low employer SSCs may increase labour demand. High employee SSCs may reduce labour supply and work incentives, particularly for individuals with weaker attachments to the labour market such as those on low incomes, older workers and second earners. High employee SSCs lower disposable income among low earners, potentially reducing work incentives. On the other hand, low employer SSCs may help to keep labour costs down for the employer and increase labour demand and to minimise distortions in firms and sectors where skills and labour productivity are low.

High SSCs could risk making informal employment relatively more attractive. In practice, employers are often in a position to transfer most of the SSC burden back to workers. Exceptions to this are when workers have strong bargaining power (which might be lower in an economy like Lithuania where there are large skill mismatches and relatively fewer high-skill workers in demand), when many workers are paid around the minimum wage (which cannot legally be reduced further), when workers value social protection (which may increase given visibility of employee SSCs) and when unemployment replacement rates are generous (not particularly generous in Lithuania). On this basis, employers may be able to transfer the SSC burden to Lithuania workers, albeit this is limited due to low employer SSCs.

The employer SSC floor ensures low-income workers receive a minimum SSC benefit contributions but it could risk disincentivising employers from hiring

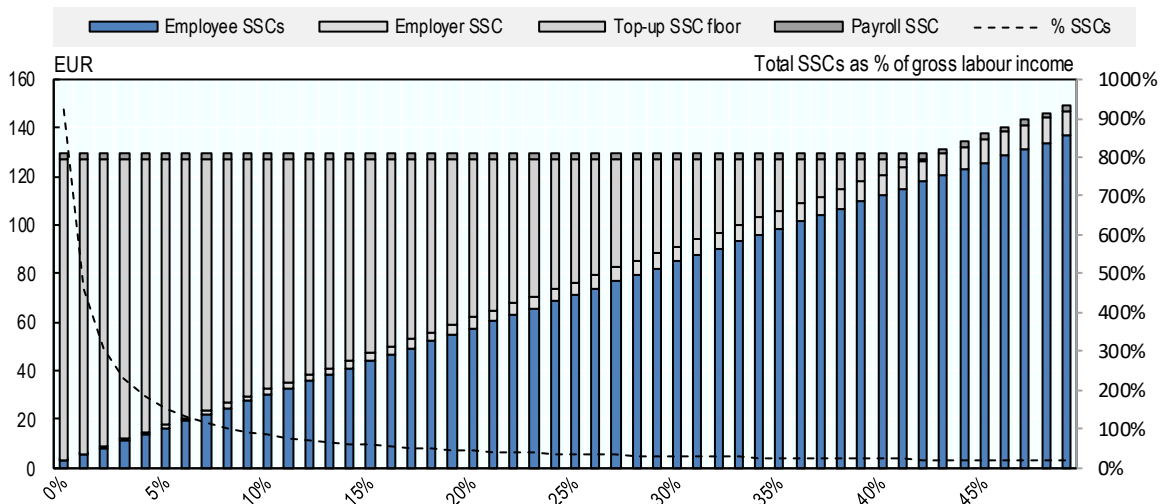
The employer SSC floor was introduced in Lithuania in 2018. The employer SSC floor (or minimum amount), which was introduced in 2018, ensures that a minimum SSC contribution is paid on behalf of employees. For low-income employees with a monthly wage below the MMS (43% of AW in 2020), employers must calculate and pay employer and employee SSCs (at a total rate of 20.97%) on the MMS base for employees from an income base of at least the MMS. As such, employers pay employer and employee SSCs on behalf of employees based on the difference between the calculated wage and the MMS. The SSC floor does not apply to all workers and some are excluded including pensioners, disabled persons, young workers, workers receiving maternity, and paternity or child care benefits.

The employer SSC floor ensures that low-income workers make a minimum SSC contribution and indirectly ensures that they benefit from a minimum social benefit. At low income levels, SSCs would be low if it were not for the employer SSC floor due to relatively low employee SSCs, employer SSC and payroll rates (Figure 3.18). The employer SSC acts as a top-up by ensuring a minimum SSC contribution for low-income workers. The employer SSC floor also has the potential advantage of encourage employers to engage in the formal economy by helping to reduce the under-reporting of hours worked.

However, the employer SSC floor produces high tax wedges at very low incomes which could disincentivise employers from hiring low-income workers. At low-income levels (up to 21% of the AW in 2020), the employer SSC floor contribution is the largest contributor to total SSC contributions (at 10%, 15% and 20% of the AW, the SSC floor represents 72.6%, 64.3 and 52.9% of total SSCs) (Figure 3.18). As such, the employer SSC floor drives high SSCs and tax wedges as a share of gross incomes (at 10%, 15% and 20% of the AW, the employer SSC floor contributions represents 69.7%, 39.5% and 24.4% of gross incomes). 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. At 44% of the AW, the employer SSC is floor phased-out and the effective employer SSC remains constant thereafter. Beyond 44% of the AW, total SSCs (employee and employer SSCs) continue to rise in nominal terms (because incomes are rising) but total SSCs as a share of gross incomes remains flat at 21.3% (19.5% + 1.47% employer SSCs + 0.3% payroll SSCs).

Figure 3.18. The employer SSC floor ensures that low income workers make a minimum SSC contribution

Decomposition of SSCs in Lithuania in 2020, 0 – 50% of the AW



Source: OECD analysis.

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).

Employers appear to reduce hiring in response to the SSC floor

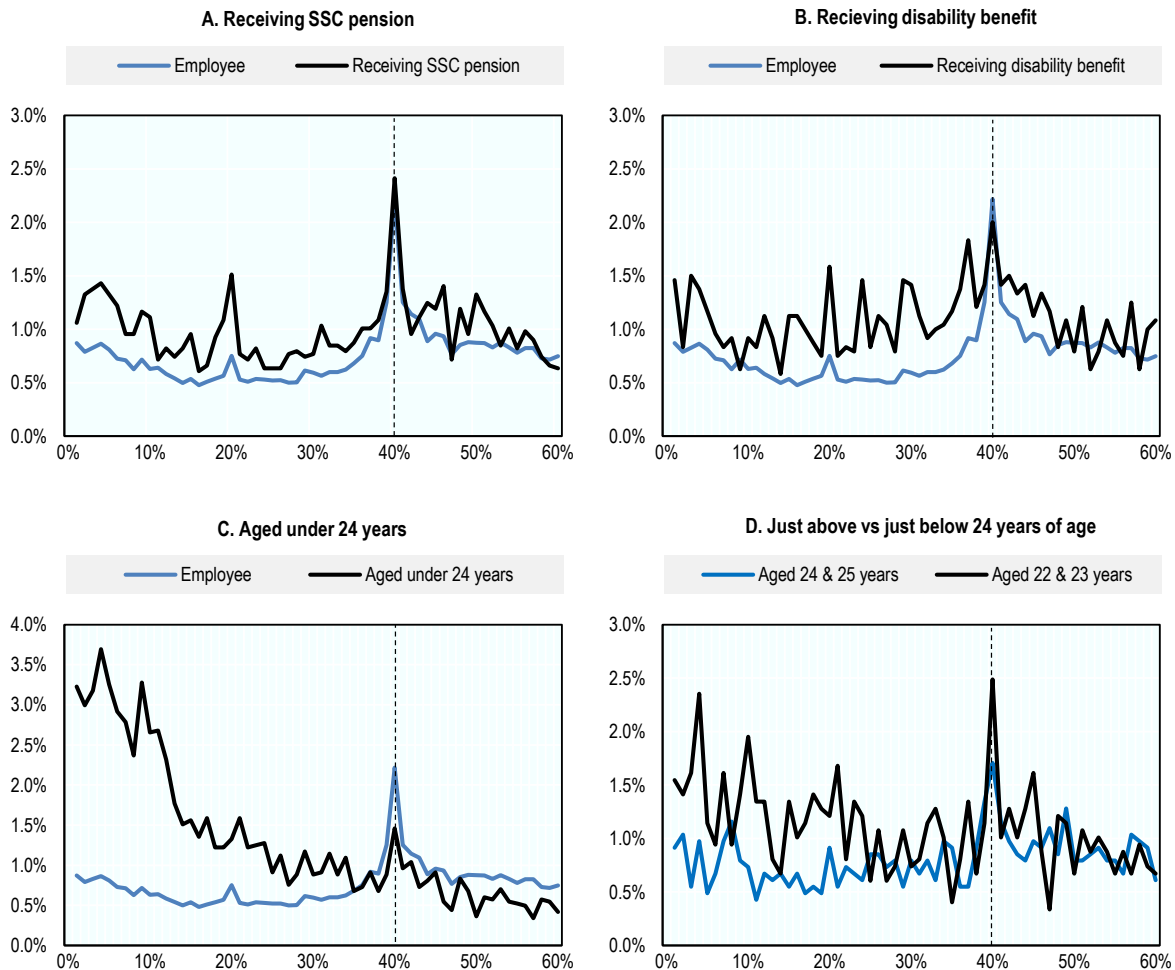
A simplistic comparison shows that there are fewer employees when the SSC floor applies compared to when it is not. Due to the employer SSC floor, employers pay employer and employee SSCs on an SSC base of the MMW for employees earning income below the MMW. The employer SSC floor produces a higher tax wedge than would otherwise be the case (in the absence of the SSC floor), which could disincentive employers from hiring low-income workers. However, do employers reduce hiring where the SSC floor is effective? Leaving aside the large share of employees earning the MMW, a simple comparison on either side of the MMW shows there are fewer employees for a given income range below the MMW than above it. 5.6% and 5.4% of employees earn between 10% and 20% and between 20% and 30% of the AW but a notably higher 8.0% and 7.2% earn between 50% and 60% and 60% and 70% (Figure 3.19, Panel A). This trend is consistent with reduced hiring below the SSC floor (although it does not demonstrate reduced hiring).

Employees that are exempt from the SSC floor are more concentrated where the SSC floor is in place. Employees that are exempt from the SSC floor include those receiving social insurance pensions or disability benefits and those under 24 years of age. These employee groups have greater distributional concentration below the MMW where the SSC floor is effective (Figure 3.19). At incomes below the MMW, the share of employees with a disability consistently exceeds the share of standard employees (44% vs 26%) whereas above the MMW (i.e. between 50% and 60% of AW) the former is only modestly above the latter (21% vs 18%) (Figure 3.19, Panel B). A similar trend is observed for employees receiving an SSC pension who are also exempt from the SSC floor (Figure 3.19, Panel B). Below the MMW, the share of employees aged under 24 years far exceeds the share of standard employees (67% vs 26%). However, it is possible that these employees are more concentrated in this part of the income distribution for reasons other than the operation of the SSC floor such as they tend to earn lower incomes for different reasons due to having lower skills and educational attainment (which could be controlled for in an econometric setting as part of future work).

Employers hire employees just below the SSC floor exemption age cut-off at a greater rate than employees just above the age cut-off. The SSC floor age cut-off (i.e. exempt under 24 years of age) facilitates a quasi-experimental comparison of the share of employees by income just above and below the age cut-off. Employers should prefer to hire a 23-year-old who would be exempt from the SSC floor and attracts a lower tax wedge than a 24-year-old to whom the SSC floor applies (holding other factors constant). Below the MMW where the SSC floor applies, the share of employees aged 22 and 23 (i.e. 46%) is 56% higher than the share of employees aged 24 and 25 (i.e. 29%) (Figure 3.19, Panel D). This compares to just 4% higher above the cut-off (i.e. 40 – 60% of AW). This provides indicative evidence that employers hire employees that are exempt from the SSC floor at a greater rate than those that are not. A more precise estimate could be obtained by controlling for additional explanatory variables such as skills and educational attainment in a regression discontinuity design as part of future work.

Figure 3.19. Some evidence is consistent with employers reducing hiring where the SSC floor applies

Employee groups that are exempt from the SSC minimum floor, % of employees, by employment income as % of AW



Note: Analysis based on 43,389 individual taxpayers with positive employment income. Of these, 5.2% receive disability benefits. 8.3% are aged less than 24 years of age. 8.1% receive an SSC pension. 3.2% and 3.5% are aged between 22 and 23 and 24 and 25 respectively. Two ages are to increase sample size.

Source: OECD analysis of microdata 2019.

To support better health outcomes and inclusive growth, Lithuania could raise social spending funded by SSCs and general taxation

Low levels of social spending could be increased to support inclusivity. Social spending as a share of GDP in Lithuania is low in international comparison (Figure 2.19). Increasing social spending would help to ensure that the incomes of those who are not benefiting from rapidly rising wages (Figure 2.7) continue to see their standards of living increase (e.g. the unemployed, inactive workers and individuals with health issues).

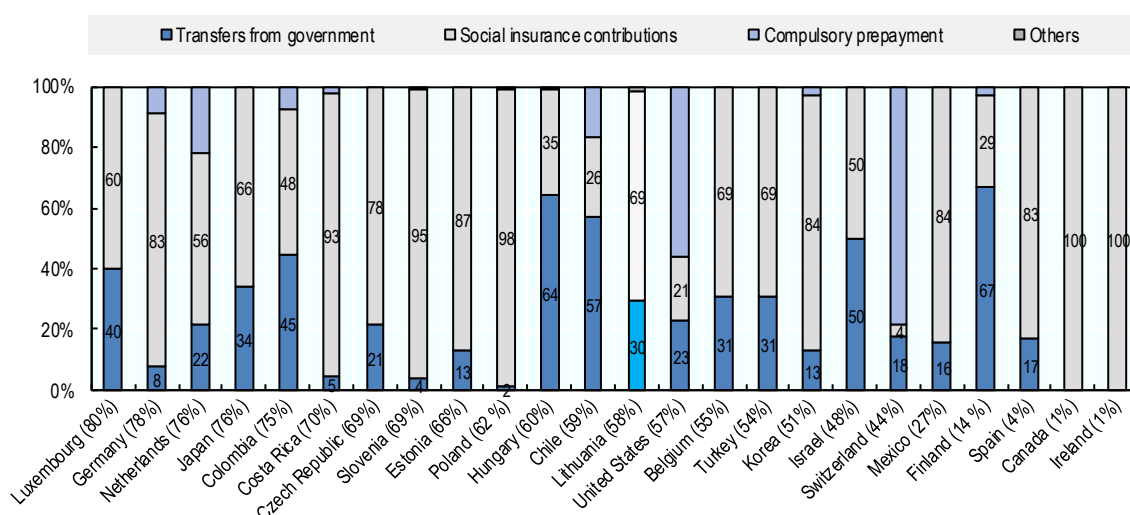
Health expenditure is primarily financed through compulsory health insurance. In Lithuania in 2019, health expenditures are primarily financed through compulsory health insurance (58% of all financing) and

out-of-pocket spending (32%) and much less so by government schemes (8%) and voluntary health insurance (1%).⁷ By comparison, in the OECD on average in 2019, compulsory health insurance represents 39% of expenditure followed by 35% in government schemes and 20% out-of-pocket expenditure (OECD, 2021^[23]). Therefore, compulsory health insurance represents a relatively more important share of health expenditure in Lithuania than the OECD more generally.

Compulsory health insurance in Lithuania relies mainly on SSC funding and to a lesser extent on transfers from government. Compulsory health insurance, the primary source of finance for health expenditure in Lithuania, is primarily financed by SSCs (i.e. 69% of total financing in 2019) (Figure 3.20). However, the pension and health funds are likely to face constraints which are expected to worsen given a rapidly ageing population and the associated increased costs associated with pensions (Figure 2.2).

Figure 3.20. Lithuania's welfare system relies mainly on funding through SSCs

Financing sources of compulsory health insurance by type of revenue, OECD countries, 2019 (or nearest year)



Note: Other includes compulsory prepayments and other domestic revenues.

Source: (OECD, 2021^[23]).

SSCs in Lithuania are currently focused towards supporting pensions and health. Of the employer and employee SSC rates, the largest shares are allocated to pension, health, sickness, maternity and unemployment. The employee SSC rate of 19.5% is divided into: pension (8.72%), health (6.98%) sickness (2.90%), and maternity (1.71%). The employer SSC rate of 1.79% is divided into: unemployment (1.31%), accidents at work and occupational diseases (0.16%) and other contributions to long-term-work benefit and the guarantee fund (0.32%).

In 2019, Lithuania partly shifted the funding of social insurance pensions from SSCs to general taxation, but the reform may have limited impact on the general financial sustainability of the social insurance fund. Lithuania's shifting of the financing of the non-earnings-related part of social insurance pensions to general taxation will not materially change the overall resources for social expenditures. In 2019, the authorities shifted the financing of the general part of pension SSCs to general taxation and to the PIT. The employee pension SSC rate was 8.72% in 2019 (where it currently remains in 2021), which represented a reduction from the previous employee pension SSC rate of 3.0% plus the employer pension SSC rate of 22.3% in 2018. To offset the reduction in the pension SSC rate, the progressive PIT rate was introduced and part of the PIT revenue is used to fund social insurance pensions. However, this shift to

funding social insurance through the PIT represents only a substitute for the lost SSC funds and does not materially increase resources to the SSC fund.

The sources of financing to the welfare system could be diversified. 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 through general taxation has some advantages as well as limitations (Table 3.10). 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.

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. Maternity benefits are often funded mainly through general taxation in EU countries.

In a changing world of work, financing social benefits partly through general taxation could help ensure that welfare support remains available for a large number of people. Structural changes in the economy including digitalisation and automation are resulting in an increasing number of workers which make smaller SSC contributors (self-employed, temporary workers and workers with irregular working hours (OECD, 2017^[24]). These structural changes in the economy present new sustainability challenges for welfare systems that are financed primarily through SSC contributions.

Table 3.10. Advantages and limitations of financing health systems

	Advantages	Limitations
General taxation	<ul style="list-style-type: none"> - Pool risks for whole population - Potential for administrative efficiency and cost control - Redistributes between high and low risk and low- income groups in the covered population 	<ul style="list-style-type: none"> - Risk of unstable funding and often underfunding due to competing public expenditure - Inefficient due to lack of incentives and effective public supervision
Social security contributions	<ul style="list-style-type: none"> - Generate stable revenues - Often strong support from population - Provides access to a broad package of services - Involvement of social partners - Redistributes between high and low risk and high and low income groups in the covered population 	<ul style="list-style-type: none"> - Poor are excluded unless subsidized - Payroll contributions can reduce competitiveness and lead to higher unemployment - Complex to manage governance and accountability can be problematic - Can lead to cost escalation unless effective contracting mechanisms are in place

Source: International labour organisation. Adapted from (OECD, 2018^[25]).

The design of the benefit system

The design of unemployment benefits

The rationale for unemployment benefit programmes in most countries include protecting workers against joblessness while containing poverty. Unemployment benefit (UB) programmes protect workers against the risk of income loss during joblessness. They also reduce the risk of wage losses upon re-employment by allowing workers to spend more time to find a job that matches their skills than they might otherwise. Unemployment insurance (UI) programmes help to contain poverty and to ensure both a fairer distribution of income in society (OECD, 2020^[26]).

Unemployment benefit coverage is limited by strict entitlement conditions. Factors that determine UB in Lithuania include the contribution record, the minimum and maximum amounts, the fixed and variable components and the benefit duration. With regard to eligibility, unemployment benefit is available to people aged over 16 who have not reached retirement in Lithuania. SSCs must have been made for at least 12 months in the last 30 months, which has now been brought in line with the 12 month median minimum contributions period across OECD countries (OECD, 2018^[27]). However, only about a third of the unemployed registered with the Employment Services are entitled to unemployment benefit (Užgalė et al., 2020^[28]). While strict entitlement conditions increase the financial incentives to find employment quickly, they also bear the risk of strongly penalising vulnerable population groups who struggle to find employment despite job search efforts. The unemployment benefit is neither means-tested nor taxable and unemployed persons can re-apply for unemployment benefit after 12 months if the minimum contribution requirements are met (note that unemployment benefit is included in the means-test for social assistance benefit).

The unemployment benefit consist of fixed and variable components, set by the authorities each year. The fixed component set at 23.27% of the MMS (in the month for which the UB is paid) produces an UB floor. The minimum UB is EUR 149.39 in 2021, up modestly from EUR 141.25 in 2020 and based on the fixed component (at a rate of 23.27%).⁸ The max UB of EUR 840 in January 2021 is up from EUR 760.01 in 2020. The max is set at 58.18% of the gross monthly AW as calculated by the Lithuanian Department of Statistics.⁹ The variable component, which is linked to the former level of insured income of the unemployed,¹⁰ is 38.79%, 31.03% and 23.27% in months 1 to 3, 3 to 6 and 7 to 9 respectively.

Similar to some OECD countries, the unemployment benefit design in Lithuania is determined by previous income, time-limited and declines with unemployment duration. In most OECD countries initial income support for the unemployed is provided through contributory unemployment insurance systems in which benefits for eligible job losers are a function of the previous wage and are time-limited (OECD, 2020^[26]). Among countries with declining UB schedules like Lithuania, Chile, Latvia and Slovenia, the initial net replacement rate (NRR) are often high (OECD, 2020^[26]). Unemployment NRRs show the proportion of the net household income before the job loss that is kept (note that since the OECD TaxBen NRR indicators assume a full contribution record) (Figure A.A.2). In all countries, the transition from UB to social assistance benefit produces a decline in the NRRs. Hence, even in countries with constant UBs such as Austria, France, Germany and Portugal, the level of support for the unemployed declines over time. Lower UBs in the long-term imply lower income support at a time when workers might value it the most as they progressively deplete any existing assets to smooth consumption (OECD, 2020^[26]).

Lithuania's unemployment duration of 9 months is of a relatively short duration in international comparison. The duration of UB is 9 months in Lithuania regardless of contribution history. For unemployed persons not more than 5 years below the retirement age, the duration of the UB is extended to 11 months (provided early retirement is not available to them). The rationale for reduced UB over time in Lithuania is to provide higher levels of income stabilisation during the initial months of unemployment and higher incentives to take up a job thereafter (Navicke, Avram and Demmou, 2016^[29]). In most OECD countries, UBs are granted for at least twelve months (Koutsogeorgopoulou, 2020^[30]). The maximum

duration of UB varies from less than six months in Hungary and Israel to close to three years in Iceland and Sweden (OECD, 2020^[26]).

At low and middle incomes, the unemployment benefit design produces greater incentives to find work for longer unemployment spells. For longer unemployment spells, unemployment benefit is cut producing lower NRRs (Figure 3.21). For low, middle and high incomes (at 50%, 100% and 150% of the AW respectively) at short unemployment spells (1 – 3 months), the NRR declines from 83% to 76% to 59%. For medium unemployment spells (3 – 6 months), the NRR starts lower at 72% and falls to 64% and 59% and for longer unemployment spells (6 – 9 months), the NRR starts lower again and falls to 52% and 49%. The declining variable rate means that for longer unemployment spells, higher levels of previous (insured) income are needed to reach the same max UB. For short, medium and longer UB spells, the maximum UB is reached at gross incomes of 114%, 142% and 190% of the AW.

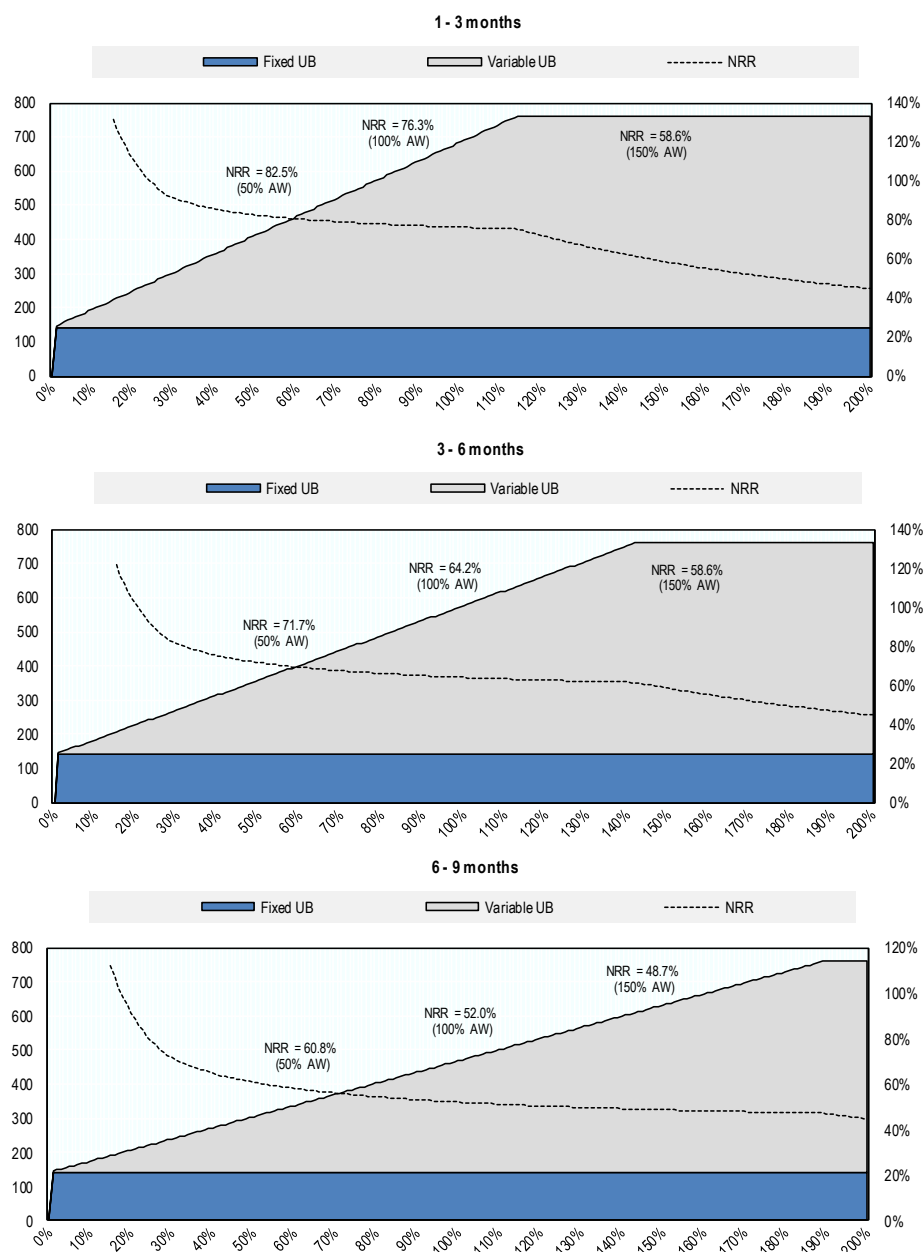
At high incomes, unemployment replacement rates are lower overall but remain constant for the unemployment period before declining sharply thereafter. At and above 190% of the AW, the UB is constant even with longer unemployment spells (Figure 3.21). A worker with previous insured income of 200% of the AW receives the same UB of EUR 760 (45% of the AW) throughout the 9 month duration. For these high earners, the subsequent decline in income as they transition from UB to social assistance benefits is relatively greater compared to lower earners thus producing one very large incentive to find work before the 9 month mark.

In countries such as Lithuania where unemployment benefits are untaxed, net replacement rates tend to be higher. UBs are not taxed in Lithuania, unlike several OECD countries such as Belgium, Canada, Denmark, Ireland and Norway. Any increase in labour taxes reduces in-work income without reducing out-of-work income, thus increasing NRRs and the attractiveness of unemployment in addition to the relative bargaining power of employees over employers.

In international context, low-income unemployed in Lithuania have relatively high NRRs for short and medium unemployment spells but much lower NRRs for long unemployment spells. For short spells of unemployment, low-income singles in Lithuania have among the highest NRRs in the OECD (82.5% vs 67.1%) (Figure 3.21). For medium spells, low-income singles in Lithuania have NRRs similar to but modestly above the OECD average (60.8% vs 52.9%). Therefore, NRRs are relatively high in Lithuania during the current 9 month UB duration. For longer spells of 10 months, NRRs in Lithuania are among the lowest in the OECD (because the UB duration of 9 months has expired and unemployed persons have transitioned to social assistance benefits). Consequently, under the three unemployment periods examined for a low-income worker, the NRRs in Lithuania change from among the highest NRRs after 2 months to among the lowest NRRs after 10 months. Given Lithuania's UB duration of 9 months, the sharp decline in the NRR at 10 months is significant relative to other countries. Given UBs in Lithuania are mostly determined by previous incomes, and that wages are somewhat low in Lithuania and include an income cliff at older ages (see Figure 2.7 and Figure 2.12), unemployment NRRs in Lithuania should remain relatively high to prevent the unemployed from falling deeper into poverty.

Figure 3.21. The unemployment benefit design produces greater incentives to work for longer unemployment spells

Unemployment benefit (fixed and variable portions) and NRR, by previous gross wage as a share of AW, 0 – 200%

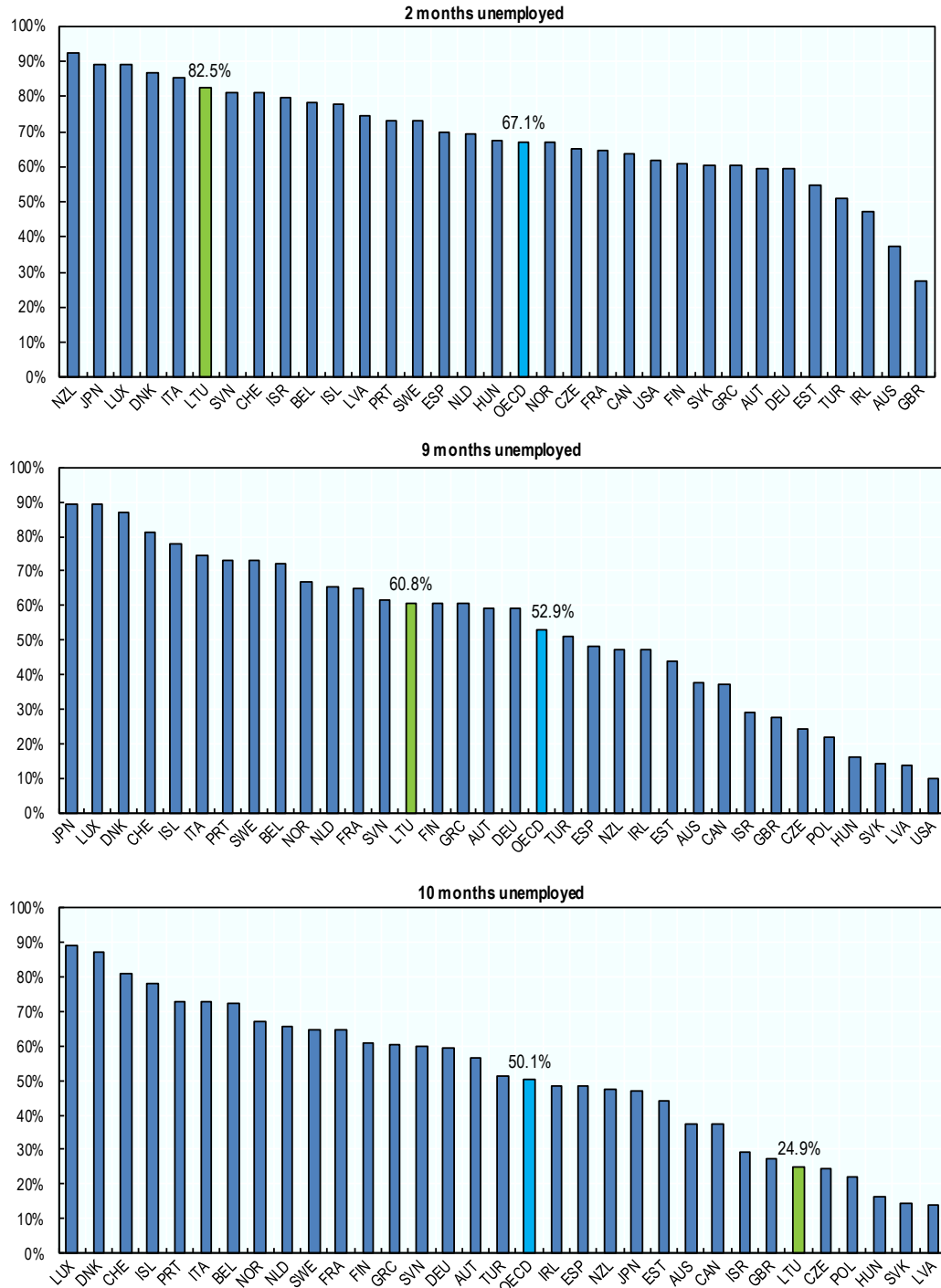


Note: The net replacement rate (NRR) shows total unemployment benefit as a share of net income (which represents a proxy for previously insured income in the model). Unemployment NRRs are calculated by comparing net family income out-of-work with net family income in work. Due to very high NRRs at low income levels, the NRR starts at 15% of AW. High NRR below this threshold represent a very small proportion of individuals.

Source: OECD analysis.

Figure 3.22. In international comparison, unemployment replacement rates in Lithuania are high for short spells but low for long spells

Net replacement rate in Lithuania and OECD countries, single individual at 50% of the AW, after 2, 9 and 10 months of unemployment, in 2020

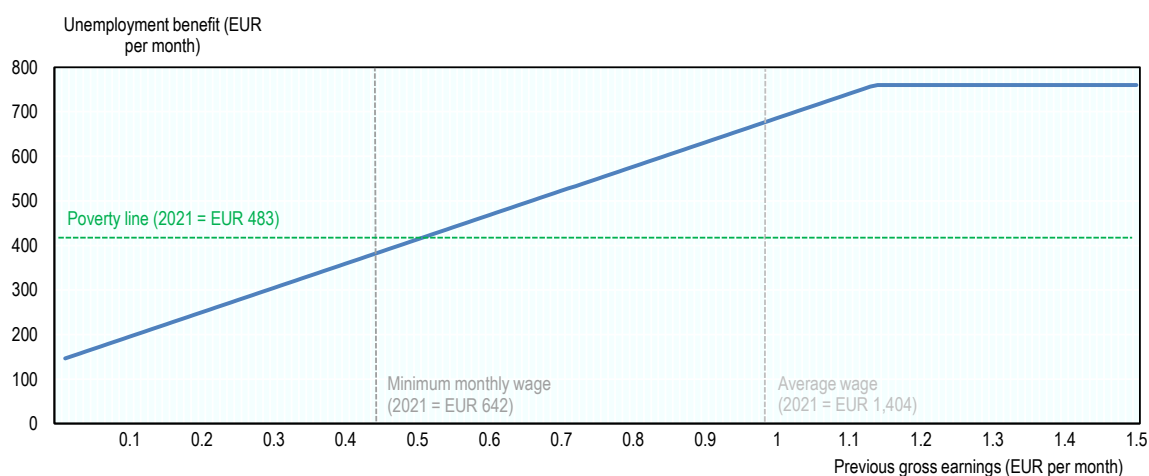


Note: OECD average is an unweighted average of the countries shown. OECD TaxBen NRR indicators assume a full contribution record.
Source: OECD Tax and Benefit model TaxBen.

Poverty risks are high for minimum wage Lithuanian workers who become unemployed. Lithuanian workers with previous gross earnings of 60% of AW or less in 2021 would be below the poverty line in the first three months of unemployment (Figure 3.23). A worker earning the minimum monthly wage in 2021 (46% of AW) would thus be further below the poverty line in unemployment. A distributional question then arises as to the share of Lithuanian workers that earn below these income thresholds who would face poverty risk in the event of unemployment. Given that 40% of individuals have monthly gross wage incomes of between EUR 500 and EUR 1,000 in 2020 (i.e. 35 – 70% of AW as calculated using the Lithuanian AW), the cohort who would face poverty in the event of unemployment is quite large. More generally, 56% of the unemployed are at risk of poverty in Lithuania 2020, up 2 percentage points on 2019. On the other hand, low-income unemployed persons in the first three months of unemployment have relatively high unemployment net replacement rates (NRR). For single individuals earning half the AW, NRRs are 83% in Lithuania vs 67% in the OECD, albeit they decline sharply in later months.

Figure 3.23. Poverty risks are high for minimum wage Lithuanian workers who become unemployed

Unemployment benefit in the first 3 months of unemployment, by previous gross income, 2021



Note: Long and continuous employment record (22 years) is assumed. Based on the 2nd month of unemployment. At a previous income at the minimum monthly wage, unemployment benefit is EUR 398 (fixed = EUR 642 x 23.27% and variable = EUR 642 x 38.79%).

Source: OECD Tax and Benefit model TaxBen.

Reform options

Given comparatively high levels of long-term unemployment and to give workers more time to find a job that matches their skills, the duration of unemployment benefit could be extended. Long-term unemployment in Lithuania (10 months or more) is relatively high in Lithuania compared to the OECD and over 20% of jobseekers stayed on unemployment for at least 9 months in 2016 (OECD, 2018^[27]). To support the long-term unemployed, the maximum period of UB could be extended, as has been proposed in previous OECD Economic Surveys (OECD, 2020^[31]) (OECD, 2018^[32]) and brought more closely in-line with the OECD average (of 12 months). Given high skill-mismatches in Lithuania, an UB extension would provide the unemployed with more time to find a job that matches their skills. This underlines the importance of implementing active labour market policies. From a distributional perspective, extending the

UB duration would benefit those at relatively higher poverty risk such as the low-skilled and older-workers particularly elderly women since they are more likely to be found among the long-term unemployed.

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.

The extension of the unemployment benefit duration should not be financed through reduced net replacement rates. The extension should not be financed through reducing the relatively high NRRs in the initial months of unemployment and reducing the UB income cap, which affect those on (previously insured) high incomes more. The former option would risk pushing the unemployed further into poverty. While the latter option would make the UB design more redistributive and equal, it would weaken the link between incomes and UBs which encourages formal work. These options could be considered in the long-term if wages were to increase significantly in Lithuania. Higher wages if achievable in the long-term would also support the currently low levels of social expenditure through higher labour taxes so that the duration of UB could be extended while maintaining the design.

To contain the high at-risk-of-poverty rates among the unemployed, eligibility criteria could be eased to widen unemployment benefit coverage. Under the New Social Model in Lithuania in 2017, the coverage of UBs were increased by easing eligibility conditions and made more generous by extending the duration of benefits to 9 months and raising payment rates (OECD, 2020^[31]). 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, given high and rising poverty rates among the unemployed (more than half the unemployed are at risk of poverty in 2020) (Figure 2.11), and that a low one-third of the unemployed registered with the Employment Services are entitled to UB (Užgalė et al., 2020^[28]), coverage could be further extended by easing eligibility restrictions. However, the impact of reducing the minimum SSC contribution on poverty and UB coverage may be limited (MoSSL impact assessment).

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.

Poverty risk faced by the unemployed is linked to relatively low wages. As we have seen UBs can be high relative to wages for low and middle-incomes, but they are also low relative to wages in other OECD countries because they are by definition mechanically linked to Lithuanian wages since the fixed portion of UBs are anchored against the government set level of MMS (which is set annually according to wage levels) and the variable portion of UBs is based on previous income levels. Even if Lithuania were to increase the fixed and variable rates used to calculate UBs, wage would remain a key determinant of UB.

Lithuania should maintain a strong link between previous income and unemployment benefits to encourage formal work. The variable component of UB is linked to the former level of insured income, which raises the relative attractiveness of formal employment. A strong link between previous earnings and UB encourages workers to progress in formal work by increasing income, effort and hours and more broadly investment in a career in the formal economy because, in the event of unemployment, they will be financially additionally protected through higher levels of UB. However, as this link weakens for higher

earners as the maximum limit on UB is imposed, formal employment then becomes relatively less attractive for higher earners.

Lithuania should continue its policy of not taxing unemployment benefits. As discussed previously, the Lithuanian authorities have decided against taxing UBs, unlike several OECD countries (such as Belgium, Canada, Denmark, Ireland and Norway). However, since SSCs are non-deductible from taxable personal income in Lithuania (i.e. they are paid out of after tax earnings), also unlike most OECD countries, there is little justification for taxing UBs in Lithuania. In addition, taxing UBs would further reduce NRRs risking pushing individuals further into poverty.

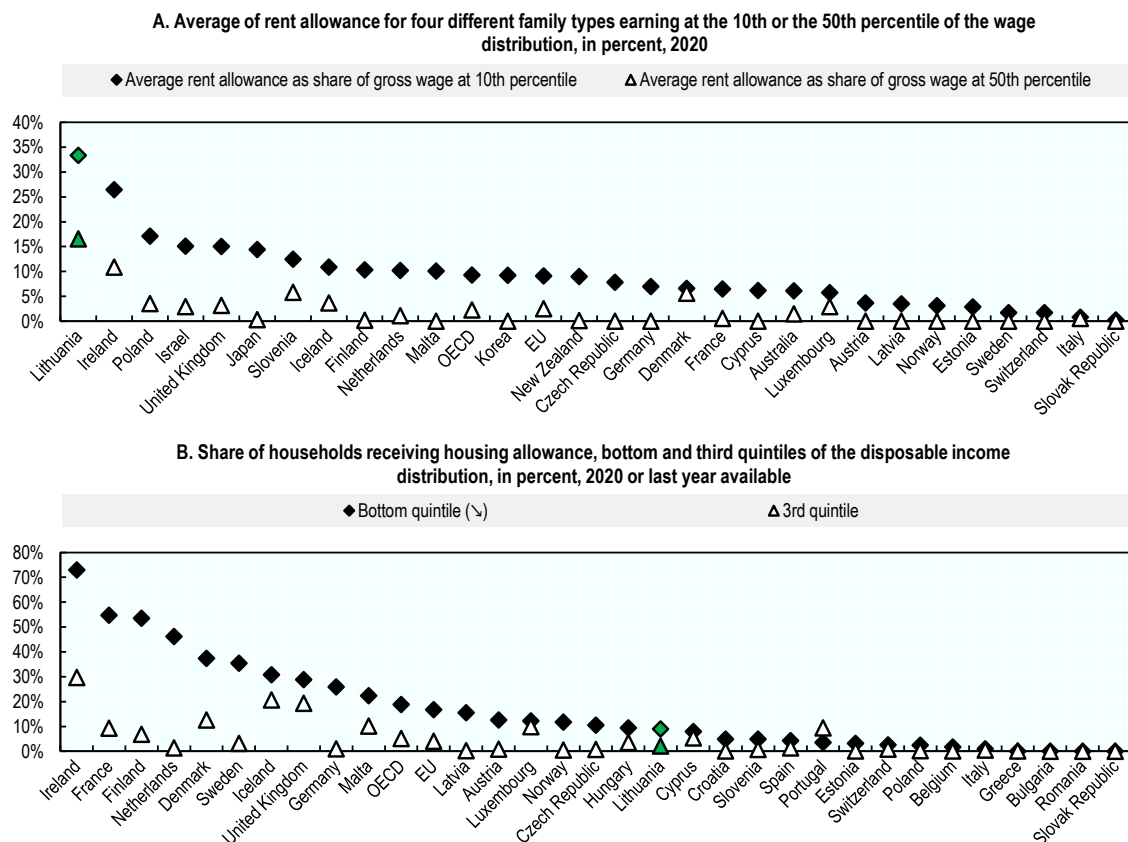
The design of housing benefits

Housing assets are a main source of wealth in Lithuania. In a paper on housing wealth using microdata in Lithuania, (Bielskis and Ciginas, 2020^[33]) make a number of important observations. First, the home ownership rate at 93.2% in Lithuania is among the highest in the EU. Second, total household assets in Lithuania are comprised of mostly of real assets (95.3%). Of all real assets, 67.5% is accumulated through housing as the main residence with a further 18.2% related to other real-estate¹¹. Accordingly, the share of renters is low and the lowest real estate wealth is accumulated by renters. Third, the authors distinguish between households that own old Soviet-era houses without mortgages but their wealth value from real-estate is small compared with younger households that own new houses with mortgages that have higher net wealth value. Indeed, a high 51.3% share of low-income households in 2017 in Lithuania live in dwellings that are owned outright (OECD, 2018^[32]). This means the value of real estate can be relatively high even for some of the lowest income households (i.e. individuals that hold little liquid wealth but sizable illiquid assets) (OECD, 2017^[24]).

However, housing quality is relatively poor. Around 6.5% of the low-income population (bottom quantile) in Lithuania experience severe housing deprivation, living in overcrowded and poorly equipped dwellings (OECD, 2018^[32]). This figure is high in international comparison. Housing quality remains an important challenge in post-socialist countries where much of the stock of housing was privatised after the independence; the current owners of these dwellings often have financial difficulties to maintain and upgrade them (OECD, 2017^[24]).

Lithuania has a generous housing benefit but its reach is limited. Lithuania has among the most generous benefit schemes in the OECD (Figure 3.24, Panel A). For families earning 10% and 50% of the AW, rent allowance represents 33% and 17% of gross wage respectively. However, the reach of the housing benefit is limited (Figure 3.24, Panel B). Of families in the bottom quintile, only 9% receive the housing allowance.

Figure 3.24. Lithuania has among the most generous housing benefit schemes in the OECD but its reach is limited



Note: Panel A: 1. Rent allowance calculated based on assumed rent of 20% of average wage. 2. Only shows central government housing allowance. Where no national scheme exists, a representative region was chosen, refer to country specific information for more details: <http://www.oecd.org/els/soc/benefits-and-wages-country-specific-information.htm>. 3. Full-time earnings are either at the 10th or the 50th percentile of the full-time wage distribution. No transitional benefits for entering the labour market are considered; social assistance but no unemployment benefits are considered. 4. The four family types considered are (1) single person, (2) single parent with two children aged 4 and 6, (3) one-earner couple and (4) one-earner couple with two children aged 4 and 6. Earnings are either at the 10th- or the 50th-percentile of the full-time wage distribution. 5. Data for New Zealand are preliminary and data for Korea refer to 2018. Panel B: 1. No information available for Australia, Canada, Chile, Colombia, Costa Rica, Japan, Korea, Mexico, New Zealand, Türkiye and the United States due to data limitations. Only estimates for 100 or more data points are shown. 2. Quintiles are based on the equivalised disposable income distribution. Low-income households are households in the bottom quintile of the net income distribution. 3. Data for Germany and Italy refer to 2019 and for Iceland to 2018. 4. In the United Kingdom, net income is not adjusted for local council taxes and housing benefits due to data limitations. Source: (OECD, 2021^[34]), indicator PH3.3.

Housing benefits aimed at renters and those in poor quality homes is significant, particularly for larger high-income families

One type of housing benefit in Lithuania that partly covers rental costs, available to renters and those living in worn-out dwellings, can represent a significant share of income. Housing benefit policy in Lithuania represents a large and complex policy area. This section focuses on the design and incentives produced by one type of housing benefit (HB hereafter) (*būsto nuomos mokesčio dalies kompensacija*) modelled in OECD TaxBen. Under this HB, part of housing rental costs are reimbursed by individuals and families under certain conditions including if they do not own a property, if the property is sufficiently worn-out or small in size. The HB is means-tested based on net income by family type whereby

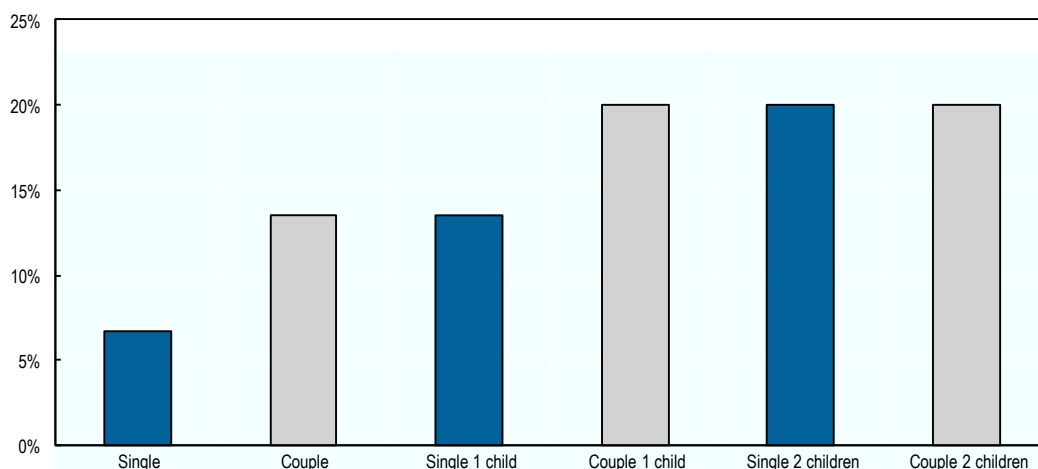
larger families (either with more adults or children) can continue to receive the HB at higher income levels¹². While the HB remains unaffected below the limit, it ceases in-full and at once when the limit is exceeded. For eligibility, assets and income cannot exceed defined limits. The HB is also capped at the level of rent (depending on the region and other factors), assumed at 20% of gross income in OECD TaxBen. HB per person is equal to the amount of compensation multiplied by the number of family members. In 2020, the HB is set at EUR 92.92 per person (7% of AW). A couple or a single individual with one child (i.e. both have same family size) have a max HB of EUR 185 (14% of AW) while a couple with one child have a max HB of EUR 274 (20% of AW).

Housing benefits are larger for larger families but are capped at rent levels. The value of the HB is substantial. For a single person, a parent with two children and a parent with 3 children, the HB represents 7%, 20% and 20% of the AW respectively (Figure 3.25). For a parent with 2 children, the HB value is 2.3 times that of child benefits. For larger families, HBs are greater and remain in place at higher incomes (Figure 3.26).

The financing of the housing benefit is partly shifting to the municipalities. A reform in December 2021 transfers a portion of the financial responsibility of the housing benefit scheme from the State to the municipalities in January 2024.

Figure 3.25. Housing benefits are larger for larger families but are capped at rent levels

Housing benefits as a share of the average wage in Lithuania, by family type, 2020

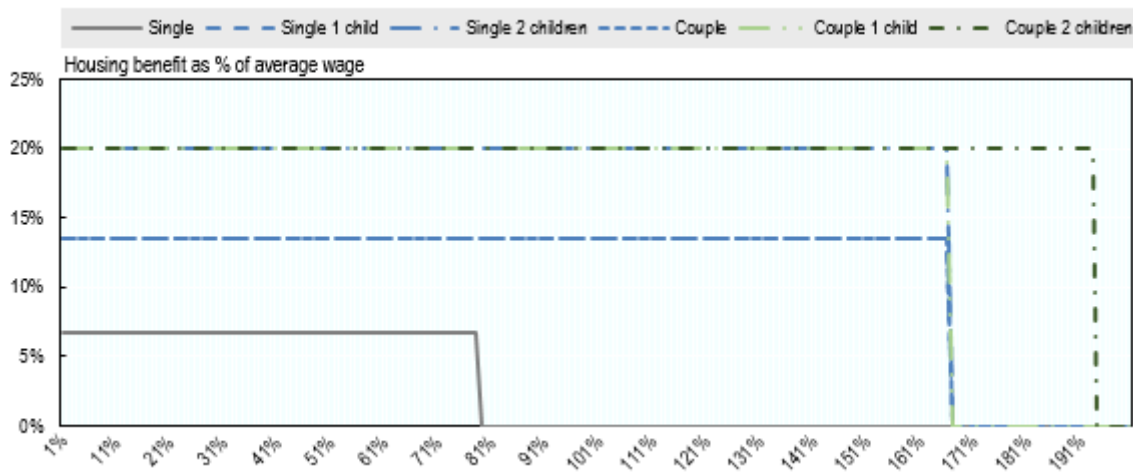


Note: The HB is also capped at the level of rent which in OECD TaxBen is assumed to be 20% of gross income.

Source: OECD Tax and Benefit model TaxBen.

Figure 3.26. Housing benefits remain in place at higher incomes for larger families

Housing benefits as a share of the average wage in Lithuania in 2020, for different family types, by gross income



Source: OECD Tax and Benefit model TaxBen.

Housing policy options

Consideration could be given to expanding the availability of the housing benefit. Lithuania has one of the most generous HB schemes in the OECD but its reach is limited (Figure 3.24). Expanding the availability of the housing benefit could be considered.

The availability of the housing benefit could be expanded, perhaps in particular to support single individuals. Single individuals are among the most at risk of poverty groups in Lithuania (Figure 2.11). From the perspective of household size, single-person households are the poorest (Bielskis and Ciginas, 2020^[33]). Compared with larger families with two adults or with children, single individuals receive not only relatively smaller housing benefits but those benefits are fully withdrawn at a lower level of income than for larger family types (approximately 80% of the AW), implying that middle-income single individuals just below the AW could also be at risk. Single individuals are less likely to own property (Bielskis and Ciginas, 2020^[33]) and may be more likely to be renters. Increasing the income level at which HB is available could be considered to support middle-income families but it would be costly and the withdrawal threshold is relatively high in international comparison. A preferred option could be to expand the availability of the HB with a focus on single individuals.

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 of the real estate tax including the relatively high exemption limit. 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.

The design of social assistance benefits

Social assistance benefit in Lithuania provides last resort income support for low-income households in need. Social assistance benefit (SA hereafter) is a last resort income support available to low-income individuals and families in need in Lithuania. A small 2 to 3% of the Lithuanian population receive SA. SA is available to a range of low-income individuals (and families) including the unemployed, retirees, low-income workers, students, persons taking care of children and other dependents. SA is granted for 3 months, but it can be renewed an unlimited number of times if circumstances remain unchanged. For unemployed persons of working age that are capable of work, the amount is progressively reduced with duration.¹³ Since 2021, the benefit for a single person decreases in general following a different reduction schedule.

Social assistance is based on state-supported income, which is linked to consumption needs and several other interconnected policy levers. SA is determined by several policy levers set by government. The factors are formalised mathematically in equation (1). The base of SA is represented by state-supported income (SSI). In terms of the calculation of SSI and shown in equation (1), the amount of SA in 2020 is calculated as the difference between SSI and income (defined as the average monthly net income of the family together per person¹⁴) so that the SA increases for each additional person in the family but at a declining rate (this occurs through the functioning of the equivalence scale). For example, for a single person in Lithuania in 2020, SA is 100% of the difference between the SSI and the average net monthly income per single person (where net income refers to gross income less PIT and SSCs). For persons living together and the second and third person, the share is reduced for each additional person, which is referred to as the income equivalence scale.¹⁵ Other factors in equation (1) that increase the level of income that can be disregarded for means-testing the SA (i.e. income disregards) and family size. The income disregards (ID) rule makes work more attractive by ‘disregarding’ a portion of net income from the SA means-test, conditional on the family structure. Overall, the authorities can then increase the level of SA in several ways including by raising the level of SSI, the income equivalence scales per person and income disregards. SA will also be higher for larger families (in equation 1 both directly through the numbers in the family and also more indirectly through a higher cumulative income equivalence scale) and for lower net income levels.

$$(1) \text{ SA} = [\text{SSI} - (\text{net income}/\text{no. family members})] \times [\text{cumulative income equivalence scale}]$$

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) (Navicke, Avram and Demmou, 2016^[29]). This time lag has resulted in recent increases in social benefit not keeping pace with rising inflation.

State-supported income was further increased in 2022. In January 2020, 2021 and 2022, SSI was increased from EUR 125 to EUR 128 to EUR 129 respectively. In June 2022, it was further increased to EUR 147 to combat rising energy prices.

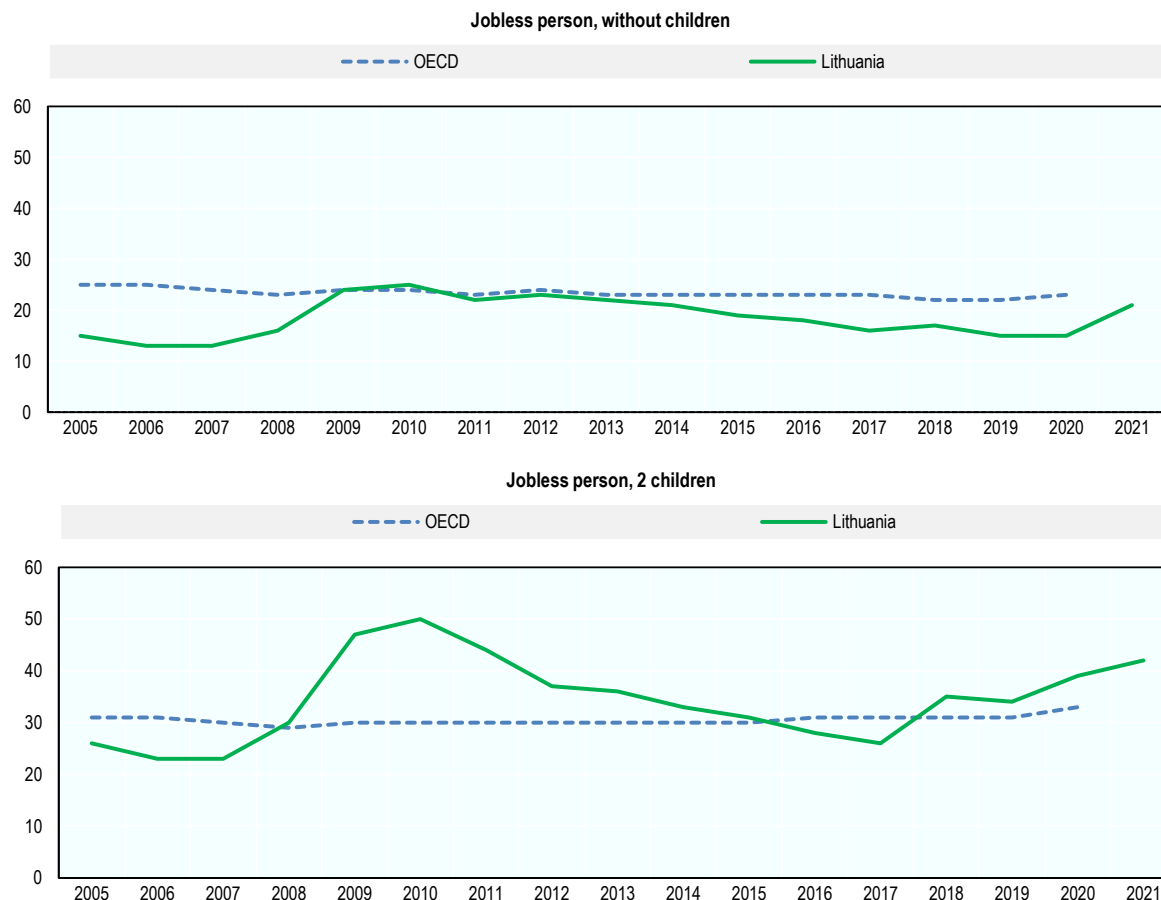
The amount of social assistance was increased and differentiated by payment duration in June 2020. For a single person, when SA is paid up to 6 months, the amount of SA is the difference between 1.4 SSI per person per month and the actual income of a single person. When SA is paid up to 6 to 12 months, SA is the difference between 1.2 SSI per person per month and the actual income of a single person. When SA is paid for more than a year, SA is the difference between 1.1 SSI per person per month and the actual income of a single person. With regard to a family, for a first family member, SA is the difference between the amount of 1.1 SSI per person per month and the actual income of the family member. For a second family member, SA is 90% of the difference between the amount of 1.1 SSI per person per month and the actual income of the family member. For a third and subsequent family members, SA is 70% of the difference between the amount of 1.1 SSI per person per month and the actual income of the family member.

However, social assistance benefits in Lithuania reduce poverty by less than in the OECD average. Figure 3.27, Panel A shows income of a jobless single individual claiming guaranteed minimum income benefits (but not unemployment benefits) as a percentage of median disposable income in Lithuania and OECD countries. The analysis highlights that minimum incomes in Lithuania alleviate poverty risks to a lesser extent than the OECD average for jobless single individuals, suggesting that Lithuania could consider increasing the SSI for this group.

Minimum income supports have increased recently. Minimum-income benefits form part of the redistribution system. Poverty avoidance and poverty alleviation are primary objectives of minimum-income benefits. An indicator of income adequacy (IA) is the guaranteed minimum income (GMI) as a share of the median disposable income. GMI is the net income of a jobless family claiming social assistance benefits that is not eligible for unemployment benefits (as they have expired). Lithuania has increased minimum incomes in recent years, more so for jobless persons with 2 children than for persons without children (Figure 3.27, Panel B).

Figure 3.27. Income adequacy improved in 2021

Guaranteed minimum income amount as % of median disposable income, Lithuania and the OECD, 2005 – 2021



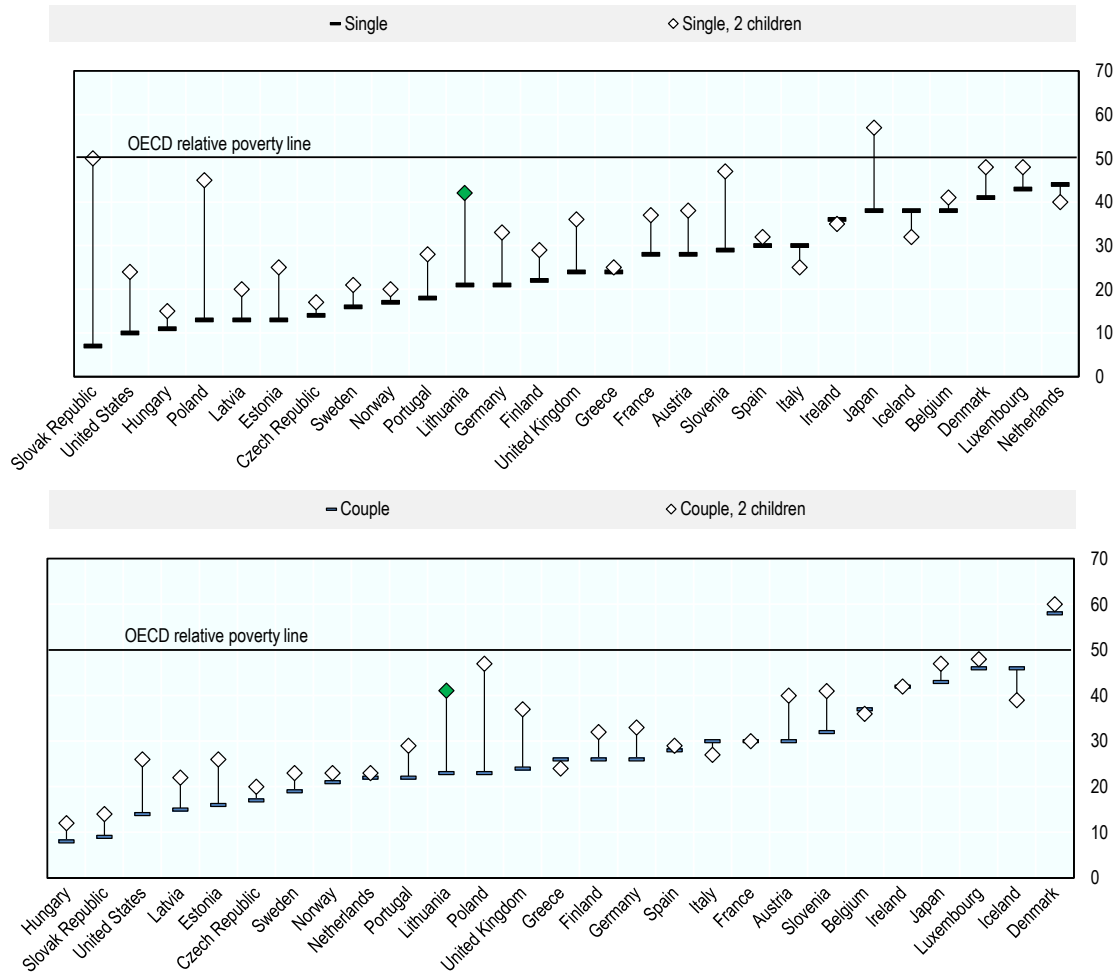
Note: Housing benefits not included. Both the numerator and denominator of the income adequacy indicator are adjusted for family size using the square root of the family size.

Source: OECD Tax and Benefit model TaxBen.

Benefits of last resort are modest for single individuals but among the highest for families with children. GMI as a share of median incomes are below the poverty line in Lithuania and in most OECD countries (Figure 3.28). A single individual without children in Lithuania has a minimum income of 29% of the median disposable income in 2021 vs a poverty line of 50% of the disposable median income. GMI as a share of median incomes in families with children is higher relative to single persons in Lithuania and in OECD countries generally.

Figure 3.28. Income adequacy is relatively high for families with children

Guaranteed minimum income amount as % of median disposable income, 2021



Note: Housing benefits not included. Both the numerator and denominator of the income adequacy indicator are adjusted for family size using the square root of the family size.

Source: OECD Tax and Benefit model TaxBen.

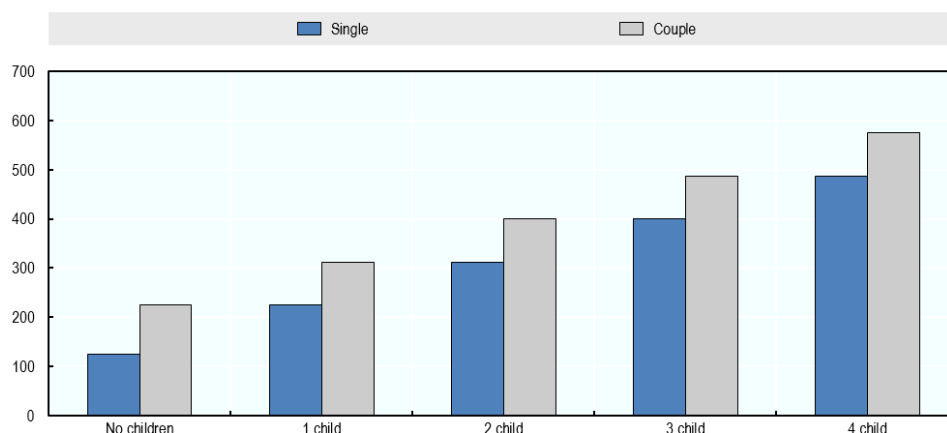
Social assistance increases progressively for larger size families. As implied by equation (1), the max SA benefit increases progressively with larger family size (Figure 3.29).¹⁶ In 2020 the max SA for a single person would be EUR 125, a couple EUR 225 (EUR 125 + EUR 125*80%), a single parent with two children EUR 313 (EUR 125 + EUR 125*80% + EUR 125*70%) and a single parent with three children EUR 400 (and so on). In terms of the rate of increase of the SA, since the income equivalence scale in 2020 declines with additional persons (100% of the difference for the first adult, 80% for second and 70% thereafter), after the second person, the 70% share remains constant and the rate of SA increase remains the same (in absolute terms). In addition, social assistance declines as incomes increase from low to middle-income levels, at first quickly and then more gradually as incomes rise for different family types.

On top of social assistance, a further pupil assistance is available to low-income families with school children. On top of SA, pupil assistance is also available to low-income families with school-age

children. The amount of the pupil assistance is BSB*2 per year (paid in cash). It is available to families with average monthly income per family member lower than 1.5*SSI.

Figure 3.29. The social assistance benefit is larger for larger families

Maximum social assistance benefit by family type, 2020



Note: Since the OECD TaxBen baseline scenario assumes the first and second child in a family are aged 4 and 6 respectively and pupil assistance is available to students studying from 6 to 18 years, pupil assistance is only available to families with at least two children in the OECD TaxBen model.

Source: OECD Tax and Benefit model TaxBen.

Social assistance benefit policy options

Given the scale of the poverty challenge, Lithuania should continue to increase social benefits through increasing state-supported income. The most effective way to increase SA in Lithuania in 2020 is through increases to the SSI and the income equivalence scale based simulations of 10% increases in different policy levers (from baseline level in 2020) (Figure 3.30). At middle-income levels (50% of AW), SSI remains the most important factor but income disregards becomes relatively more important as net incomes increase and so too does the share that can 'disregarded' from the means-test.

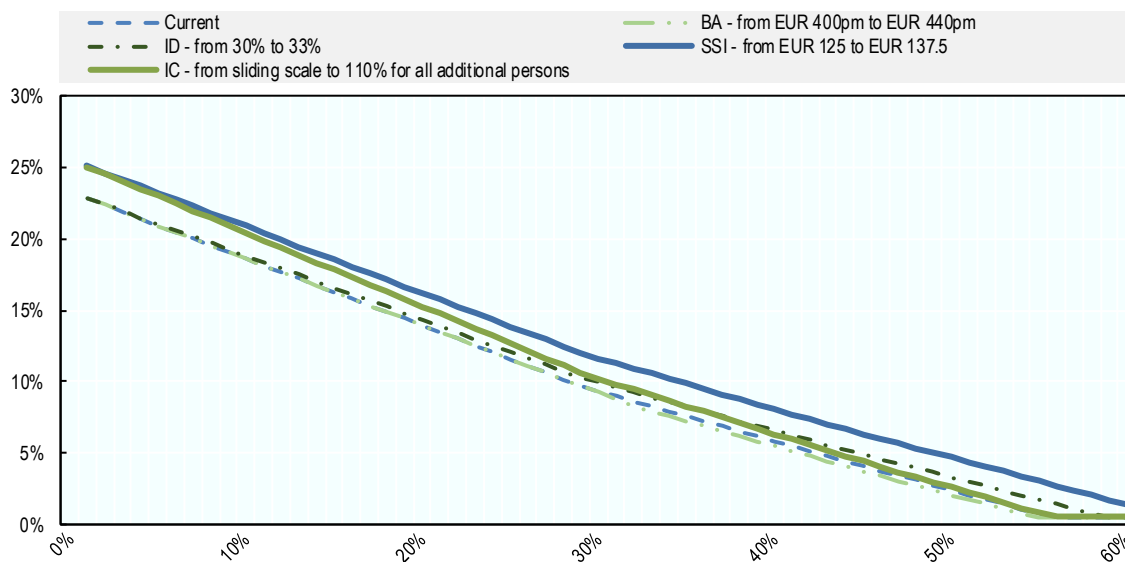
Recent increases in social benefit are insufficient to keep pace with rising wages and inflation so regular indexation of SSI increases could be considered. In recent years, Lithuania has introduced reforms to support those most in need including linking the SSI to consumption needs in 2019 and increasing the amount of the SSI since then (most recently to EUR 147 per month in June 2022). While these reforms provide modest support in the direction of containing poverty rates, the amounts are low and the rates of increase may lag those of inflation and wage growth. Lithuania could change its policy of ad-hoc annual SSI increases to regular indexation of SSI increases with inflation.

While the design of social benefit supports larger families, it may be low for single individuals on a relative needs basis. The SA available to childless single individuals could be relatively low compared to larger families given their needs. Based on a square root equivalence scale (where the needs of a family are reflected by the square root of family size), the max SA benefits for larger families are high relative to singles. Compared to a single individual, a family of four receives 3.2 times the SA but has only twice the needs. A relatively higher benefit for larger families was also the case for the housing benefit (see Figure 3.24) highlighting Lithuania's strong policy focus on protecting families. However, single individuals may be somewhat under compensated by SA based on their needs relative to larger families. One option to reduce this disparity would be to increase the overall level of the SSI but to simultaneously rebalance the

equivalence scales by reducing them after the second person thus further protecting high risk of poverty single individuals and single parents. Such a rebalancing of the equivalence scale would be in line with international norms. The income equivalence scale in Lithuania in 2020 (at 100%, 90% and 70% per additional person respectively) is relatively high (the Eurostat scale of poverty calculations which is 100%, 50% and 30%) which implies that Lithuania gives relatively high weights per each additional person in international comparison. In 2021, the amounts of social assistance have since been revised.

Figure 3.30. Increasing state-supported income and the income equivalence scale are effective policy levers for raising social assistance benefits

Simulating social assistance benefit, for a given 10% increase in SSI, income equivalence scale, income disregards and the basic allowance, single family with two children, Lithuania in 2020



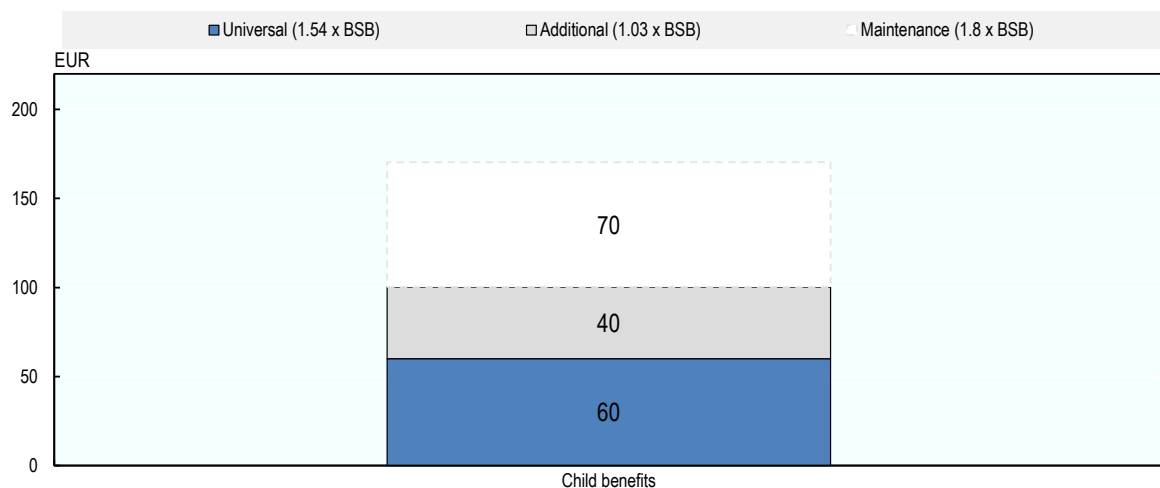
Source: OECD Tax and Benefit model TaxBen.

The income disregards rule encourages formal employment, but it could be enhanced for single individuals and couples. The income disregards (ID) rule in Lithuania allows a portion of net in-work income to be 'disregarded' for the SA means-test. The portion disregarded is higher for larger families and more so for larger single parent families (for individuals or couples with no children, it is 15%, for couples raising one or two children it is 20%, for couples raising three or more children it is 25%, for individuals raising one or two children it is 30% and for individuals raising three or more children it is 35%) (note that since June 2020, disregards were increased by a further 5 p.p.). The ID rule slows the decline of SA as incomes rise encouraging formal employment. As income rises, the rate at which the SA declines is slower for larger and single parent families (such as a single parent with four children), providing a greater incentive to escape the poverty trap relative to childless single individuals and couples. For a low-income couple with 4 children, if there were no ID rule in place at gross incomes of EUR 300, 500 and EUR 700, the family would receive SA of EUR 390, EUR 282 and EUR 192 in 2020. With the ID rule (where 25% can be disregarded for this family type), the family would instead receive EUR 436 (+12%), EUR 355 (+25%) and EUR 288 (+50%).

The design of child benefits

Lithuania currently has several child benefits focused on supporting low-income and larger families with children. This section focuses on the universal child benefit (UCB) and the additional child benefit (ACB) rather than the COVID-19 supplemental child benefit (CCB) and the maintenance child benefit (MCB). The CCB is temporary (and not part of any baseline child benefit analysis) and the MCB refers to state alimony paid to single parents (and not a government benefit in the normal sense). UCB is EUR 60.06 per child per month in 2020 (1.54 x basic social support or BSB of EUR 39 per month 2020) (Figure 3.31). As the name suggests, the benefit is paid universally to all children (up to 18 years of age and up to 21 years of age if studying) and is not means-tested. ACB is EUR 40.17 per child per month in 2020 (1.03 x BSB). ACB is aimed at supporting low-income families with one to two children, families with three or more children and children with disabilities. Unlike UCB, ACB is means-tested for low-income families with one or two children. The average family's income per person per month should not exceed EUR 250 per month (or SSI x 2) or EUR 3 000 per year¹⁷ (note that a single parent with one or two children implies a family of two or three persons while a couple with one or two children implies a family of three or four persons). For a family of two, three or four persons, the family's monthly income should not exceed EUR 500 (EUR 6 000pa), EUR 750 (EUR 9 000pa) and EUR 1 000 (EUR 12 000pa) respectively. ACB is not means-tested for larger families with 3 or more children. Lastly, and although not the focus of this review, the MCB is EUR 70.2 per child per month in 2020 (1.8 x BSB). MCB applies to children that do not receive all (or part) of the support awarded from their parents. It is aimed at supporting single individuals raising children (and is not available to couples). A family may be entitled to one, two or all three of the child benefits, in which case the benefits are added together.

Figure 3.31. The main child benefits in Lithuania are the universal and additional child benefits

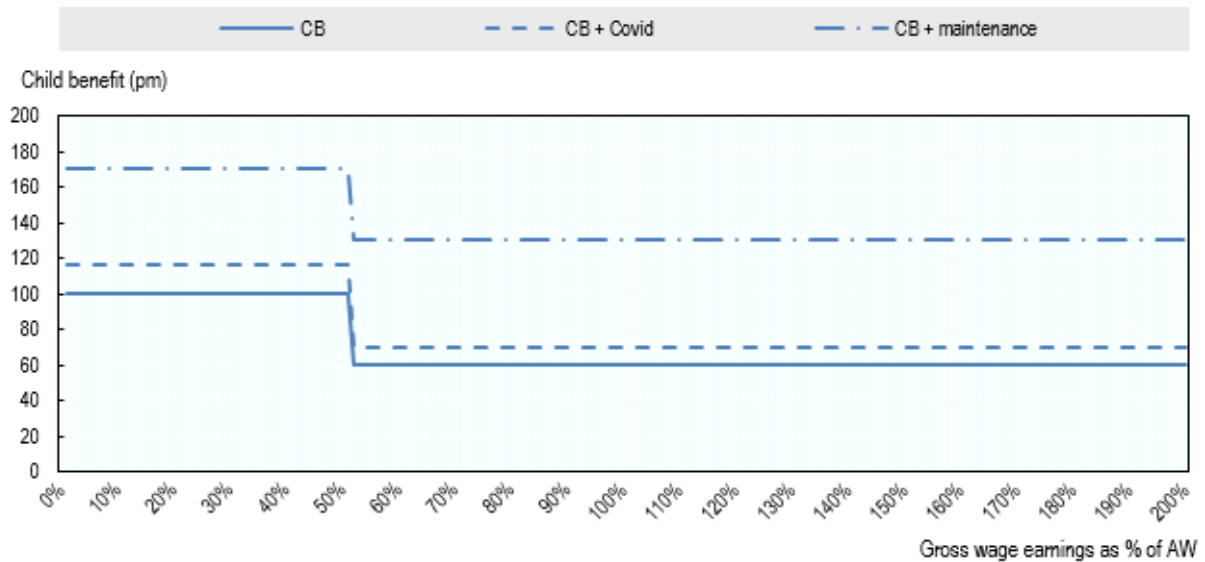


Source: OECD analysis.

While the universal child benefit remains in place regardless of income, the mean-tested additional child benefit is withdrawn at higher incomes for smaller families. The UCB remains constant across the income distribution (as it is paid regardless of income) while the ACB is withdrawn at higher incomes (as it is means-tested based on average family net income) (Figure 3.33).¹⁸ For a single parent with one child, the ACB is withdrawn at 52% of the AW (as net income exceeds EUR 500).

Figure 3.32. Child benefits fall as incomes rise due to the withdrawal of the mean-tested additional child benefit

Child benefits in Lithuania in 2020, single person with one child, by gross income



Note: Total child benefit (CB) is the sum of the universal child benefit and the additional child benefit. The child benefit plus a COVID-19 supplement is the sum of the increased UCB and ACB. The child maintenance benefit includes child benefit but not the COVID-19 supplement. Source: OECD analysis of *Taxing Wages 2021*.

Child benefit policy in Lithuania favours larger families and parents in a couple

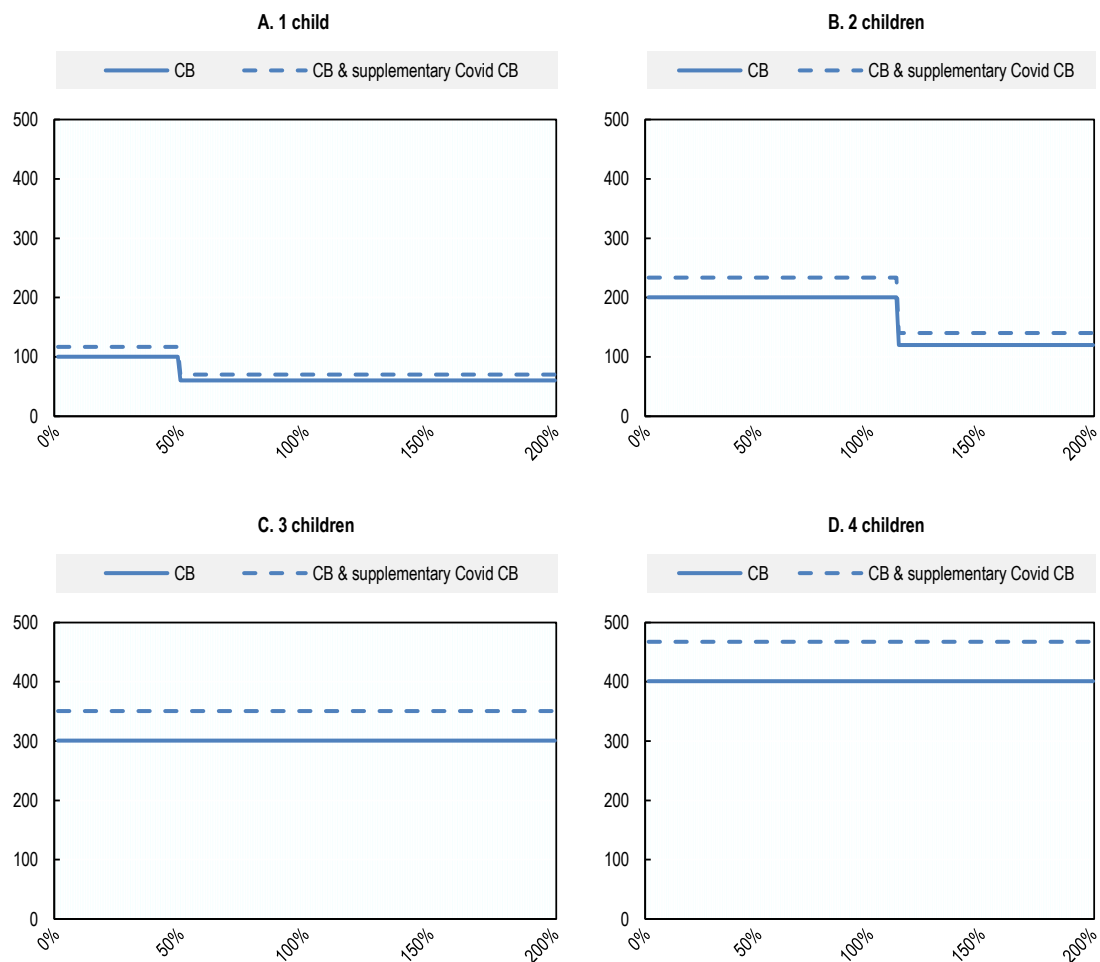
Child benefit amounts increase linearly for each additional child at lower income levels. For low-income families, the monthly child benefit (CB) amount increases by EUR 100 per additional child. Below the ACB income threshold (45% of the AW), a single individual or a couple with one, two, three and four children would each receive a total monthly CB of EUR 100, EUR 200, EUR 300 and EUR 400 respectively. CB (i.e. UCB and ACB) declines at higher income levels as the means-tested ACB is withdrawn (Figure 3.33).¹⁹ For single parents with one and two children, the ACB is withdrawn fully and at-once at ~50% and ~82% of AW respectively.

High income families with two children face a higher tax burden than an equivalent family with a third child because the ACB is not withdrawn. In addition to larger families receiving greater child benefits with more children, middle and higher-income larger families with three or more children benefit from the non-withdrawal of the ACB as incomes rise (relative to families with two or less children) (Figure 3.33).

Child benefit policy is more favourable to couples than single parents at middle-incomes. Couples with one child benefit from the ACB at higher income levels (up to ~82% of AW) relative to single individuals with one child (only up to ~50% of AW) as the benefit is based on the average family's income per person. Similarly, couples with two children continue to benefit from the ACB up to ~113% of AW compared to just ~82% for single parents with two children. This occurs partly because there are two adults instead of one in the couple with the same gross earnings so they are eligible for means-tested benefit for longer.

Figure 3.33. Single families with more children receive greater child benefits

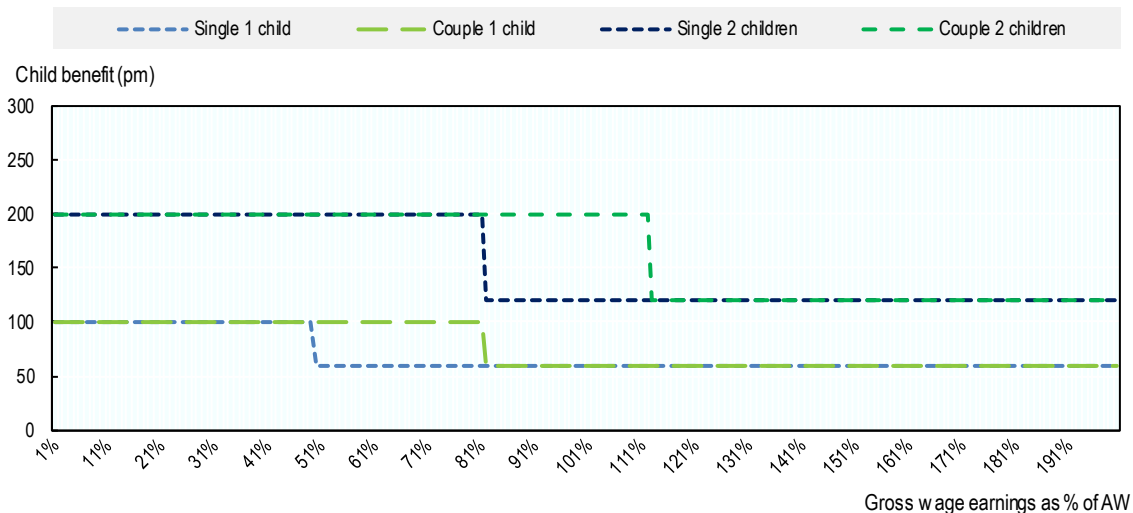
Monthly child benefits (EUR) by gross wage as a % of average wage, single families with children, 2020



Source: OECD analysis of *Taxing Wages 2021*.

Figure 3.34. Child benefit policy modestly favours middle-income couple parents over single parents

Child benefits for single and couple parents with one and two children in Lithuania in 2020, by gross income



Source: OECD analysis of *Taxing Wages 2021*.

The withdrawal of the additional child benefit is not insignificant in absolute and relative amounts.

For a single parent with one or two children, the withdrawal of the ACB would represent a nominal decline in the monthly child benefit of 40% (from EUR 100 to EUR 60 and from EUR 200 to EUR 120 respectively). In the latter case of a single parent with two children the loss of EUR 80 per month is not insignificant at 5.7% of the AW. The withdrawal of the child benefit could produce some risks of poverty trap, which are explored later (see Figure 4.27) and a gradual tapering could be considered if administratively feasible.

A temporary additional child benefit was introduced in response to the pandemic

A once-off additional lump-sum child benefit was introduced in June 2020 to reduce the effects of COVID-19 on families. The maximum child benefit per child per month in 2020 is EUR 100 (60 UCB + 40 ACB) and EUR 117 when the additional 'covid' lump-sum is included (70 + 47).²⁰ These combined child benefits represent 7.1% and 8.3% of the AW respectively. The once-off lump-sum child benefit introduced in June 2020 to reduce the effects of the COVID-19 pandemic increased the child benefit by 17%.

The additional covid child benefit raises the benefit by the same proportion regardless of family type. For single individuals and couples, the COVID-19 supplement increases the benefit by 17% regardless of the number of children. Although the CCB and MCB are not included in child benefits as part of the baseline analysis in this report, if they were to be included, a single family with one child can receive a max total child benefit of EUR 170 (comprised of UCB EUR 60, ABC EUR 40, CCB EUR 17 and MCB EUR 70) and a single family with two children can receive a maximum of double or EUR 340 (EUR 120, EUR 80, EUR 34, EUR 140).

Although not a standard child benefit paid by government, the maintenance child benefit is a significant support for single families. The MCB is targeted at the children of single individuals. The MCB is paid to children not receiving all or part of the support awarded by the child's parents. The MCB is a max of EUR 70 (BSB x 1.8) per month per child and increases linearly with more children in absolute terms. For low earners, compared to the UCB and ACB (EUR 60 + EUR 40), the MCB (EUR 70) represents a significant 70% increase in combined child benefit. Given that low-income couples and single individuals have the same child benefits regardless of the number of children, the MCB also represents a 70% increase in benefits compared to couple families. For higher income wage earners (above the ACB income threshold), compared to only the UCB (EUR 60), the MCB (EUR 70) represents a larger 117% increase. Despite the increase represented by the MCB, it is not means-tested and remains constant regardless of income.

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Notes

¹ According to data from Statistics Romania, monthly gross average earnings increased from 4143 Romanian leu in January 2018 to 6031 Romanian leu in January 2022.

² Note that the microdata sample size is insufficiently large to examine the tax shares at the income level where the top PIT rate and SSC ceiling apply.

³ The monthly average wage of EUR 1 400 is based on OECD secretariat estimate for 2020. In Lithuania, the average wage applied to calculate the state social insurance contribution base is approved by the law of Approval on Budget Indicators of the State Social Insurance Fund for the relevant year. It is the average gross monthly earnings (including salary data for the sole proprietorships) published by the Statistics of Lithuania of Q3 and Q4 for the year before the previous year and Q1 and Q2 for the previous year. In the third quarter of 2019, the average gross monthly earnings in the whole economy (individual enterprises included) totalled EUR 1 306.30. In the third quarter of 2020, the average gross monthly earnings in the whole economy (individual enterprises included) totalled EUR 1 443.80.

⁴ The monthly average wage of EUR 1 400 is based on OECD secretariat estimate for 2020.

⁵ Note that the average wage (AW) calculated by Statistics Lithuania and OECD Taxing Wages are similar but not the same.

⁶ The basic allowance is applied to employment and related income.

⁷ Individuals or groups of the population obtain health care through a variety of financing arrangements. These involve a range of third-party schemes but also, by convention, payments made directly by households. Government financing schemes, on a national or subnational basis or for specific population groups, entitle individuals to health care based on residency, and form the principal mechanism to cover health care costs in close to half of OECD countries. The other main method of financing is some form of compulsory health insurance (managed through public or private entities) (OECD, 2021^[23]).

⁸ $\text{EUR } 607 * 23.27\% = \text{EUR } 141.25$ in 2020 and $\text{EUR } 642 * 23.27\% = \text{EUR } 149.39$ in 2021.

⁹ A gross monthly AW of EUR 1,306.3 in Q3 2019 implies unemployment benefit cannot exceed EUR 760.01 in January 2020 and in Q3 2020, the gross monthly AW is EUR 1 443.8 and so the maximum unemployment benefit cannot exceed EUR 840.

¹⁰ Insured income is all incomes of an individual from which the unemployment insurance contributions were paid or had to be paid. The average monthly insured income is calculated taking account of the amount of the actual insured income of an unemployed person for every month during the previous 30 months.

¹¹ Only 10.5% of wealth corresponds to self-employed business and 3.7% is accumulated through financial vehicles.

¹² According to OECD TaxBen, the net annual income of a person without a family is 62 SSI, net annual income for a family of two or three persons is 122 SSI and net annual income *per person* for a family of four or more persons is 35 SSI. The model also assumes the location is Vilnius.

¹³ Since 30 September 2016, the list of circumstances under which cash social assistance cannot be reduced was expanded. The scheme of proportionate reduction of social benefit is not applied if at least one of the following conditions holds: the Employment Service did not offer a job or an opportunity to participate in active labour market policy measures; a working-age unemployed person (who is employable and not in education) participated in useful social activity organized by the municipal administration. In the model, it is assumed that one of the above conditions are satisfied, thus the reduction in social benefits is not modelled.

¹⁴ The average monthly income of the resident is determined based on their income in the previous 3 months from which the social benefit is granted.

¹⁵ More specifically, for persons living together, for the first person, SA is 100% of the difference between the SSI per person and the average monthly income of the persons living together per person. For the second and third person, the share is reduced to 80% and 70% respectively.

¹⁶ It is a maximum because it assumes persons with more income can earn a smaller fraction of the SA.

¹⁷ Income refers to income in the previous calendar year. In the TaxBen model, this is assumed to be current gross income.

¹⁸ Similarly, the child maintenance benefit is paid regardless of income and as long as the requirements are met – the child is part of a single family (i.e. children who do not receive all or part of the support awarded by the child's parent).

¹⁹ With the exception of the child maintenance benefit, which is only available to single families and not couples.

²⁰ Not including the maintenance child benefit.

4 The incentives to work in Lithuania

This chapter provides an assessment of the incentives to work in Lithuania. It begins with a discussion of optimal tax theory and an evaluation of the tax burden in Lithuania. Next, the chapter examines the current incentives to enter work followed by the incentives to progress in work.

Introduction

Lithuania's policy preference for redistribution may come at the cost of weaker work incentives among low earners. The optimal tax theory literature suggest a trade-off between strong targeted redistribution and weak work incentives where neither option is necessarily better but rather they provide possible options depending on a countries objectives. Striking the right balance between work incentives and redistribution depend on a society's current distribution of income (relatively unequal in Lithuania), desire to redistribute (relatively strong in Lithuania) and the responsiveness of labour supply. Given Lithuania's policy emphasis on redistribution, some modest to high PTRs and METRs are to be expected. High and positive effective tax rates at low-incomes are common among low-income workers in most countries and reflect not just low work incentives but also strong redistribution. High METRs are also caused by the phasing-out of targeted supports, which is sometimes the case in Lithuania. Indeed, the better the tax and benefit system targets low incomes, the higher the PTRs and METRs such that high effective tax rates can demonstrate effectively targeted redistribution policy.

Unemployment and social assistance benefits represent one form of redistribution that can lead to incentive traps. Research shows that tax and benefit policies are more effective at the extensive margin (i.e. encouraging the unemployed to enter work) than the intensive margin (encouraging those in work to work more) since the former low-income unemployed group tend to be more responsive to tax and benefit policies (i.e. they have a greater labour supply elasticity). On the extensive margin, Lithuania provides social supports to the unemployed and inactive persons, particularly single families with children. Such redistributive policies are equitable but they invariably produce incentive traps (see Box 4.2). Unemployment states can be short-term (individuals are entitled to unemployment benefit) and long-term (individuals are entitled to lower social assistance benefit) (Box 4.2),¹ which in turn produce short and long-term PTRs. Short and long-term PTRs then measure work attractiveness during short and long-term unemployment spells respectively. As is the case in Lithuania and many OECD countries, UBs are gradually reduced in the short-term and then replaced in the long-term by lower social assistance benefits (see Table A.A.1), which increases work attractiveness for longer unemployment spells thus potentially avoiding unemployment and/or inactivity traps.

Optimal income tax theory provides some general insights on the setting of taxes and benefits to balance efficiency and distributional objectives. There are a number of key insights from the literature for when marginal tax rates should be higher (Figure A.A.2). First, when governments care about redistribution. Second, when few families and individuals are subject to the top marginal tax rate. Third, when a large numbers of families and individuals earn higher incomes. Fourth, when taxpayers are relatively less responsive to high tax rates. Low incomes in Lithuania may not provide a strong case for higher marginal effective tax rates, but wages have been rising rapidly in recent years. The responsiveness of low-income workers in Lithuania at the extensive margin is likely to be higher (as is the case in many countries) and relatively responsive groups should not face high tax rates. The substantial participation elasticities found for low-income workers imply that low-income workers should not face high effective tax burdens when moving into work, unless the preference for redistributing income to individuals out-of-work is extremely strong (Saez, 2002_[1]). Instead, marginal tax rates should be higher further up the income distribution at points where taxpayers are less responsive but less prevalent.

Table 4.1. Lessons from optimal tax theory

Cases when METRs should be higher (according to optimal tax theory)	Application to Lithuania
The government cares more about redistribution.	The XVII Government of Lithuania has placed a focus on redistribution, given its priority to reduce poverty, inequality and social exclusion. This may suggest that the government gives less weight to the loss in welfare of higher marginal tax rates.
Few families are subject to the marginal rate.	Lithuania's low wage distribution implies few families are subject to the higher PIT rate and associated PIT METRs, so the cost in terms of labour supply would be lower than otherwise.
A larger number of families earn higher incomes.	Given the large share of low earners, it will be more challenging to raise marginal effective tax rates without negatively impacting labour supply. This case does not support higher METRs.
Families are relatively less responsive to high tax rates (i.e. the cost in terms of reduced labour supply is lower).	Low-income earners are typically more responsive to high effective tax rates. Taxpayers are typically more responsive at the extensive margin. Given the relatively high share of low-income and unemployed persons in Lithuania and evidence of a relatively high informal economy, this may support the case for lower METRs at lower incomes and higher METRs at higher incomes (where taxpayers may be relatively less responsive in terms of labour supply). More evidence is needed to evaluate the differential labour supply responses among low and high-income earners in Lithuania.

Source: OECD analysis; (Brewer et al., 2006^[2]).

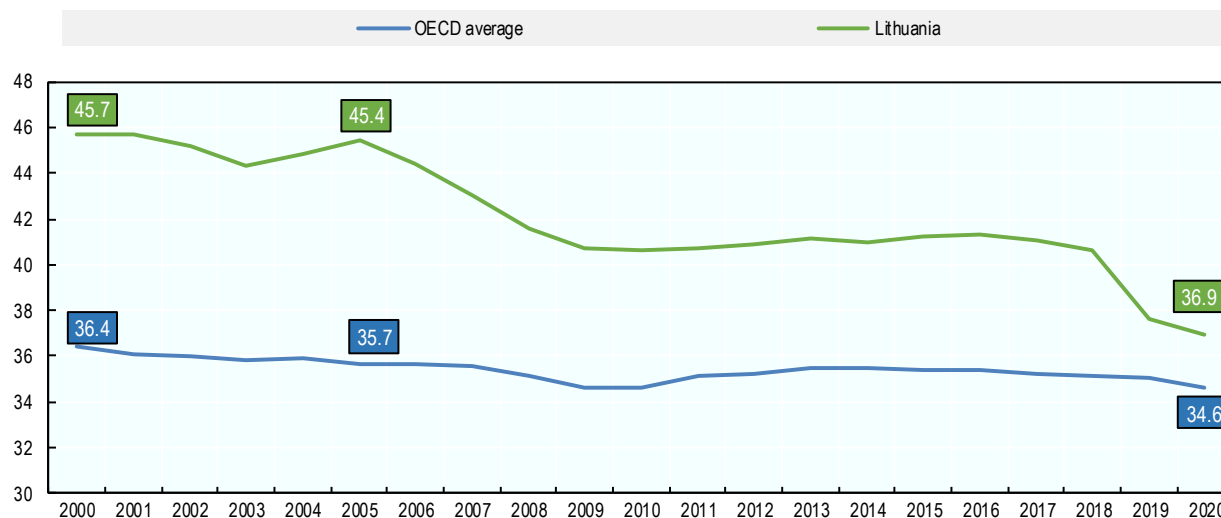
The tax burden in Lithuania

Lithuania has narrowed the tax wedge gap with the OECD average. Over the past two decades, the tax wedge in Lithuania has been declining notably before and during the Great Financial Crisis and more recently during its labour tax reform in 2019 and the subsequent COVID-19 pandemic that followed it (Figure 4.1).

Despite declines in 2019 and 2020, Lithuania's labour tax burden remains above the OECD average. The average tax wedge in Lithuania for a single person at the average wage was 36.9% in 2020, above the OECD average of 34.6% (Figure 4.1). The tax wedge in Lithuania is driven mostly by employee SSCs and PIT, unlike the OECD average where the decomposition represents a more balanced split across employee SSC, employer SSCs and PIT. The average tax wedge in Lithuania fell in 2019 due partly to the cut in SSC rates and the accompanying introducing of the progressive PIT as part of the labour tax reform. It fell further in 2020 due to further reforms including COVID-19 tax and benefit provision responses (Figure 4.2). The tax wedge fell in 29 out of the 37 OECD countries in 2020, largely reflecting lower income taxes and linked to lower nominal AWs reflecting policy changes including tax and benefit measures introduced in response to the COVID-19 pandemic (OECD, 2021^[3]).

Figure 4.1. Lithuania's tax wedge has narrowed the gap with the OECD in recent decades

The average tax wedge in Lithuania and OECD, single person without children at the average wage, 2000 - 2020

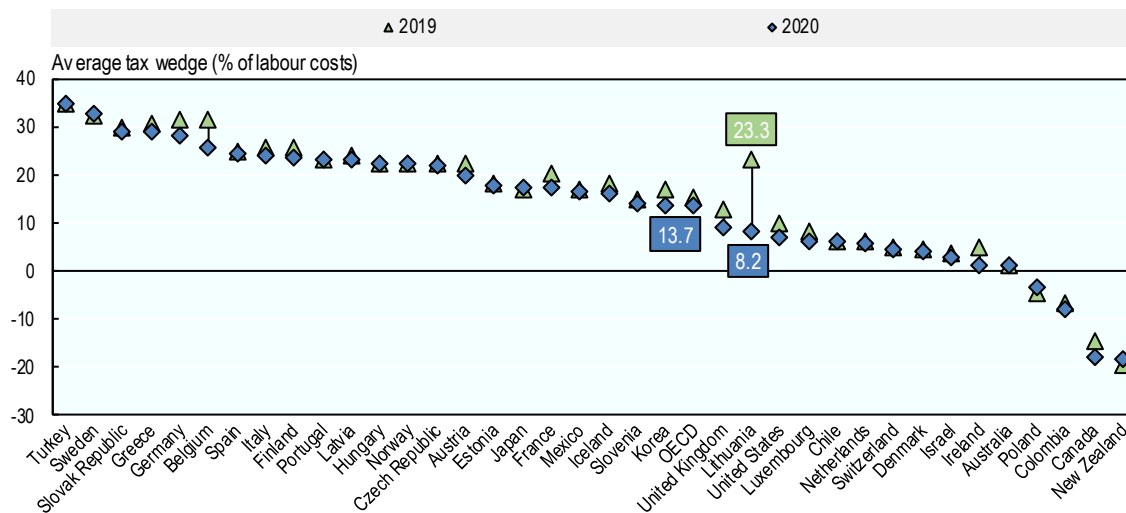


Source: *Taxing Wages 2021*.

Lithuania cut the tax wedge in 2020 on low-income single parents by more than other OECD countries. The labour market in OECD countries in 2020 experienced a shock of a scale and spread not seen in recent memory (OECD, 2021^[3]). Vulnerable groups, such as low-income workers, women and young people were disproportionately affected. Governments introduced measures to support employers and employees, such as job retention schemes, wage subsidies in addition to changes to labour taxes and cash benefits. Lithuania introduced a set of tax and benefit provisions including increasing the BA (see section 3.2) and the universal and additional child benefits (Figure 3.30). The average tax wedge in Lithuania declined between 2019 and 2020, modestly for an average wage earner but significantly for single and one-earner married couples with two children. Among low-income single parents with two children (at 67% of AW), the average tax wedge declined from 23% in 2019 to 8% in 2020 (Figure 4.2). The average tax wedge decline in the OECD was more modest, falling from 15% to 14%. Outside of these cases of low-income parent families, the average tax wedge in Lithuania for most other families is not that dissimilar to the OECD average.

Figure 4.2. The tax wedge for low-income single parents in Lithuania fell sharply in 2020

Average tax wedge for single parents with two children at 67% of the AW, Lithuania and OECD countries, 2019 and 2020



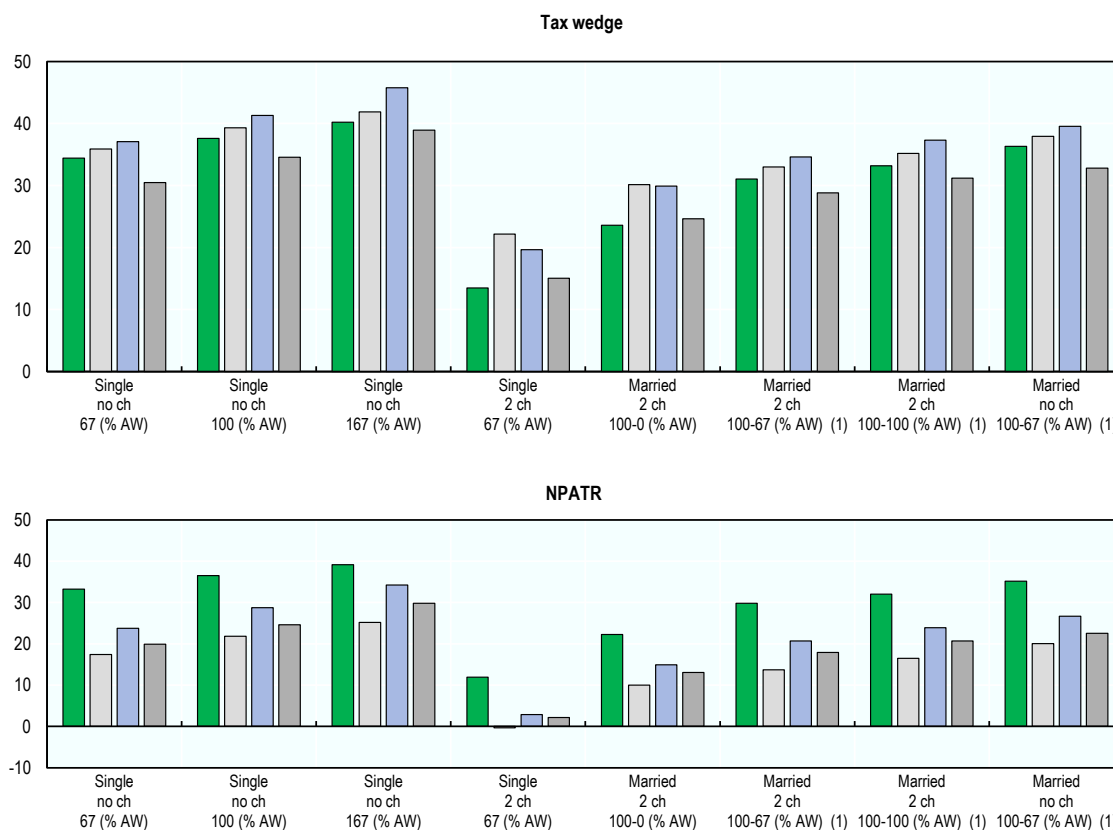
Source: *Taxing Wages 2021*.

The tax wedge for all families in Lithuania lies below the average of the OECD-EU 22 and the Baltics.

The tax wedge in Lithuania is below the average of the OECD-EU 22 and the Baltics for all family types but above many family types compared to the OECD average (Figure 4.3, Panel A). For low-income single parents (67% of AW) with two children, the tax wedge in Lithuania is markedly lower compared to all of the above average benchmarks. The NPATR in Lithuania is above the average of the OECD, the OECD-EU 22 and the Baltics in 2021 for all family categories, owing importantly to Lithuania's high employee SSCs (Figure 4.3, Panel B).

Figure 4.3. The tax wedge in Lithuania is similar to Latvia and Estonia but sharply lower for low-income families with children

The tax wedge and the net personal average tax rate, by family type, 2021



Note: Baltics refers to an unweighted average of Latvia and Estonia.

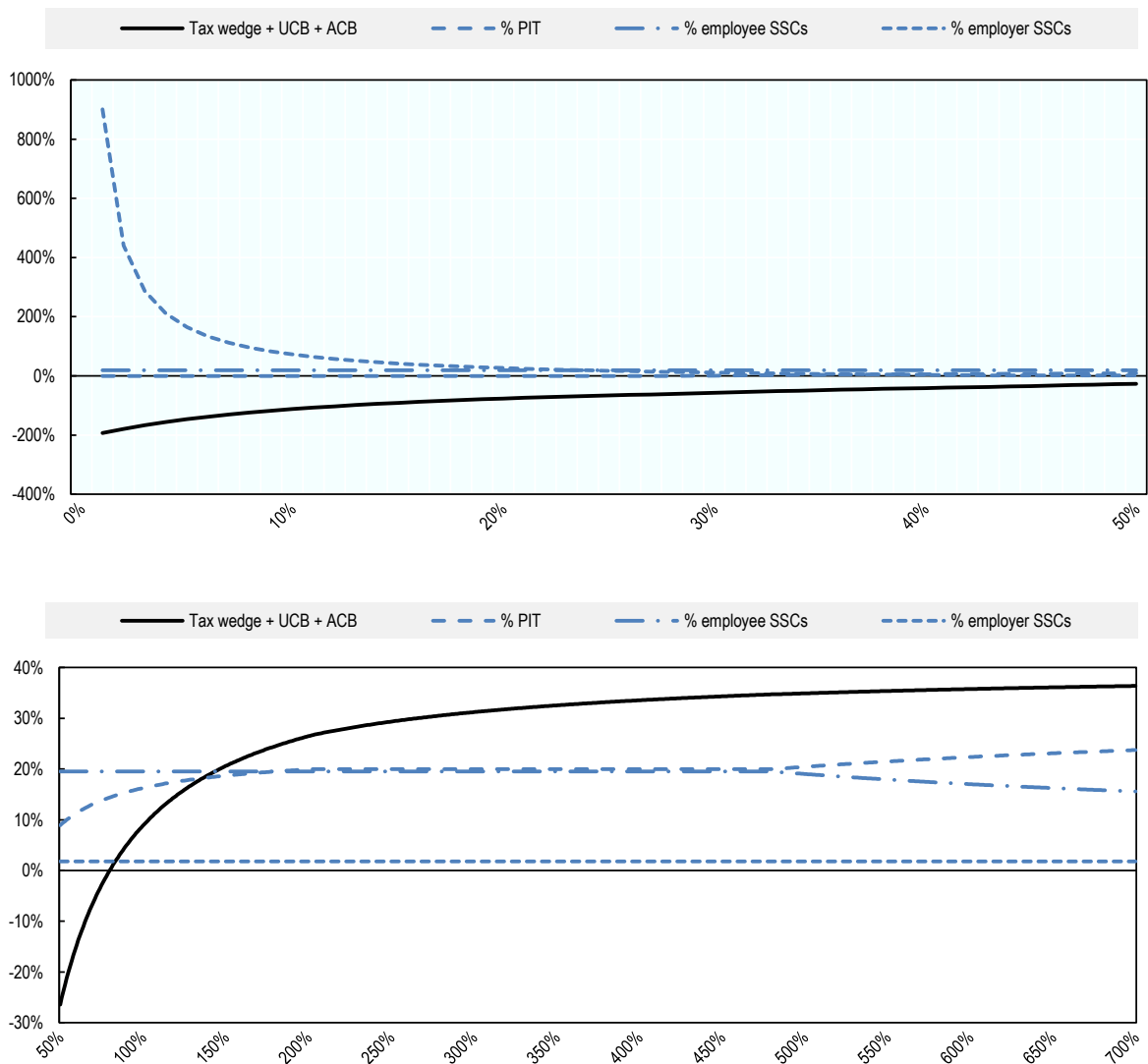
Source: *Taxing Wages 2022*.

The tax wedge on very low incomes is very high due to the employer SSC floor. The employer SSC floor (aimed at widening social contribution coverage, see Figure 3.17) produces tax wedges that are high at low incomes but then decline sharply (Figure 4.4) (at gross incomes of 1%, 10%, 20% and 30% of the AW, the tax wedge is 92.1%, 54.0%, 37.0% and 28.6% respectively).

The tax wedge is progressive between half and twice the average wage, which is an income range comprising a large share of Lithuanian workers. The shape of the tax wedge is progressive between half and twice the AW, determined largely by the BA and to a lesser extent the progressive PIT rate schedule (as the higher PIT rate threshold does not kick-in until higher incomes and the employee SSC and the employer SSCs are flat) (Figure 4.4). Above twice the AW, the tax burden is relatively flat - between 200% and 600% of the AW, the tax wedge remains flat at 40.6%. Given the income distribution in Lithuania (Figure 2.9), the progressive tax wedge (Figure 4.4, Panel B) likely applies to many workers.

Figure 4.4. The tax wedge is progressive at low and middle incomes but flat at high incomes

Tax wedge, single individuals with no children, 0 – 700% AW



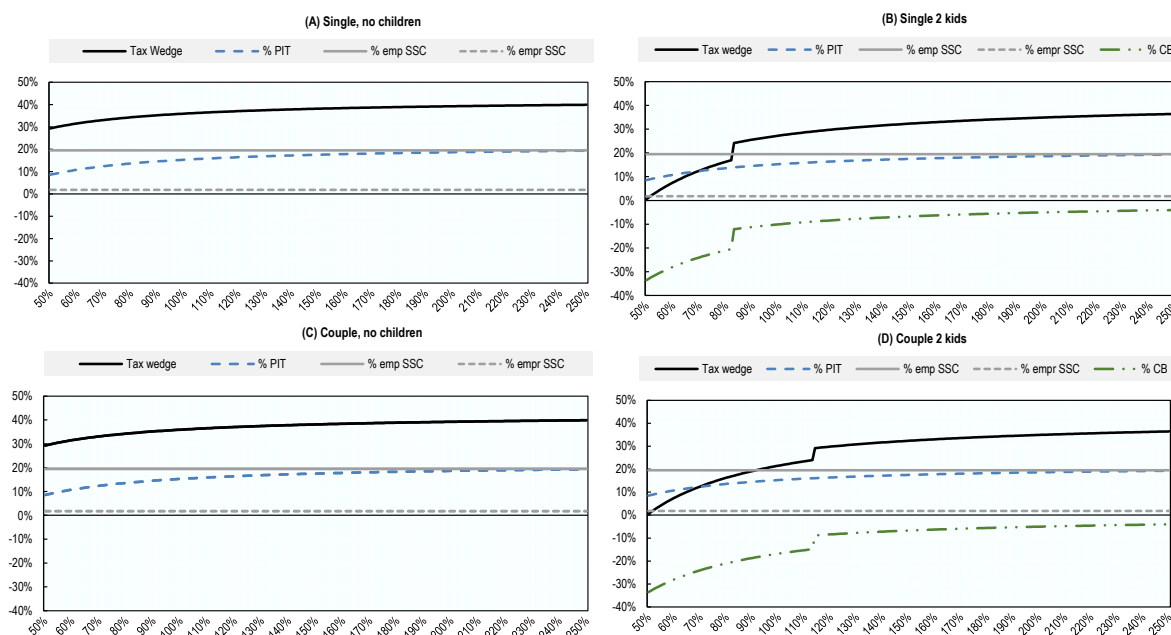
Note: To account for the skewed tax wedge distribution in the analysis, the income distribution is divided above and below 50% of the AW.

Source: *Taxing Wages 2021*.

Single individuals face higher tax burden than single parents at all income levels, but especially at low incomes. For single parents with two children, child benefits produce a lower tax wedge at lower incomes and the tax wedge to be more progressive when compared to single individuals (Figure 4.5) (at 50%, 100% and 150% of the AW, the tax wedge is 0.5%, 27.3% and 32.4%). Childless singles and couples face similar tax wedges (Figure 4.5, Panel C).

Figure 4.5. Low-income single individuals face high relative tax burdens

Average tax wedge decomposition in Lithuania in 2020, gross incomes of 50% - 250%



Note: To examine the tax burden where most incomes are in Lithuania, incomes are considered between 50% and 250% of the AW (thus excluding an examination of very low and very high incomes as seen previously). Child benefits refer to universal child benefit and the additional child benefit (and not the COVID-19 supplemental child benefit and the maintenance child benefit). Child benefits are also shown as a share of labour costs (%CB). Note that the tax wedge includes child benefits but not other benefits.

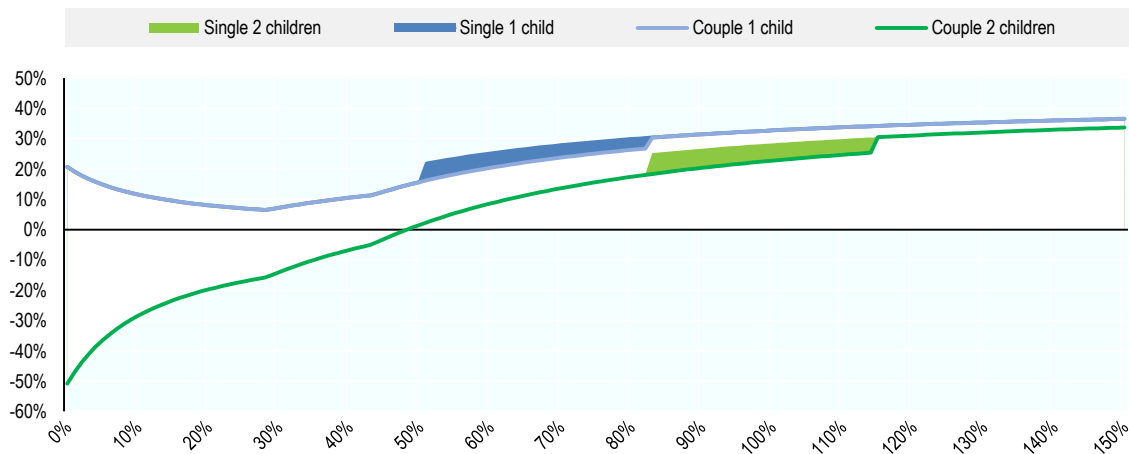
Source: OECD analysis of *Taxing Wages 2021*.

At middle-incomes, single parents face higher tax burdens than couple parents as the additional child benefit is withdrawn earlier. Middle-income couple parents with one child face lower tax burdens than middle-income single parents with one child (an additional 6% at 50% of the AW, which declines to 3% by 83% of AW) (Figure 4.6). Similarly, middle-income couple parents with two children face a lower tax burden than middle-income single parents with two children (an additional 7% at 83% of the AW, which declines to 5% by 114% of the AW) (Figure 4.6). At the AW for example, compared to a single family with two children, a couple with two children faces a lower tax wedge (19.1% vs 25.9%).

At low incomes, single individuals shoulder the bulk of the tax burden. The negative tax burdens faced by low-income single parents and the higher tax burdens faced by single individuals without children imply that single individuals shoulder the bulk of the tax burden at low income levels. Single parents with two children do not start to pay tax until about half the AW (gross incomes of 49% of the AW and when the covid child benefit is included at 54% of the AW). At 2/3 of AW, the tax wedge faced by single parents with two children is a third of single individuals (11% vs 33% respectively) (Figure 4.7).

Figure 4.6. At middle-incomes, single parents face higher tax burdens than couple parents

Tax wedge for single and couple parents with one and two children, incomes from – 0 150%, 2020

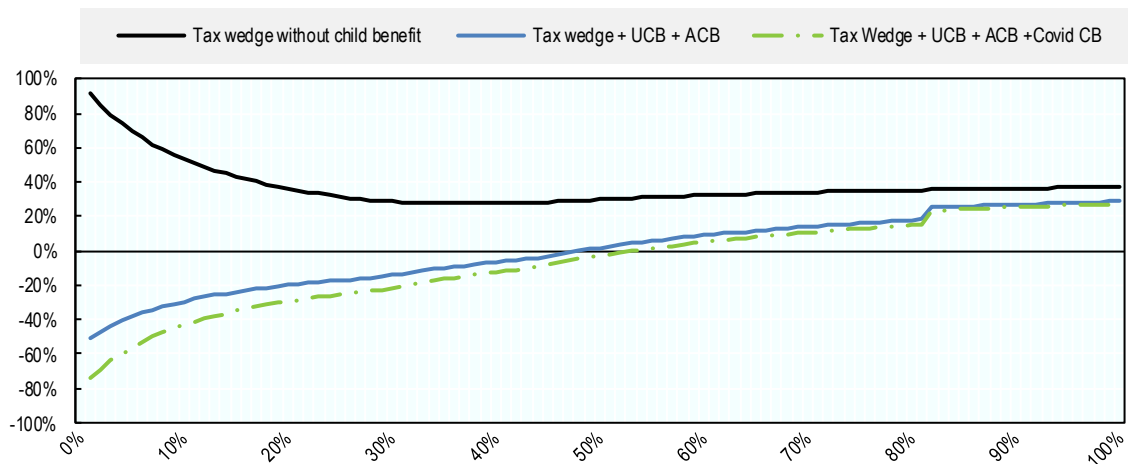


Note: Child benefits refer to both universal child benefit and additional child benefit.

Source: OECD analysis.

Figure 4.7. Low income single parents face negative tax burdens

Average tax wedge decomposition in Lithuania, childless single compared to single parent two children, gross incomes from 0% - 100%, 2020

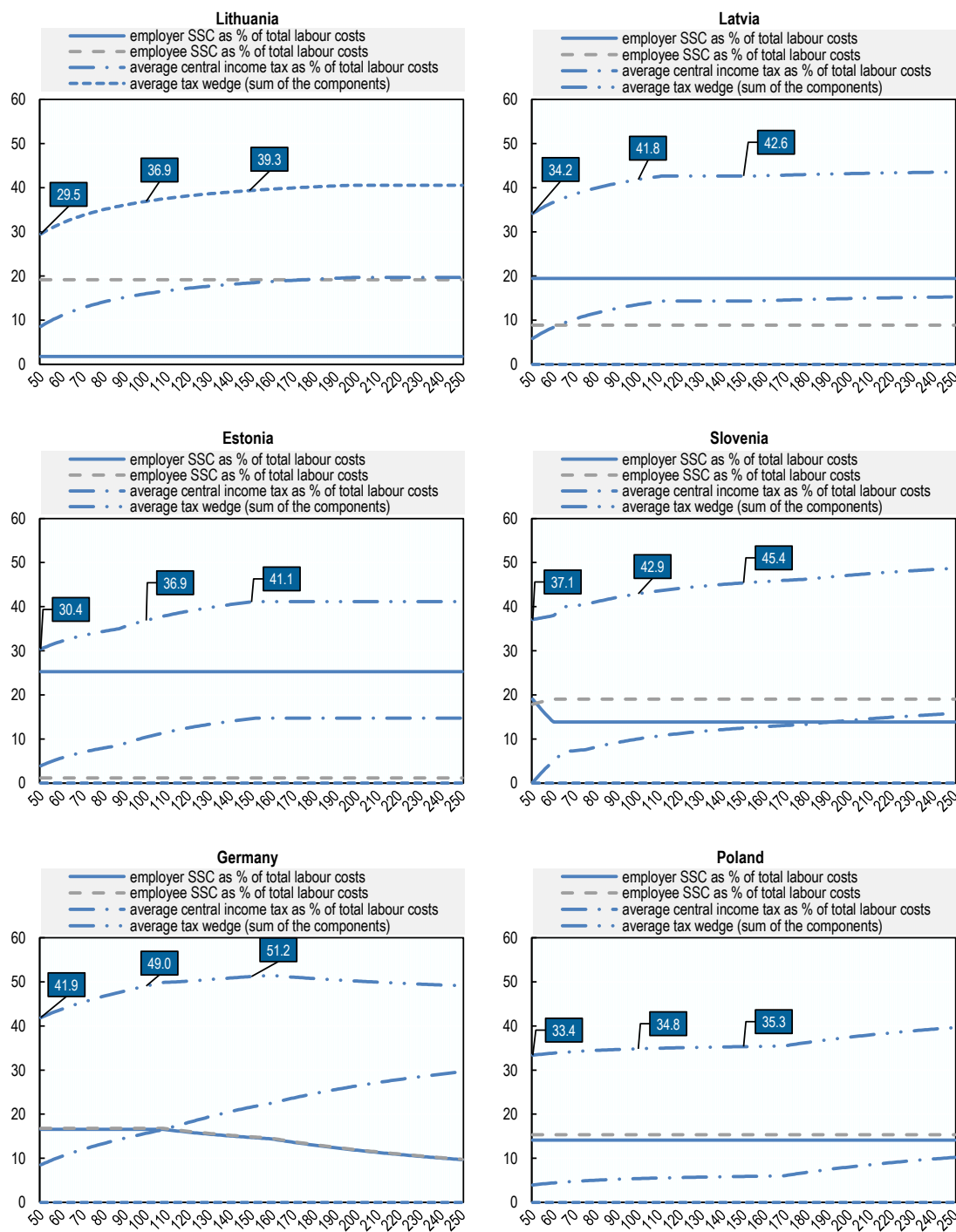


Source: OECD analysis of *Taxing Wages 2021*.

The tax wedge in Lithuania is somewhat low at both low and high incomes compared to selected peer countries. The tax wedge in Lithuania is low among low-income single individuals at half of the AW, where at 29.5% the tax wedge is the lowest among the selected OECD countries, similar to Estonia and only Poland has a lower tax wedge. At higher income levels of 150%, 200% and 250% of the AW, the tax wedge in Lithuania is also comparatively low at 39.3%, 40.6% and 40.6% respectively. These rates are below the average tax wedge of the other five comparison countries at these income levels (which are 43.1%, 43.8% and 43.6% respectively). Some countries have much higher tax wedges at 200% of the AW such as Germany (50.1%) and Slovenia (47.1%).

Figure 4.8. The tax wedge is not progressive at top incomes in international comparison

Average tax wedge decomposition in Lithuania and selected countries in 2020, single individuals with no children



Note: Average central income tax refers to the PIT. Since the gross income data to compare these countries are taken from OECD Taxing Wages 2021, which was produced earlier in 2021, the tax wedge results for Lithuania differ very slightly with the previous which are based on a more recently revised gross incomes for Lithuania. Unlike in the previous graph, this figure shows PIT, employee SSCs, employer SSCs and cash benefits as a share of labour costs.

Source: *Taxing Wages 2021*.

Tax wedge progressivity is low at higher income levels compared to selected peer countries.

Lithuania's tax wedge is progressive for low and middle incomes in international comparison but less so at higher incomes (Figure 4.8). Between 50% and 250% of the AW, Lithuania's tax wedge rises by 11.1 p.p. (from 29.5% to 40.6%), faster than Germany which rises by only 7.2 p.p. (from 41.9% to 49.1%). In addition, the tax wedge for low-income single individuals (67% of AW) as share of the tax wedge for high-income single individuals (at 167% of the AW) in Lithuania was the 10th highest in the OECD in 2021, indicating relatively low tax wedge progressivity.

Unlike many OECD countries, low-income single parents in Lithuania face negative tax wedges.

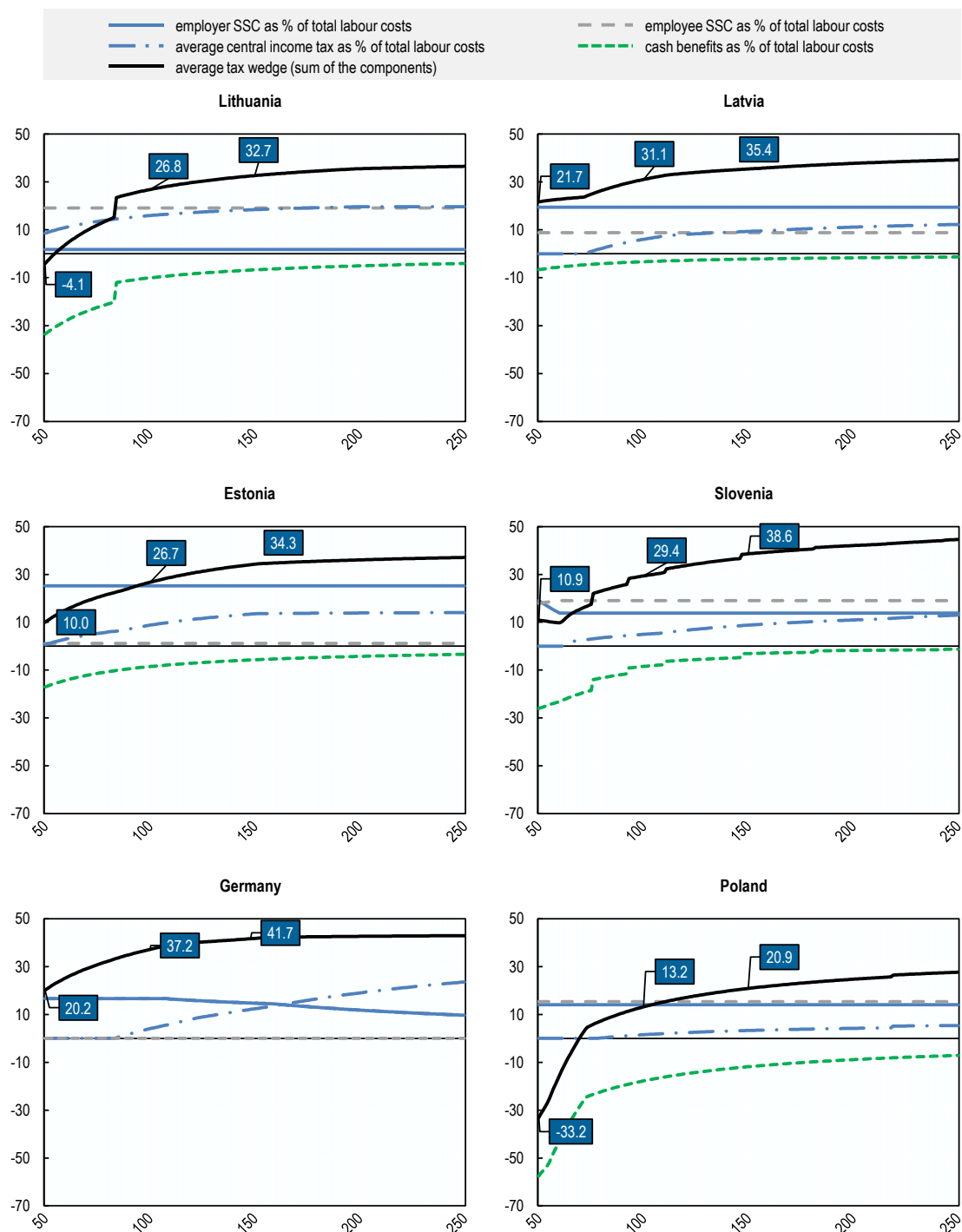
For single parents with two children the tax wedge is somewhat low across the income distribution. Low income parents with two children (at 50% of AW) face not just a lower tax burden than selected OECD countries but a negative tax wedge of -4.1% (the selected OECD group average is 5.9%) (Figure 4.9). The negative tax burden for low-income parents in Lithuania arises because child benefits exceed PIT and SSCs in the tax wedge calculation.

High income single parents face somewhat low tax wedges in international comparison. At higher incomes, the tax wedge in Lithuania for parents with two children is low compared to the selected OECD countries.

The jump in the tax burden in Lithuania due to the withdrawal of the additional child benefit is modest but sharp in international comparison. The withdrawal of the ACB produces a fairly sharp increase in tax burden at 83% of the AW. While Slovenia, Latvia and Poland also show increased tax burdens between 70% and 90% of the AW, these are less sharp than in Lithuania.

Figure 4.9. The tax burden faced by single parents in Lithuania is low relative to peer countries

Average tax wedge decomposition in Lithuania and comparison countries in 2020, single parents with two children



Note: Child cash benefits include COVID-19 supplement benefits here as is standard in the OECD Taxing Wages model. Since the gross income data to compare these countries are taken from OECD Taxing Wages 2021, which was produced earlier in 2021, the tax wedge results for Lithuania differ very slightly with the previous which are based on a more recently revised gross incomes for Lithuania. Unlike in the previous graph, this figure shows PIT, employee SSCs, employer SSCs and cash benefits as a share of labour costs.

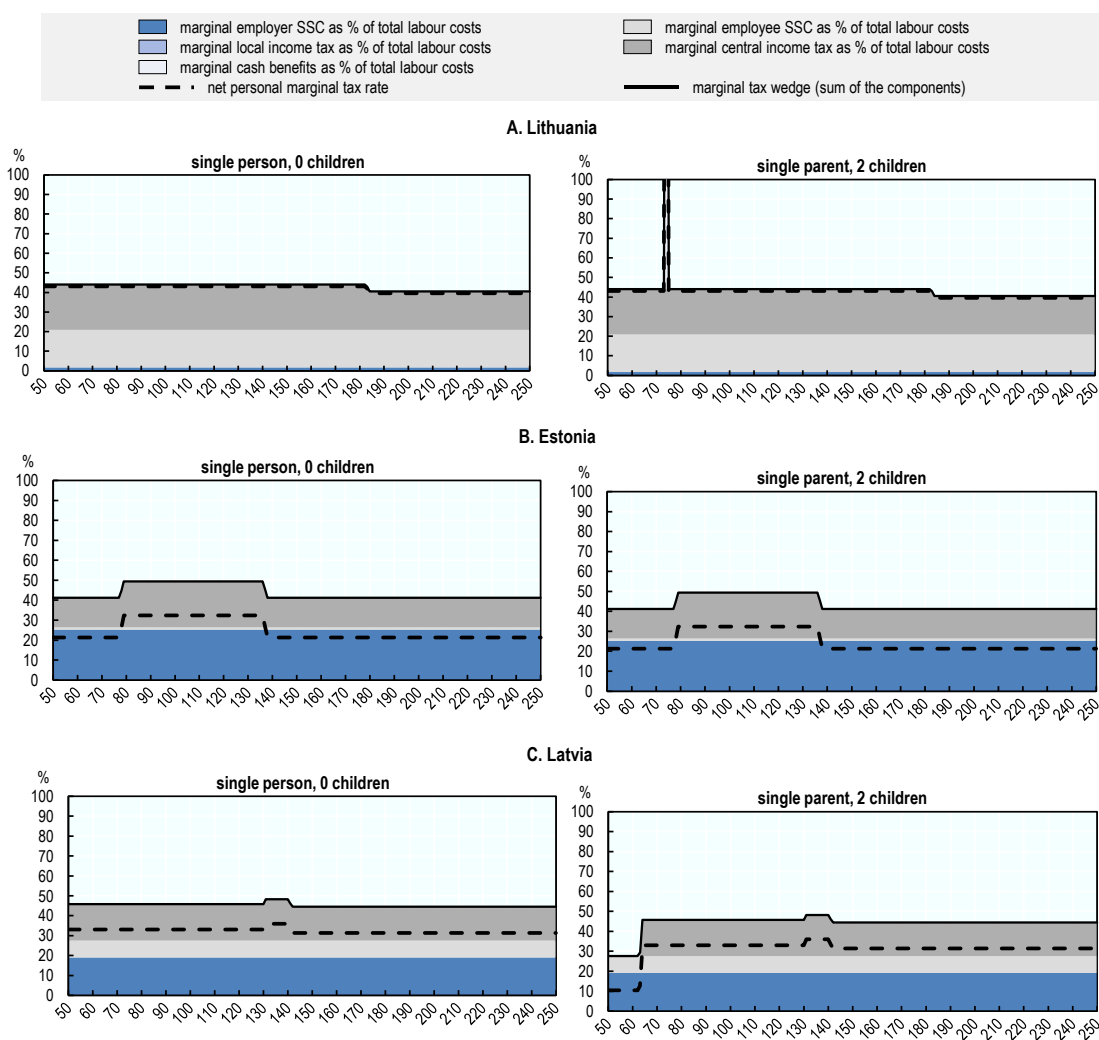
Source: OECD analysis of *Taxing Wages 2021*.

The marginal tax wedge for single individuals is quite flat. Compared to some OECD countries, the METR for singles remains flat at 43% for incomes up to about 180% of the AW before falling modestly to 40% as the BA is fully withdrawn (Figure 4.10A) (SSC ceilings do not take effect until higher income levels and so the marginal tax wedge is not impacted). Thus, the minimal variation in the METR points to limited behavioural distortions.

There is a sharp but brief spike in the marginal tax wedge below the AW as the additional child benefit is withdrawn. The METR for single parents jumps significantly at 74% of AW (Figure 4.10A) as the additional child benefit is withdrawn. Similarly sharp and brief increases in METRs are seen in Poland and Slovenia for parents with two children as benefits are withdrawn (OECD, 2021^[3]).

Figure 4.10. There marginal tax wedge spikes for single parents as the additional child benefit is withdrawn

Marginal tax wedge decomposition in Lithuania and comparison countries, single persons with no children and single persons with two children, 2021



Source: *Taxing Wages 2022*.

The incentives to enter work

Standard PTR measures

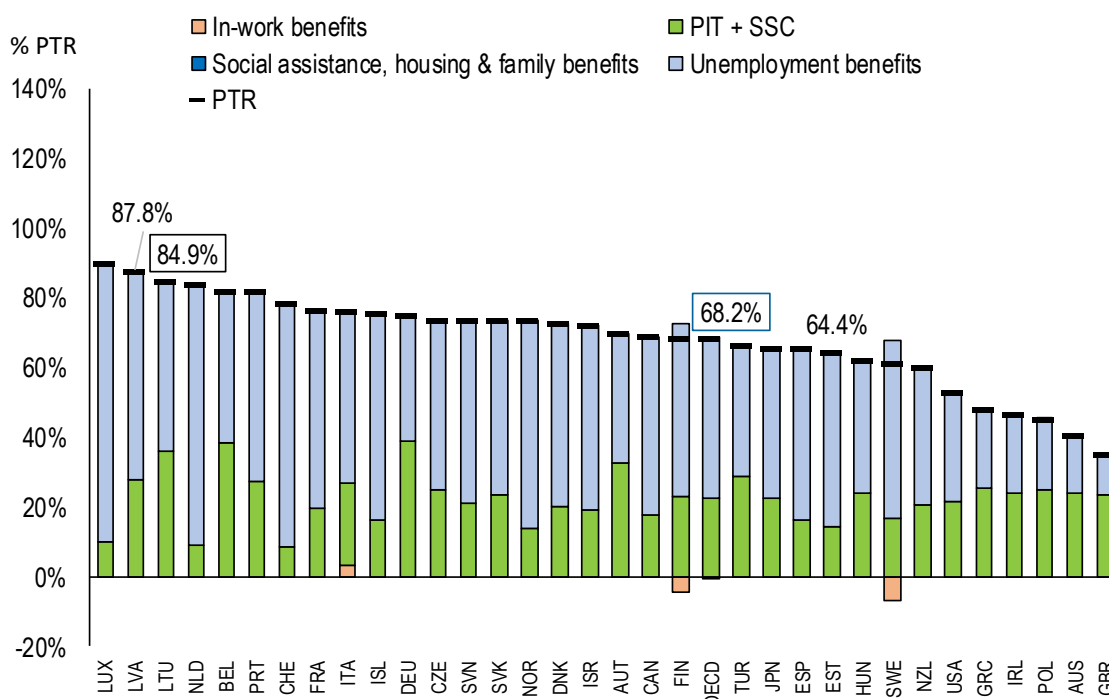
A description of how the participation tax rate (PTR) is calculated and can be interpreted is provided in the appendix (see section 6) and in Box 4.1. A discussion of alternative PTR calculations is provided in Box 4.3. Work incentive traps are examined in Box 4.2.

Measured using the standard PTR measure, the incentive to enter work for AW single individuals is among the lowest in the OECD, due mostly to the loss of unemployment benefits. Employing the standard PTR methodology (see Box 4.3), Lithuania has the third lowest work attractiveness for a single person at the AW in 2020 (a PTR of 84.9%), behind only Latvia and Luxembourg and above the OECD average (Figure 4.11). This reflects a lower incentive to work at short unemployment spells. The largest contributor to the work disincentive for single persons at the AW comes from benefits not taxes, specifically unemployment benefit (UBs), which represent half of the disincentive (49.1% as a share of gross income). This is not unusual in international comparison with most of the work disincentive for most OECD countries attributable to UB. Latvia, Estonia and the OECD average are in a similar range of UB as a share of gross income.

The contribution of PIT and SSCs to the work disincentives for single individuals is high. PIT and SSCs represent 36% of gross income, among the largest shares in the OECD. Lithuania's PIT and SSCs are significantly larger than Latvia (27.8%), Estonia (14.4%) and the OECD average (22.4%).

Figure 4.11. Work attractiveness in Lithuania for average-income singles is relatively low

PTR decomposition (standard methodology) in Lithuania and OECD countries in 2020, single person at 100% of the average wage



Note: For details on the standard PTR methodology, see Box 4.3. Note: 33 OECD countries are examined. OECD refers to an unweighted average of the countries shown. The PTR is calculated based on the 2nd month of unemployment.

Source: OECD Tax and Benefit model TaxBen.

Box 4.1. Interpreting participation tax rates

Like METRs, PTR measurements are inversely related to work incentives because a high PTR indicates weak work incentives while a low PTR indicates strong work incentive. PTRs generally range between 0 (strong incentive to work) and 1 (weak incentive to work), with some rare exceptions. Although the analysis that follows will compare PTRs relative to other incomes, family types and countries, the table below gives an indication of how to interpret standalone PTRs in absolute sense. A PTR of 1 indicates no change in financial position from work (i.e. the additional gross earnings from entering work is exactly matched by taxes on gross income and the loss of benefits). A PTR of 0 indicates an individual keeps all earnings from working (i.e. pays no taxes and loses no benefits as they enter work). As a general rule of thumb, below a PTR of 0.5, work starts to pay. A PTR greater than 1 indicates a financial penalty to working while a PTR less than 1 indicates additional benefits gained from working.

Lower PTRs are associated with stronger financial incentives to work

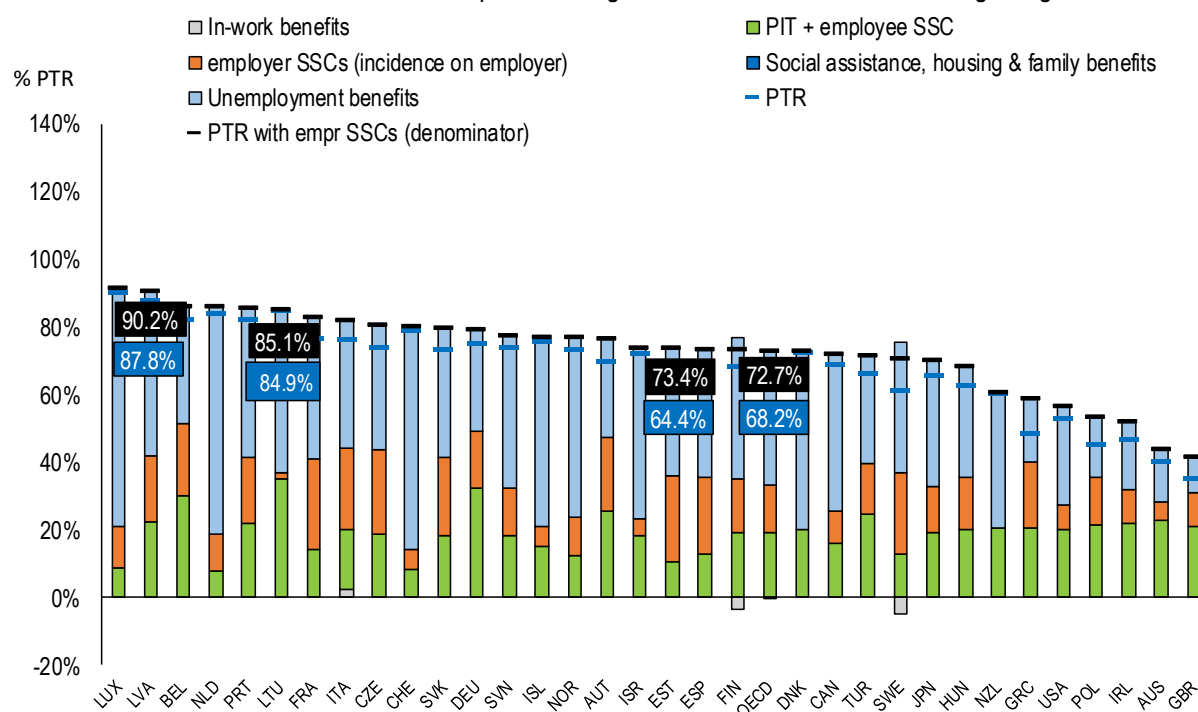
PTR	Financial incentive to work	Description
> 100%	Penalty to work.	Compared to being unemployed, working makes the taxpayer worse-off. Gross income earned from entering work is outweighed by taxes on gross income and the loss of benefits received. For example, when out-of-work income is greater than in-work income, the PTR > 1.
100%	No financial gain to work.	Taxpayer is in the same financial position as if they were unemployed. The combination of tax and benefit withdrawal exactly subsumes all gross income from moving into work. For example, when net in-work income and net out-of-work income are equal, the PTR is equal to 1.
50%	Work starts to pay below this point.	As general rule of thumb, work pays below this point relative to unemployed. At this point, the difference between net in-work income and net out-of-work income is half of gross income.
0%	All earnings kept by working.	Compared to being unemployed, working taxpayer keeps all earnings and loses no benefits. For example, when the difference between net in-work income and out-of-work income is equal to gross income, the PTR is 0.
< 0%	Additional benefits to work.	Compared to being unemployed, working provides additional benefits and less taxes. For example, when the difference between net in-work income and net out-of-work income is greater than gross income, the PTR is <1.

Non-standard PTR measures

When employer SSCs are included in the PTR, the incentive to enter work for AW singles shifts from the 3rd to the 6th lowest in the OECD. The non-standard PTR will measure work as less attractive relative to the standard PTR in countries with smaller employer SSCs such as Lithuania (see Box 4.3). By including employer SSCs (that are relatively small in Lithuania vs most countries), PTRs increase by more in most other OECD countries than Lithuania, thus making work relatively more attractive in Lithuania (Figure 4.12). The non-standard PTR measure shows Lithuania has the 6th lowest work attractiveness in the OECD vs the 3rd lowest when the standard PTR was used.

Figure 4.12. Using a nonstandard PTR measure, the work disincentive in Lithuania remains in the top quintile among OECD countries

Standard PTR and non-standard PTR decomposition, single individual at 100% of the average wage in 2020



Note: OECD refers to an unweighted average of the countries shown.

Source: OECD Tax and Benefit model TaxBen.

Box 4.2. Work incentive traps

Redistributive tax and benefit policies can produce both short and long-term incentive ‘traps’

The unemployment trap. This trap occurs when benefits paid to the unemployed (and/or high tax rates imposed on low-income workers) narrow the gap between income received when in-work and out-of-work. This creates little incentive for an individual to move into work, thereby ‘trapping’ them in unemployment.

The inactivity trap. The inactivity trap is similar to the unemployment trap, except that it occurs where generous social assistance (and/or other benefits) are paid to an inactive individual (as opposed to an unemployment benefit, which an inactive person would be ineligible for), which produces little difference between in-work and out-of-work income thus ‘trapping’ them in inactivity. The inactivity trap can occur within families when an inactive partner would be taxed at relatively high levels due to their partner’s income.

The poverty trap. A third poverty trap can also occur as a result of targeted government support to the poor. While targeted government supports reduce fiscal costs relative to more expensive universal supports, they invariably require phasing-out. As they are phased-out, targeted supports reduce the multiple avenues of work incentive for those in employment including the incentive to increase earnings, the number of hours worked, the effort applied to work and investment in work-related training and skills. Consequently, a poverty trap encourages low-income workers to remain in poverty and dependent on benefits rather than to increase work and become income independent.

The first two traps of unemployment and inactivity correspond to short and long-term unemployment durations (where long-term is defined as greater than 9 months in Lithuania) which are in turn associated with short-term PTRs (where unemployment insurance benefit is received) and long-term PTRs respectively (where unemployment assistance benefit is received). Therefore, PTRs measure the extent to which those out-of-work are 'trapped' in either unemployment (usually higher PTRs, reflecting low work incentives) and inactivity (typically lower PTRs, reflecting higher work incentives). The poverty trap can instead be measured using METRs.

Table 4.2. Measuring unemployment traps using PTRs

Traps	Unemployment state	Duration in months (in Lithuania)	Unemployment benefit	Associated PTRs
Unemployment trap	Short-term	<= 9	Unemployment benefit	Short-term PTRs (typically higher)
Inactivity trap	Long-term	> 9	Social assistance benefit	Long-term PTRs (typically lower)

Source: OECD analysis; (O'Donoghue et al., 2003^[41]) (Immervoll, 2004^[51])

Non-standard PTR measures by income, family type and unemployment spells

High SSCs are a contributor to the disincentive to enter work at low incomes, even at short employment spells. UBs are the largest contributor to the disincentive to enter work (Table 4.3). Reducing them further is challenging given poverty rates among the unemployed (Figure 2.1). Excluding UBs, the largest contributor 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 UBs 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.

Table 4.3. There is little financial gain to entering work at low incomes

Incentives to enter work by income and family type, single individuals and single parents with two children, non-standard PTR, 2-months unemployed, 2020

AW	Family	Non-standard PTR			Contribution to Lithuania PTR				
		Lithuania rank	Lithuania	OECD	UB	Family & SA	Employee SSCs	Employer SSCs	PIT
40%	Single	7 th	89%	78%	63%	0	19%	2%	6%
	Single 2k	13 th	80%	74%	63%	-10%	19%	2%	6%
50%	Single	6 th	88%	74%	58%	0	19%	2%	9%
	Single 2k	6 th	85%	75%	58%	-3%	19%	2%	9%
100%	Single	6 th	85%	73%	48%	0	19%	2%	16%
	Single 2k	2 nd	91%	75%	48%	6%	19%	2%	16%
200%	Single	15 th	67%	65%	27%	0%	19%	2%	20%
	Single 2k	16 th	67%	67%	27%	0%	19%	2%	20%

Note: 2k refers to 2 children. Assumes no housing benefit. 1st = highest PTR and work disincentive. Unemployment spell is assumed 2 months. Family benefits here includes social assistance and family benefits. At 40% of AW, family benefit incentive is 0% as benefits are same in and out of work. Negative social assistance due to in-work social assistance higher than out of work. Employer SSC rate is set at 1.8%.

Source: OECD Tax and Benefit model TaxBen.

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 (Table 4.4). 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, see Table 4.4). 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 (IWSA) performs a similar function at low incomes by increasing work incentives.

Table 4.4. Compared to the OECD average, Lithuania's lower work incentives are driven by larger unemployment benefits and PIT and the absence of in-work benefits

Comparison of non-standard PTR contributions in Lithuania and the OECD, single parents with two children, 2-months unemployed, 2020

AW	Comparison	PTR	Contribution to PTR						
			UB	Family & SA	Employee SSCs	Employer SSCs	Total SSCs	PIT	IW
40%	Lithuania	80%	63%	-10%	19%	2%	21%	6%	0%
	OECD	74%	54%	3%	6%	14%	21%	0.3%	-5%
50%	Lithuania	85%	58%	-3%	19%	2%	21%	9%	0%
	OECD	75%	50%	5%	7%	14%	21%	3%	-3%
100%	Lithuania	91%	48%	6%	19%	2%	21%	16%	0%
	OECD	75%	40%	4%	8%	14%	22%	10%	-0.7%
200%	Lithuania	67%	27%	0%	19%	2%	21%	20%	0%
	OECD	67%	25%	3%	8%	14%	22%	18%	-0.2%

Note: 2k refers to 2 children. Assumes no housing benefit. 1st = highest PTR and work disincentive. Unemployment spell is assumed 2 months. Family benefits here includes social assistance and family benefits. IW refers to in-work benefits.

Source: OECD Tax and Benefit model TaxBen.

Cutting relatively high SSCs or PIT at low incomes would increase incentives to enter work for parents earning near the MMW (at both short and long-term unemployment spells). Short-term unemployed parents earning income near to the MMW have low work incentives driven by relatively high UBs (Table 4.5). Working does not make this group much better off than unemployment, reflected in the PTR of 80% (i.e. at a PTR of 100%, there is no financial gain to working). In-work social assistance plays a modest role in improving work incentives. Enhancing work incentives is challenging given that it is difficult to further reduce UBs with high and rising poverty risks among the unemployed. Long-term unemployed parents earning near the MMW have modest work incentives that are similar to the OECD average after a 10-month unemployment duration.

Table 4.5. Work incentives for parents earning near the minimum monthly wage are strongly determined by unemployment duration

Incentives to enter work, single parents with two children at 40% of AW, non-standard PTR, 2020

Unemp spell	Non-standard PTR			Contribution to PTR				
	Lithuania rank	Lithuania	OECD	UB	Family & SA	Employee SSCs	Employer SSCs	PIT
2 months	13 th	80%	74%	63%	-10%	19%	2%	6%
8 months	16 th	77%	69%	48%	3%	19%	2%	6%
10 months	19 th	69%	68%	0%	43%	19%	2%	6%
20 months	14 th	69%	64%	0%	43%	19%	2%	6%

Note: Assumes no housing benefit. 1st = highest PTR and work disincentive. Family benefits here includes social assistance and family benefits. Negative social assistance due to in-work social assistance higher than out of work. Employer SSC rate is set at 1.8%.

Source: OECD Tax and Benefit model TaxBen.

Compared to the OECD average, long-term lower income unemployed face low work incentives due to relatively high PIT and the absence of in-work benefits. Long-term unemployed parents earning near the MMW continue to have modestly lower work incentives than the OECD average due to mostly to a difference of higher relative PIT in Lithuania and the absence of in-work benefits (Table 4.6) (i.e. at 20 months of unemployment, unemployment benefits, family benefits and social assistance benefits combined are lower in Lithuania than in the OECD average).

Table 4.6. Compared to the OECD average, long-term lower income unemployed face low work incentives due to relatively high PIT and the absence of in-work benefits

Comparison of non-standard PTR contributions in Lithuania and the OECD, incentives to enter work, single parents with two children at 40% of AW, 2020

Unemp spell	Comparison	PTR	UB	Family & SA	Employee SSCs	Employer SSCs	Total SSCs	PIT	IW
2 months	Lithuania	80%	63%	-10%	19%	2%	21%	6%	0%
	OECD	74%	54%	3%	6%	14%	21%	0.7%	-5%
8 months	Lithuania	77%	48%	3%	19%	2%	21%	6%	0%
	OECD	69%	44%	9%	7%	14%	21%	0.4%	-5%
20 months	Lithuania	69%	0%	43%	19%	2%	21%	6%	0%
	OECD	64%	26%	20%	7%	14%	22%	1%	-5%

Note: Assumes no housing benefit. 1st = highest PTR and work disincentive. Family benefits here includes social assistance and family benefits. Negative social assistance due to in-work social assistance higher than out of work. IW refers to in-work benefits.

Source: OECD Tax and Benefit model TaxBen.

Low-income second-earners have weak 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 unemployment spells, due mostly to high UBs but also high SSCs (Table 4.7). This incentive structure might encourage some low-income second earners to stay on unemployment up to the expiration of UBs at 9 months. However, work incentives are large 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 benefits 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.

Table 4.7. Long-term unemployed low-income second-earners have strong work incentives

Incentives to enter work, low-income second-earners by employment spell, non-standard PTRs, 2020

Unemp spell	Family incomes	Lithuania rank	Non-standard PTR		Contribution to PTR				
			Lithuania	OECD	UB	SA	Employee SSCs	Employer SSCs	PIT
2 months	50% & 50%	10 th	88%	83%	57%	0%	19%	4%	9%
	50% & 67%	8 th	87%	81%	52%	0%	19%	3%	13%
	50% & 100%	7 th	85%	77%	48%	0%	19%	3%	16%
20 months	50% & 50%	10 th	58%	64%	0%	27%	19%	4%	9%
	50% & 67%	25 th	54%	62%	0%	20%	19%	3%	13%
	50% & 100%	22 nd	51%	59%	0%	13%	19%	3%	16%

Note: Second-earner families compared against a baseline of 50% of AW first-earner and 0% of AW second-earner (i.e. unemployed). Assumes no housing benefit. 1st = highest PTR and work disincentive. Unemployment spell is assumed 2 months. Family benefits here includes social assistance and family benefits. Negative social assistance due to in-work social assistance higher than out of work. 0% family benefit disincentive as family benefits are same in and out of work. Employer SSC rate is set at 1.8%.

Source: OECD Tax and Benefit model TaxBen.

Box 4.3. Alternative PTR calculations using employer SSCs

Can employer SSCs be included in the calculation of participation tax rates?

Employer SSCs are not generally included in PTR and participation METR calculations because standard economic theory predicts that they are already reflected in equilibrium wages. Employer SSCs are not included in the OECD TaxBen or the EUROMOD current PTR and METR modelling. How might they affect comparability? First, they may confer a future benefit. However, the static modelling considers only current incomes. Second, to the extent that employer SSCs are tax incident on employees via wages in the long-term, employer SSCs are a tax on employees. If average wages are measured in an equilibrium state where these adjustments have taken place (i.e. the forward and backward shifting of employer contributions between employers and employees as translated through wages), then any difference in employer SSCs will already be reflected in the average wage. Under the assumption that such incidence shifting has taken already place, the standard calculation of PTR, does not include employer SSCs in its calculation.

While including employer SSCs is methodologically nonstandard for the calculation of PTRs, arguments exist for why they might be included in a country such as Lithuania. While including employer SSCs in the PTR represents a nonstandard approach, there are several rationale which provide a basis for considering its inclusion alongside the standard methodology in the case of Lithuania. First, there may be potential for upward bias in the PTR estimate in a country such as Lithuania given Lithuania's large and atypical imbalance between employer and employee SSCs. Second, changes in employer SSCs may be incorporated in the behavioural decision making of employers and employees prior to the adjustment of wages to an equilibrium state as predicted by economic theory. Third, including employer SSCs in the PTR calculation provides equal weight to the role of employee and employer SSCs in their potential impact on work incentives (rather than only taking account of employee SSCs as in the standard methodology).

Applying the standard PTR methodology in Lithuania to examine trends in the incentive to enter work over time produces misleading conclusions. The standard methodology poses problems when comparing before and after Lithuania's labour tax reform in 2019. For example, the standard PTR for a single individual at the average wage increased sharply from 65.1% in 2015 to 84.9% in 2020, due largely to employee SSCs representing a greater share of gross income (9.0% in 2015 and 19.5% in 2020). Such a shift appears to be striking as it was not seen in comparison countries such as Latvia, Estonia or the OECD average over the same period. However, drawing the conclusion that work attractiveness declined in Lithuania during this period would be misleading as the change reflects a policy shift to employer SSCs rather than a change in work incentives.

Several nonstandard PTRs can be calculated by including employer SSCs, which have the effect of increasing measured work incentives in countries. The table summarises the definition, rationale and equations related to a standard and a non-standard PTR measure. One way to calculate a nonstandard PTR that incorporates employer SSCs is to replace gross income in the standard PTR equation with total labour costs and assume the incidence of employer SSCs falls entirely on the employee. Conceptually, this nonstandard PTR measure would incorporate the notion that the employee considers their total remuneration to be total labour costs (instead of gross income), reflecting a dynamic setting where the employee takes account of the future entitlements associated with the employer SSC contribution (with the caveat that SSC contributions do not match perfectly with future SSC entitlements). At the same time, employer SSCs are deducted from in-work income to reflect the incidence of employer SSCs on the employee. Mathematically, as shown in table, the numerator remains the same (because total labour costs replace gross wages but simultaneously employer SSCs are deducted) and the denominator becomes total labour costs. The new denominator of labour costs comes with a new interpretation and has less of the same clear focus on current cash incomes. In addition, the decomposition of the nonstandard measure into tax and benefit components must each now be calculated as a share of labour costs, once again altering the compositional interpretation. In terms of the measured impact on work incentives, the nonstandard measure is expected to be greater than the standard measure, reflecting lower work incentives². With regard to interpretation, and contrary to standard economic theory, the nonstandard measure might be conceptualised as a pre-equilibrium work incentive measure before the full amount of incidence shifting has occurred between employees and employers. Note however that if standard economic theory is correct and the employer SSC is already reflected in reduced wages for the employee, the nonstandard measure would represent an excessively reduced work incentive measure.

Standard and nonstandard PTR measurements

PTR	Description	Rationale	PTR in LTU 2020	PTR in OECD 2020	Equation
Standard	Employer SSCs not included	Employer SSC impacts are already included in the wage	84.9%	67.9%	$(1) 1 - [Y_{\text{netIW}} - Y_{\text{netOW}}] / [Y_{\text{grossIW}}]$
Nonstandard	Employer SSCs included in denominator	Additional incidence of employer SSC falls on employer	85.1%	72.7%	$(2) 1 - [Y_{\text{netIW}} - Y_{\text{netOW}}] / [Y_{\text{grossIW}} + \text{SSC}_{\text{er}}]$

Note: PTRs relate to a single individual at 100% of the AW in 2020.

Source: OECD Tax and Benefit model TaxBen.

If employer SSCs were included in the PTR, countries would likely show reduced incentives to work but Lithuania less so due to its relatively smaller employee SSC. The non-standard PTR measure will generally measure work as less attractive in countries relative to the standard measure. The extent to which work is measured as less attractive will depend on the size of the employer SSC in the country. In OECD countries, employer SSCs differ significantly. In Lithuania, where employer SSCs are among the smallest in OECD countries, the measured reduction in the work incentive will therefore be relatively smaller compared to most other OECD countries. As a result, the nonstandard PTR will show Lithuania to have a relatively more attractive work incentive (since the measured work incentive would fall in all countries but fall by less in Lithuania). The table below shows, for a selection of comparison countries, that going from the standard to the non-standard PTR methodology changes the measured PTR by a modest 0.3% (from 84.9% to 85.1%) in Lithuania compared to a larger 4.4% (from 68.2% to 72.7%) in the OECD on average.

Standard and non-standard PTRs in Lithuania and comparison countries, single individual at 100% of the average wage in 2020

	Standard PTR	Non-standard PTR	Difference	Employer SSCs
Lithuania	84.9%	85.1%	+0.3%	1.8%
Estonia	64.4%	73.4%	+9.0%	25.3%
Latvia	87.8%	90.2%	+2.4%	19.4%
OECD*	68.2%	72.7%	+4.4%	

Note: *OECD refers to an unweighted average of the OECD countries shown.

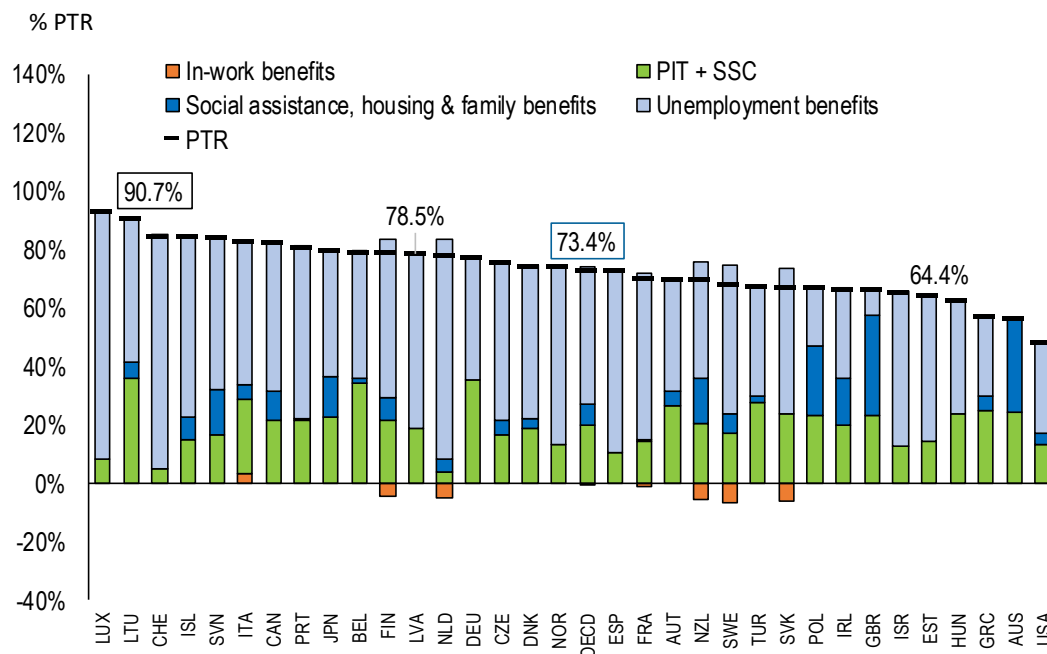
Source: OECD Tax and Benefit model TaxBen.

Standard PTR measure by income, family type and unemployment spells

Average-income single parents in Lithuania have modestly lower work incentives than single individuals. This section returns to using the standard PTR measure. Compared to a single person earning the AW in Lithuania who have a PTR of 85%, single parents have modestly higher PTRs of 91%, reflecting lower work incentives driven by family benefits, namely the ACB that is withdrawn by the AW for single parents.³ The drivers of the work disincentive for single parents are not dissimilar to those for single individuals – they are largely attributable to UB and to a lesser extent SSCs and PIT but in addition the ACB (i.e. by moving from unemployment into employment at the AW, the child benefit is reduced due to the loss of the ACB) (see Figure 4.13). The incentive to enter work is the second lowest in the OECD, behind only Luxembourg. The PTR in Lithuania is higher than that of Latvia (78.5%) and Estonia (64.4%), where in both countries there is no loss of child benefit from moving to employment and there is only a universal child benefit in place (i.e. there is no additional child benefit). The PTR in Lithuania is also significantly above the OECD average (73%), reflecting relatively weak work attractiveness in international comparison for average-income single parents with two children.

Figure 4.13. Work attractiveness in Lithuania for average-income single parents is the second-lowest in the OECD

PTR decomposition (standard methodology) in Lithuania and OECD countries, single parent with two children at 100% of the average wage, 2020



Note: For details on the standard PTR methodology, see Box 4.3. Note: 33 OECD countries are examined. OECD refers to an unweighted average of the countries shown.

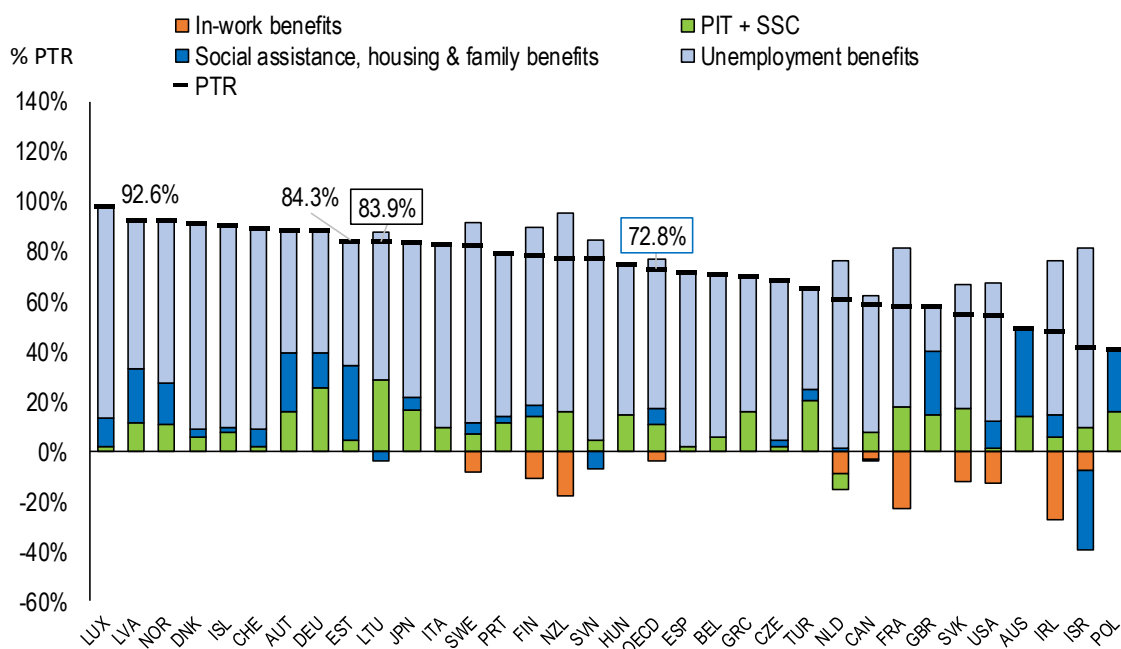
Source: OECD Tax and Benefit model TaxBen.

Measured using the standard PTR (without including employer SSCs), the share of work disincentive from PIT and SSCs for low income single parents is the highest in the OECD.

Figure 4.14 shows the PTRs for low-income single parents (50% of AW) with two children in Lithuania and OECD countries in 2020. Lithuania's PTR (of 84%) is above the OECD (73%) but below Latvia (93%) and Estonia (84%). The primary work disincentive for low-income single parents with two children in most OECD countries is the UB, which represents 60% of gross income in the OECD on average. Lithuania has a similar UB share (at 59% of gross income) to the OECD but its PTR remains higher due to a larger PIT (8.7% vs 2.5%) and particularly SSC (19.5% vs 8.0%) shares of gross income. Indeed, single parents with two children in Lithuania have the highest share of PIT and SSCs in the OECD (one non-OECD country which has an even higher share of PIT and SSCs than Lithuania is Romania, due to its high 35% SSCs as a share of gross income (see Box 3.1 for a discussion of Romania's tax reform that shifted most SSCs to the employee)). In many OECD countries including Estonia and Latvia there is a considerable work disincentive associated with social assistance, housing and family benefits but there is no such work disincentive in Lithuania. In this case for a low-income single parent with two children, this largely occurs in Estonia and Latvia due to the full loss of housing benefits which are not lost in Lithuania (in Estonia, there is also a smaller loss from social assistance) at low income levels. In all three countries, for this family type, there is no work disincentive from child benefits as they are afforded equally to families both in-work and out-of-work at low incomes.

Figure 4.14. For low-income single parents in Lithuania, the share of work disincentive driven by taxes is the highest in the OECD

PTR decomposition (standard methodology), single parent with two children at 50% of the average wage, 2020



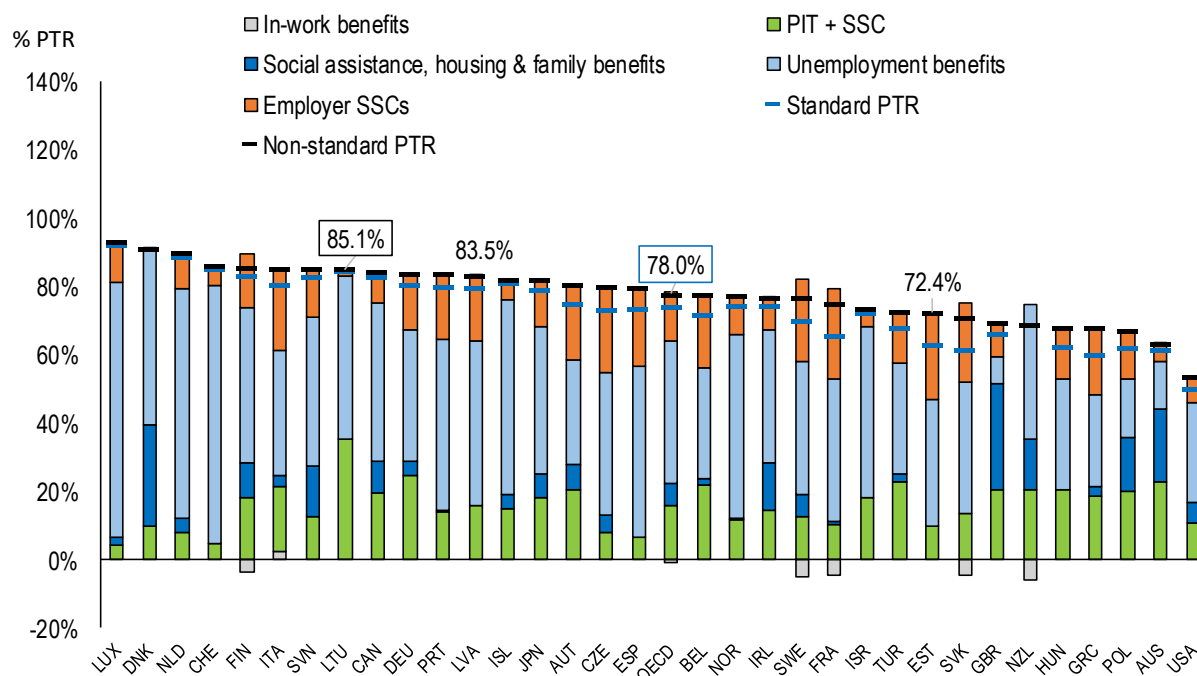
Note: OECD refers to an unweighted average of the countries shown.

Source: OECD Tax and Benefit model TaxBen.

Under both standard and non-standard PTR measures, the incentive to enter work for average-income couples in Lithuania is similar to that of single individuals. Compared to childless singles at the AW in Lithuania, couples with children have similar work incentives, as measured by both standard PTRs (84.8% vs 84.9%) and non-standard PTRs (85.1% vs 85.1%). Under the non-standard PTR measure, measured work attractiveness rises in Lithuania as expected in international comparison – Lithuania's changes from having the 5th highest work disincentives in the OECD to the 8th highest work disincentives (Figure 4.15). Under either measure, work incentives in Lithuania for average-income two parent families are relatively low. As was the case for single individuals, the contribution of PIT and SSCs to the work disincentive in Lithuania is among the highest in the OECD.

Figure 4.15. For average-income two parent families, the share of work disincentive associated with PIT and SSCs in Lithuania is the highest in the OECD

PTR decomposition (non-standard methodology), couple at 100% of the average wage with two children in 2020



Note: OECD refers to an unweighted average of the countries shown.

Source: OECD Tax and Benefit model TaxBen.

Based on the standard PTR measure, the incentives to enter work within Lithuania among groups at high poverty risk

Work incentives improve as incomes rise

The attractiveness of entering work in Lithuania for single families with and without children starts low at low income levels and rises with income, particularly for incomes above the AW as most benefits are withdrawn. This section uses the standard PTR measure for comparing work incentives within Lithuania. The non-standard PTR measure may have more value when comparing work incentives across countries. The incentive to enter work from unemployment rises at higher income levels across all family types (evidenced by a declining PTR), albeit at varying degrees (Figure 4.16). For childless singles, the incentive to enter work from unemployment is lowest at lower incomes (50% of the AW), rises gradually to middle-incomes (100% of the AW) and then rises more rapidly at higher incomes (150% of the AW). In all family types, work incentives increase sharply between 100% and 150% of the AW as the UB cap is reached⁴. Having a job at higher incomes is more attractive than at low incomes because the loss of UBs is relatively less and outweighs higher taxes as a share of gross income. For high income earners (+150% AW), work incentives are identical across family types. Raising the tax burden through a higher PIT on high earners may impact high-income families in an equal way regardless of family structure.

Single parents with one child face high unemployment trap risks

For low-income single parents with one child, unemployment traps are quite high. For low-income single parents with one child, the incentive to enter work is particularly unattractive relative to the same family on higher earnings (Figure 4.16). For single parents with one child, the incentives to enter work rise with income. The incentives to work are particularly low at lower incomes (50% of the AW) because of the loss of the means-tested additional child benefit. The incentives to work for low-income parents with one child (PTR is 93.3%) are lower than for singles (PTR is 87.5%) so the risk of an unemployment trap is higher for low income single parents with one child.

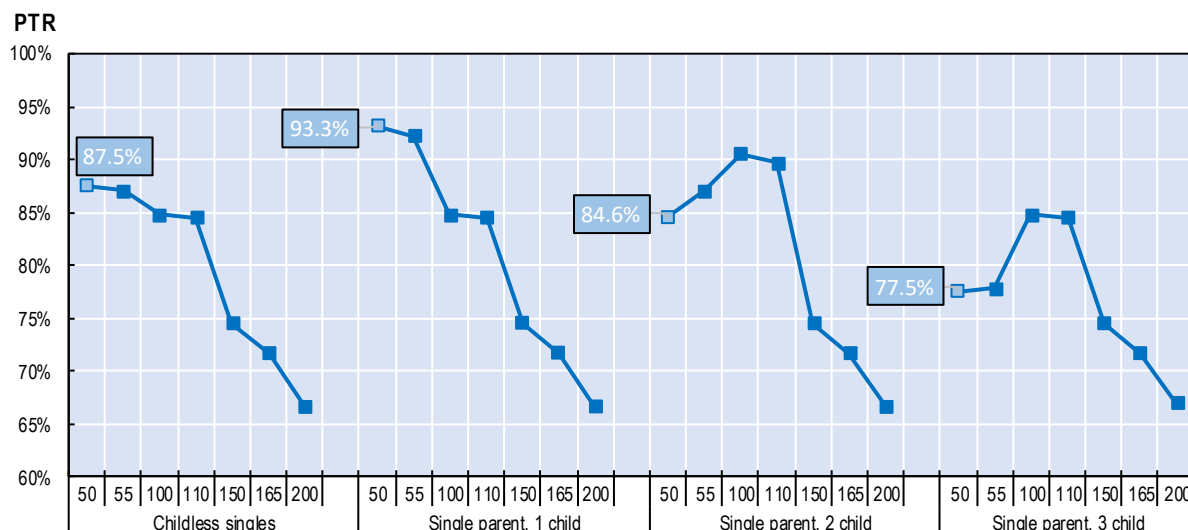
Among larger families, work is least attractive for middle-earners. For larger families with two and three children, work incentives are smaller at middle-incomes (100% of AW) than lower incomes due the ACB. The reverse is true for single parents with one child single individuals. For instance, single parents with two children at 50% and 100% of AW, PTRs are 84.6% and 90.5% (i.e. the work incentive has decreased) whereas for single parents with one child at 50% and 100% of AW, PTRs are 93.3% and 84.8% (the work incentive has increased). Therefore, compared to parents with one child, parents with two children likely face modestly higher poverty trap risk as they transition from low to middle incomes in that they may be discouraged from increasing their earnings (the poverty trap is however better investigated using METRs).

As low-income single parents grow family size from one to three children, unemployment trap risks fall and work incentives improve helped by in-work social assistance and the additional child benefit. Figure 4.16 also examines the financial incentives for a single individual to have a child and for small families to have additional children. Although child benefits are larger for larger families, they do not create a disincentive to enter work because they are available equally to both families in-work and out of work. For low-income single parents with one, two and three children, the PTRs are 93.3%, 84.6% and 77.5% respectively, reflecting greater work incentives for families with more children. For single parents with one child, lower work incentives arise from the loss of the additional child benefit while for single parents with two and three children, lower work incentives are driven by higher losses in in-work social assistance. Overall, among low-income families, unemployment trap risks are higher for smaller families.

Middle-income single parents with two children have modestly weaker incentives to return to work compared to those with one child. One atypical albeit modest incentive produced by the benefit system design is that middle-income parents with one child that have a second child face weaker work incentives. For single parents with one child, work is most unattractive at lower incomes (at 50% and 55% of AW) whereas for single parents with two children work is most unattractive at middle-incomes (at 100% and 110% of AW). This occurs because the means-tested additional child benefit is withdrawn for those in-work (making work less attractive relative to unemployment) and it is withdrawn at a lower net income level for single parents with one child than for single parents with two children. Therefore, the tapering of the additional child benefit at different incomes reduces work incentives at low incomes for the former and middle-incomes for the latter (in-work social assistance also plays a minor role for parents with two children).

Figure 4.16. Low work incentives in Lithuania tend to rise with higher incomes and family sizes

Short-term PTRs, single families with and without children at selected incomes, 2020



Note: PTRs for childless singles and single parents at selected income levels (50%, 55%, 100%, 110%, 150%, 165% and 200% of AW). The PTRs are shown within a high range on the vertical axis (from 60% to 95%) and should be interpreted accordingly. Unemployment benefit is assumed to be in months 1 – 3.

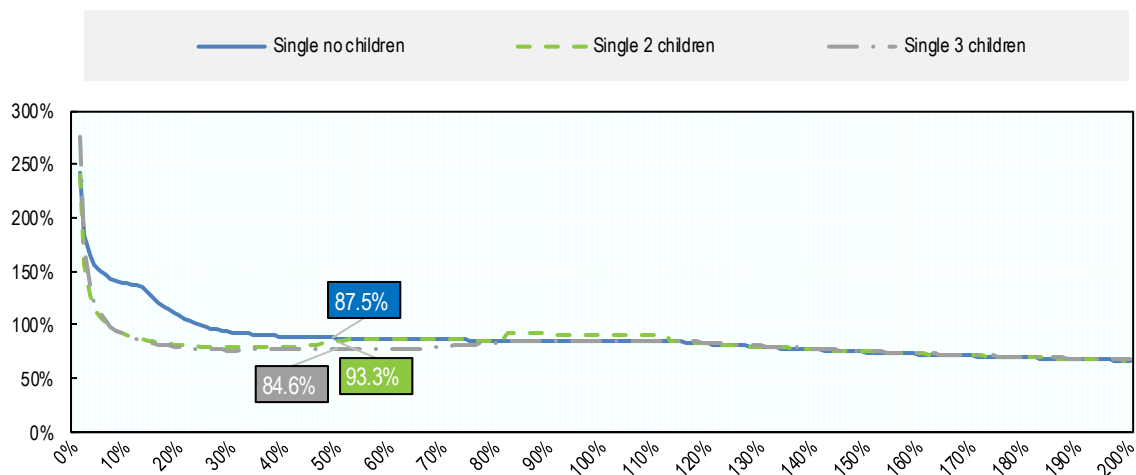
Source: OECD Tax and Benefit model TaxBen.

Very low earners are worse-off from working

Very low-income single individuals are worse-off from working. At very low incomes (10% to 50% of the AW) entering work from unemployment is very unattractive, especially for single individuals (Figure 4.17). Given that IWSA produces a PTR of just below 100% (i.e. where there is no incentive to work), very low-income childless singles (below 25% of the AW) are penalised by working as the decision to work makes them worse-off financially (reflected by PTRs above 100%). Low work incentive for poorer families partly reflect effective redistribution policies in Lithuania, including in this case relatively high UB during initial unemployment spells (Figure 3.21).

Figure 4.17. Very low-income childless singles are made worse-off by entering work

PTR decomposition (standard methodology), single individual and single parent with two children at 100% of the average wage, 2020



Source: OECD Tax and Benefit model TaxBen.

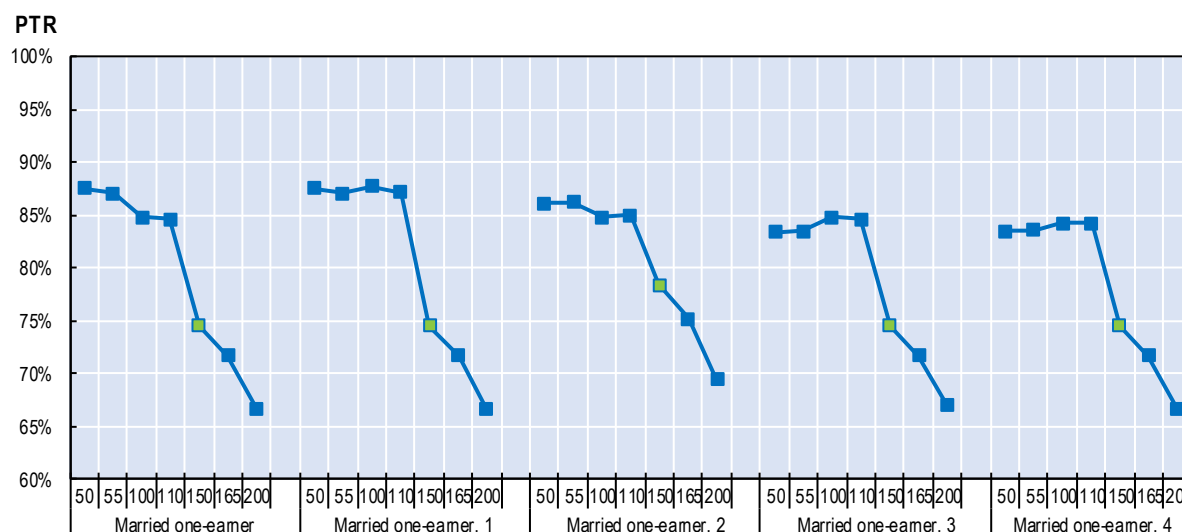
Single-earner couples earning below the average wage have weak work incentives

For one-earner couples, the incentives to enter work from unemployment for low to middle-income are relatively weak. The incentive for low to middle-income couples to enter work is relatively weak regardless of family size (Figure 4.18) since UBs are relatively high for short spells of unemployment (2 months of unemployment in this case, although the second adult not claiming UB in this modelling scenario). At higher incomes (at and above 150% of the AW), work disincentives improve but remain quite high.

For one-earner couples, the additional social assistance benefit available to larger families is likely too modest to meaningfully improve weak work incentives. Work is made modestly more attractive for low-income larger families with two or more children because of additional in-work social assistance benefit (which is greater for families with more children). However, the in-work social assistance benefit is more than offset by the work disincentives of lost benefits and higher taxes from working so that overall the additional in-work social benefit is unlikely to meaningfully enhance the already weak work incentives.

Figure 4.18. Unemployment traps are relatively high for low to middle-income one-earner couples

Short-term PTRs for one-earner couples with and without children (one adult transitioning to work from unemployment where unemployment period is 2 months) in Lithuania in 2020



Note: In the OECD TaxBen Model, the 'first adult' is transitioned from unemployment to work and claiming unemployment. The 'first adult' is assumed to have been unemployed for two months. The 'second adult' is unemployed and not claiming unemployment (in both cases, the same % of AW is used).

Source: OECD Tax and Benefit model TaxBen.

Second-earners face high unemployment trap risks

Second-earners, who are more likely to be women, tend to face lower work incentives and have higher responsiveness to work incentives than primary-earners. Second-earners have historically been, and still tend to be on average more likely to be women. The work incentives faced by second-earners are often lower than primary earners and the average tax wedges for second earners are often higher than for single individuals, which is reflected in lower participation rates. Second-earners tend to have a greater than average relative responsiveness to work incentives than other groups in most countries. Furthermore, non-tax measures such as childcare subsidies can also play a major role in the decision of second earner to enter work. Other measures such as flexible working and limited parental leave are also likely to encourage work. Given that many social transfers, including unemployment benefit, social assistance and housing support in Lithuania are targeted at low-income households, especially those with children, potential second earners in low-income households are most likely to face weak financial incentives to work.

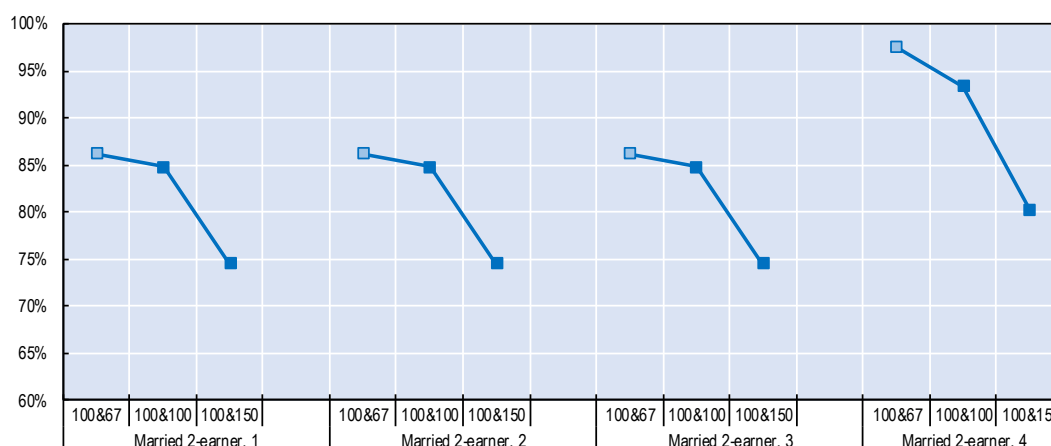
Lithuania's individual-based taxation could minimise reduced work incentives relative to family-based taxation. Lithuania operates an individual-based taxation system, as is increasingly the case in OECD countries (as opposed to family-based taxation). Lithuania does not have tax allowances or tax credits which often have family-based components. Lithuania does not face the higher work disincentives for second-earners that come with family-based taxation due to second-earners being immediately taxed at a higher marginal tax rate than individuals (i.e. the primary earner in a family-based taxation setting has already effectively used up the lower tax brackets and allowances leaving the second-earner to face higher marginal and average tax rates). Even where there is no family based taxation, many countries have benefits withdrawn on the basis of family income. Indeed, this is the case in Lithuania where social assistance benefit and other means-test benefits are based on net family income. Therefore, by

increasing their earnings second-earners in Lithuania risk reducing benefits producing a disincentive to enter work.

The incentives to enter work for low and middle-income second-earners in Lithuania are weak, particularly for those from larger families. Figure 4.19 shows the incentive for a second-earner in a married couple to enter work at different income levels (67%, 100% and 150% of the AW). The baseline case is that only one adult is earning an income of 100% of the AW and the second adult is claiming UB (assumed to be unemployed for a period of two months and their previous income is the same as the comparison in-work income). According to the analysis, second-earners with one, two and three children face the same equally low work incentives. Low-income second-earners have lower work incentives too. Low-income second-earners (at 67% of the AW) have a PTR of 86.1% compared to high-income second-earners (at 150% of the AW) who have a PTR of 74.5%. For second-earners in large families (with four children), work incentives for low-earners and middle-earners (at 67% and 100% of the AW) are even lower at 97.5% and 93.5% respectively, driven by reduced child benefits while in-work compared to unemployment.

Figure 4.19. Work incentives for low and middle-income second-earners are weak

METRs – Second earner income (at 67%, 100% and 150% of AW) versus one earner couple (at 100% of AW and unemployed adult claiming unemployment benefit) in Lithuania in 2020



Note: Two-earner couple earn 100% and 67%, 100% and 100% and 100% and 150% of the AW respectively. For one-earner couples, the 'second adult' earns 100% of the AW and the 'first adult' is assumed to be unemployed for a period of two months and receives unemployment benefit based on an assumed previous income which is the same as their in-work comparison level of income. Note that in the OECD TaxBen Model, the 'first adult' is transitioned from 67%, 100% and 150% of the AW the 'second adult' earnings is held the same at 100% of the AW.

Source: OECD Tax and Benefit model TaxBen.

At longer unemployment spells, work incentives rise as unemployment benefits are cut

For parents in the first 6 months of unemployment in Lithuania, the largest contributor to work disincentives are unemployment benefits but this switches to taxes thereafter. UBs as a share of gross income fall at longer unemployment spells. For a single parent with two children at the AW after 2, 4, 7 and 10 months out-of-work, the share of the work disincentive (as measured by the PTR) associated with UBs is 49%, 41%, 33% and 22% (in social assistance) respectively (Figure 4.20). For the same family type in each of these unemployment states, the share of the work disincentive associated with PIT and SSCs remains constant at 17% and 20% respectively (so the total tax-related disincentive is 36%).

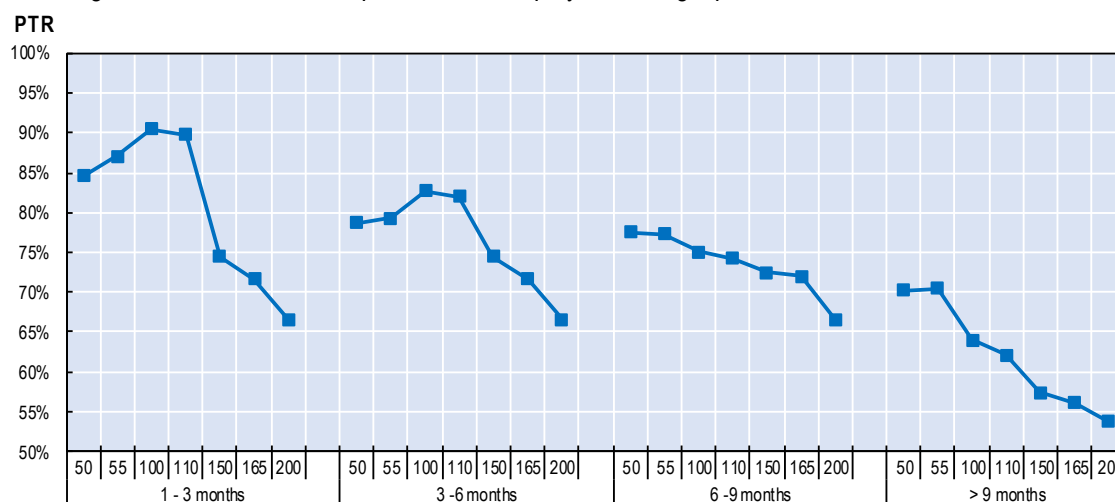
As parents remain out-of-work for longer spells, work incentives become increasingly strong due to progressively large relative declines in unemployment benefits. For single parents with two children at the AW, UB amounts decline from EUR 8,229 annually (at 2 months) by 16% to EUR 6,922 (at 4 months)

by 19% to EUR 5,615 (at 7 months) and finally transition to social assistance benefit by declining 32% to EUR 3,828 (at 10 months). The fall in UB is caused by the decline of the variable UB rate in each subsequent quarter. The increasingly rapid drops in out-of-work UB provide an increasingly strong financial incentive to enter the workforce sooner rather than later after becoming unemployed.

The unemployment benefit cap increases work incentives for individuals with higher earning potential by making unemployment less attractive (particularly short-term). UBs (fixed and variable) are capped (at EUR 760.01 in Q1 2020 or 58.18% of the AW as calculated by Statistics Lithuania) regardless of unemployment duration. Consequently, the greater UBs available at shorter unemployment spells will be capped at lower (previously insured) incomes compared to longer employment spells. For a single parent with two children, the maximum UB is reached with a (previously insured⁵) income of just 114% of the AW after 2 months compared to 143% and 190% after 4 and 7 months respectively. Compared to having no cap, capping UBs reduces the benefit to (previously insured) high-earners – who are likely to have the potential to earn more – particularly for shorter unemployment spells, which in turn increases work incentives for high-earners. Given the UB cap's role as redistributive mechanism in the design of the unemployment in Lithuania, and its potential to increase work incentives for higher-earners, a modest reduction in the cap could be considered.

Figure 4.20. The incentive to enter work falls with unemployment duration as unemployment benefits are progressively withdrawn

Short and long-term PTRs for different periods of unemployment, single parents with two children, Lithuania in 2020



Note: PTRs are for single parents with two children for longer unemployment spells corresponding to short-term PTRs (when families receive unemployment benefits at 2, 4 and 7 months respectively) and long-term PTRs (when families receive social assistance at 10 months). Analysis considers a single parent with two children in Lithuania and compares the in-work state with a range of out-of-work states.

Source: OECD Tax and Benefit model TaxBen.

As low-income parents transition to longer unemployment spells, work incentives continue to remain quite low

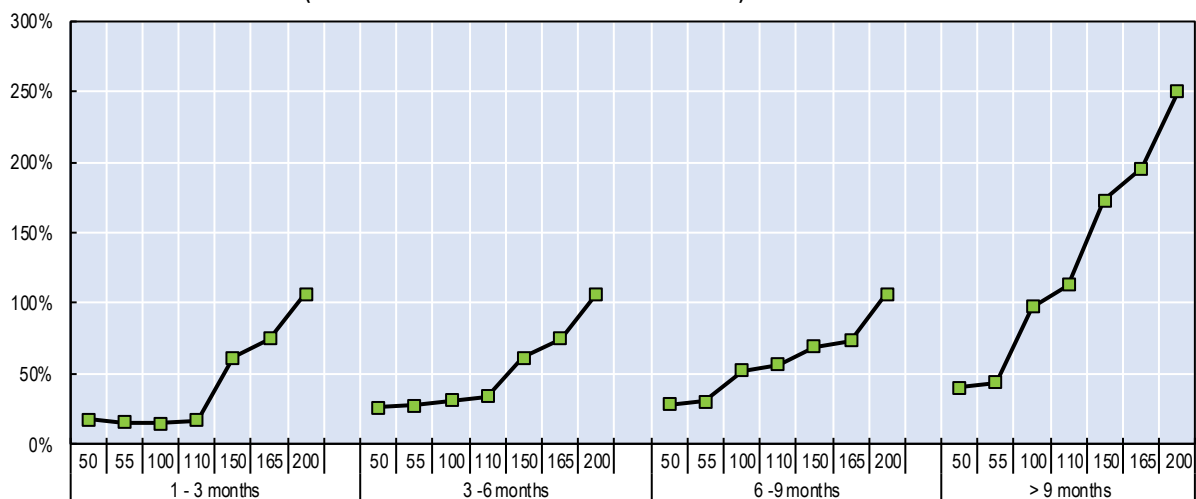
As parent's transition from nine to ten months out-of-work, and unemployment benefits are replaced by lower social assistance benefit, work attractiveness rises sharply at high incomes but only modestly at low incomes. Since UBs at nine months are higher for higher income levels and unemployed social assistance is flat across incomes (for a given family type), moving from nine to ten months out-of-work implies that UBs will decline as a share of higher incomes. Consequently, work attractiveness rises significantly with higher incomes. At low (50% of AW), mid (100% of AW) and high incomes (150% of AW), PTRs fall from 77.5% to 70.3%, 75.0% to 63.9% and 66.6% and 53.7%. However, for low-income parents, work incentives still remain quite low even at longer unemployment durations.

While the PTR measures the incentives produced by the tax and benefit system, more direct financial incentive measures could shed light on individuals incentives. While PTRs capture the incentives produced by the tax and benefit system as a share of gross incomes, it is not necessarily the case that they adequately capture the incentives that individuals respond to when considering entering work. A more direct measure of the financial incentive to work for individual decision-making (as opposed to assessing the role of the tax and benefit system) might be captured by the percentage increase in additional net earnings that an individual can gain from working instead of remaining unemployed. Unlike the PTR, this measure does not include gross income. Using this financial measure, Figure 4.21 shows that for a parent that is out-of-work for one quarter, entering work at 50%, 100%, 150% and 200% of the AW would increase net income by 17.4%, 14.9%, 61.0% and 106.6% respectively. Put differently, a high-income parent earning twice the AW, who is currently unemployed but who has the skills and opportunity to enter the labour market is in a position to more than double their net take-home income. While the probability may be low that a long-term unemployed parent have the skills and opportunities to find employment at the high earnings multiples suggested by this measure, the analysis highlights the importance of developing those skills and producing those opportunities. Despite this seemingly attractive incentive to more than double net income, the PTR associated with this same example is somewhat high at 66.6%. Similarly, in the case of a high-income individual earning twice the average wage on long-term unemployment (> 9 months), entering work would increase incomes by more than 250% but the associated PTR is 53.7%. These examples highlight the broader point that the PTR measures the work incentives produced by the tax and benefit system as a share of gross income, which can be different than more direct measures of the additional net income an individual can earn by working compared to unemployment. Consequently, it is useful to consider both measures in assessing the role of incentives on individual responses.

Figure 4.21. A more direct measure of financial incentive indicates a strong incentive to work for high-earners, if the right skills and opportunities were in place

The financial incentive to work*, single parents with two children, Lithuania in 2020

Net financial incentive to work (net in-work income vs net out-of-work income)



Note: *The financial incentive is defined as the percentage by which net income is larger in-work than out-of-work.

Source: OECD Tax and Benefit model TaxBen.

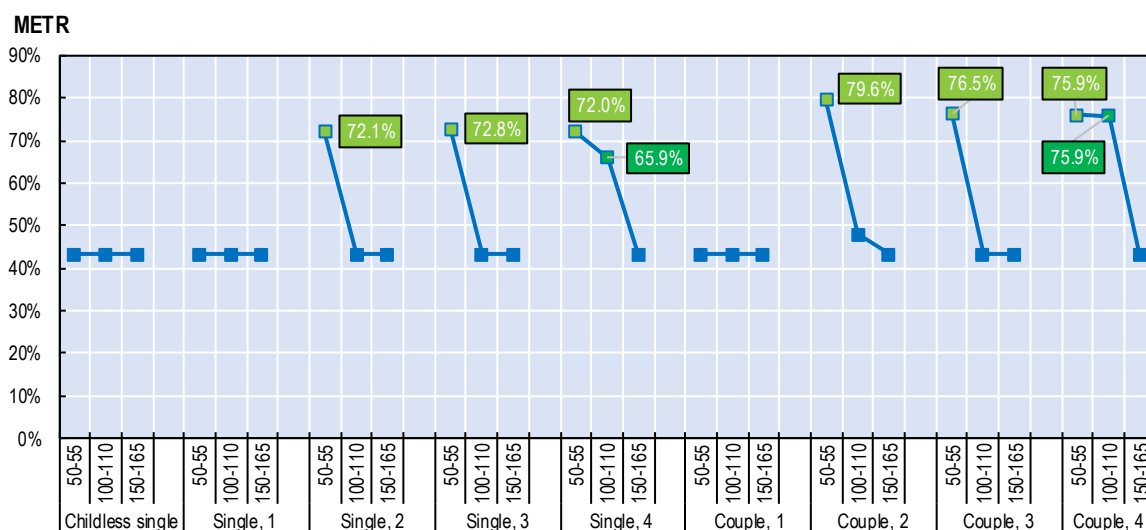
The incentives to progress in work

Larger low and middle-income single and couple families face high poverty trap risks

Poverty traps in Lithuania may exist among low-income families with two or more children and also among middle-income families with four children. The financial incentive to increase gross earnings by 10% among lower earners (from 50% to 55% of the AW) with larger families (with two or more children) is relatively low (as reflected in high METRs ranging from 70% to 80%) (Figure 4.22). The incentive to increase gross earnings by 10% is also low among middle-income families with four children. For all other family types and incomes shown, METRs are considerably lower (ranging from 40% to 50%). Drivers of the work disincentive include PIT and SSCs 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 reconciling redistribution and equity with efficiency (Table 4.1). This highlights the potentially important role of active labour market policies including linking benefits to participation in training programmes to prevent skill loss (Figure 2.20).

Figure 4.22. Poverty traps may exist among larger low-income families and large middle-income families

METRs associated with increasing income by 10% in Lithuania, various income levels and family types in 2020



Note: The calculation of the METRs is the same as the calculation of the PTR across two discrete income levels (i.e. where the out-of-work net income in this case is a lower income level) and the METRs take account of the taxation of additional in-work income plus the withdrawal of income-tested benefits. METRs for single individuals with no children, single parents with children and one-earner couples with children in Lithuania in 2020 for a 10% increase in gross incomes at 50%, 100% and 150% of the AW. Couples refers to one-earner couples and the non-earning adult is assumed not to be claiming unemployment. Housing benefits not included.

Source: OECD Tax and Benefit model TaxBen.

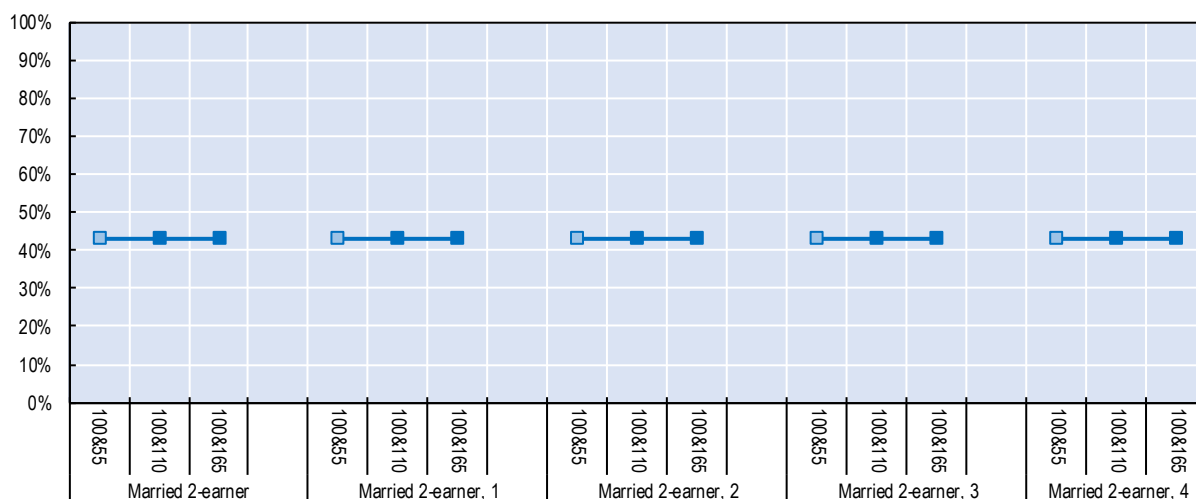
Second-earners are unlikely to face significant poverty traps

Once in employment, second-earners in a family have relatively high incentives to earn more partly because benefits are not withdrawn. Despite weak incentives to enter work for second-earners (Figure 4.19), the incentives to progress once in work are relatively high (METR is 43.3%) as there are no benefit withdrawals (Figure 4.23). Work incentives for second-earners are the same regardless of family

size and income (for the low, middle and high income points shown). The constant METRs at higher incomes reflect a lack of labour tax progressivity in Lithuania at higher incomes (Figure 4.23).

Figure 4.23. Poverty traps for second-earners are low, regardless of family size and income

METRs associated with a 10% increase in second-earner income (at 50% to 55%, 100% to 110% and 150% to 165% of AW) in Lithuania in 2020



Note: Work incentives for second-earners to progress once in work by examining the METRs associated with a 10% increase in the earnings of second-earners. In the OECD TaxBen Model, the 'first adult' is transitioned from 50% to 55%, 100% to 110% and 150% to 165% of the AW and the 'second adult' earnings is held the same at 100% of the AW.

Source: OECD Tax and Benefit model TaxBen.

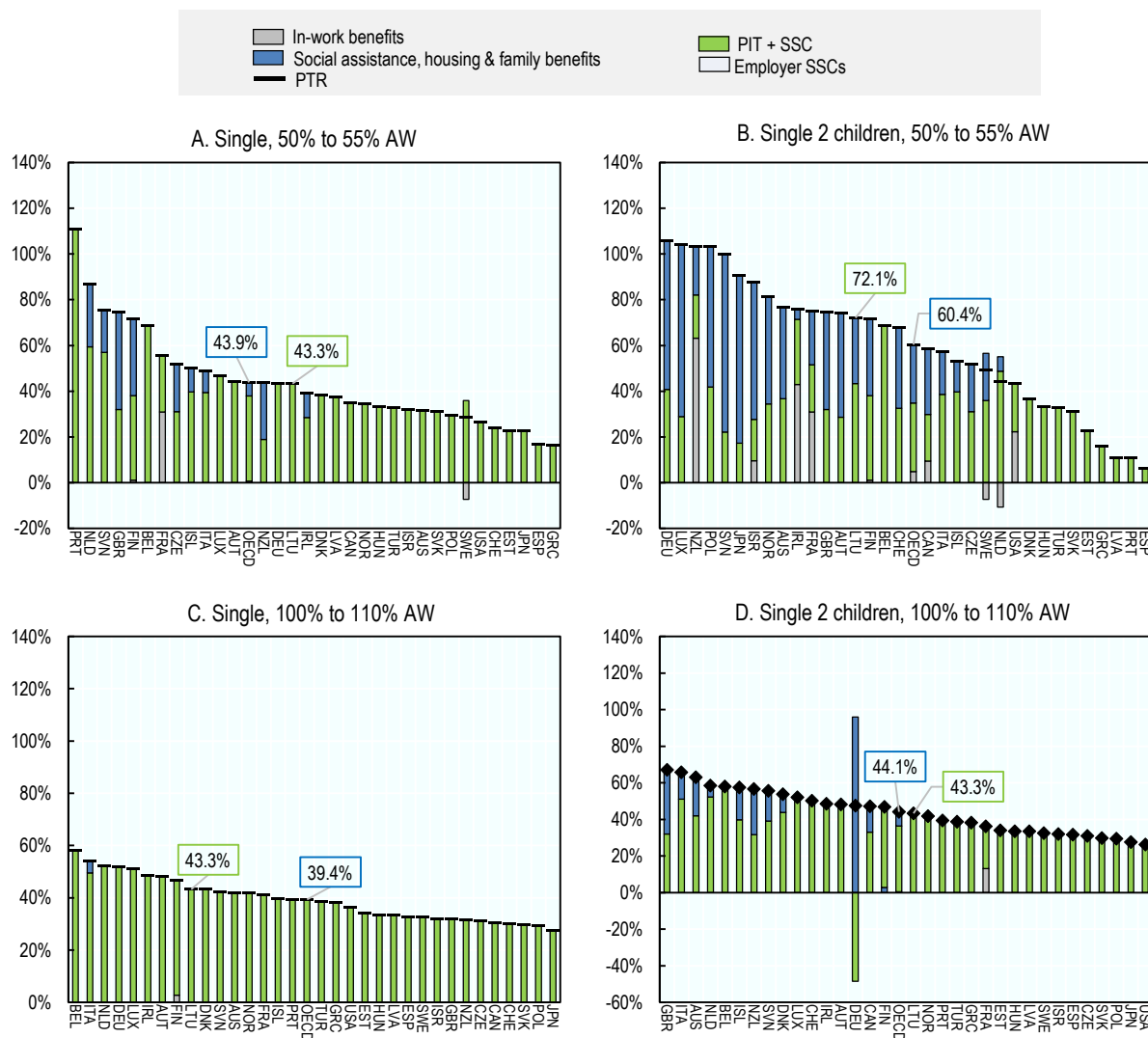
Middle-income large families are at risk of poverty traps in international comparison

Low-income single families with two children may face some poverty traps. For low-income singles, the disincentive to increase earnings by 10% is similar to the OECD average (Figure 4.24, Panel A). The work disincentive is mostly driven by the additional PIT and SSCs that would be paid upon earning more. For low-income single parents with two children, the disincentive to work more is significantly higher than for singles without children and higher than the OECD average due higher taxes and the loss in social assistance benefit (Figure 4.24, Panel B).

Large low and middle-income families in Lithuania have relatively lower incentives to progress in work by international comparison, producing potential poverty traps. For low-income large single families (with four children) the METR is high at 72.0%, driven by PIT and SSCs (43.3%) and the loss of social assistance (28.7%) vs the OECD average METR of 57.6% (Figure 4.25, Panel A). Similar results compared to the OECD are obtained for one-earner couple families (Figure 4.25). For middle-income large families, the disincentives to progress in work are similarly high and above the OECD average, driven mostly by taxes. For middle-income one-earner couples with four children, the disincentive to progress in work is higher due to a relatively larger loss in in-work social assistance benefit (since social assistance in Lithuania is increased per each additional person in the family including adults).

Figure 4.24. Low-income single families with children face high poverty traps in international comparison

METRs associated with a 10% increase in earnings at 50% of AW and 100% of AW, single individuals without children and single individuals with two children, Lithuania and OECD countries, 2020

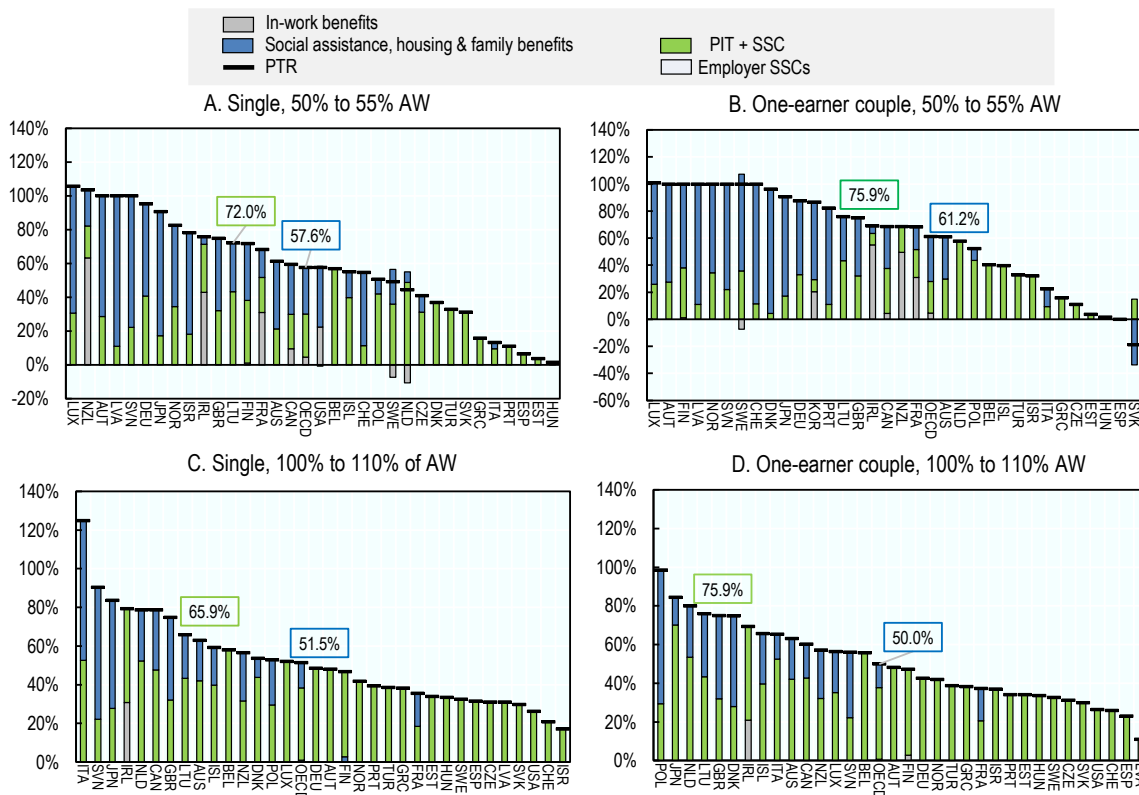


Note: Figure shows METRs in Lithuania and OECD countries associated with a 10% increase in earnings for single individuals with and without children with low-incomes (50% of the AW) and medium earnings (100%). Includes housing benefit. Note that family and housing benefit have no incentive impact as they are the same for those in work at both 50% and 55% of the AW.

Source: OECD Tax and Benefit model TaxBen.

Figure 4.25. Incentives to progress in work for large families are relatively low in international comparison, particularly at middle-incomes

METRs associated with a 10% increase in earnings at 50% of AW and 100% of AW, single individuals and one-earner couples with four children in Lithuania and OECD countries, 2020



Note: Figure 4.25 shows METRs in Lithuania and OECD countries associated with a 10% increase in earnings for larger families (with four children) with low-incomes (50% of AW) and middle incomes (100% of AW). Includes housing benefit. Note that family and housing benefits in Lithuania have no disincentive effects since they are the same for workers in both states.

Source: OECD Tax and Benefit model TaxBen.

The withdrawal of the housing and child benefits may induce poverty traps

The housing benefit produces sharp increases in the METR at certain income levels for some families. As discussed previously (see section 3.3), the value of the housing benefit (HB) in Lithuania is substantial. For a single person for instance, a parent with two children and a parent with 3 children, the housing benefit represents 6.6%, 19.8% and 20.0% of the AW respectively. The HB is withdrawn fully and at once for single individuals, parents with two children and parents with three children at 68%, 147% and 172% of the AW respectively (Figure 4.26). Below the net income limits, the HB is unaffected so that, for example, a single person who increases their earnings by 10 per cent from 60% to 66% has an METR of 43% due mostly to taxes (PIT and SSCs) rather than benefits (i.e. the housing benefit remains in place at both income levels). Once the net income limit is exceeded, the HB is immediately and fully lost. For a single person who earns slightly more income than the previous example and instead increases their earnings by 10 per cent from 67% to 74% of AW, the METR is significantly higher at 137%. For parents with children, even higher METRs exceeding 100% are observed as the housing benefit is withdrawn,

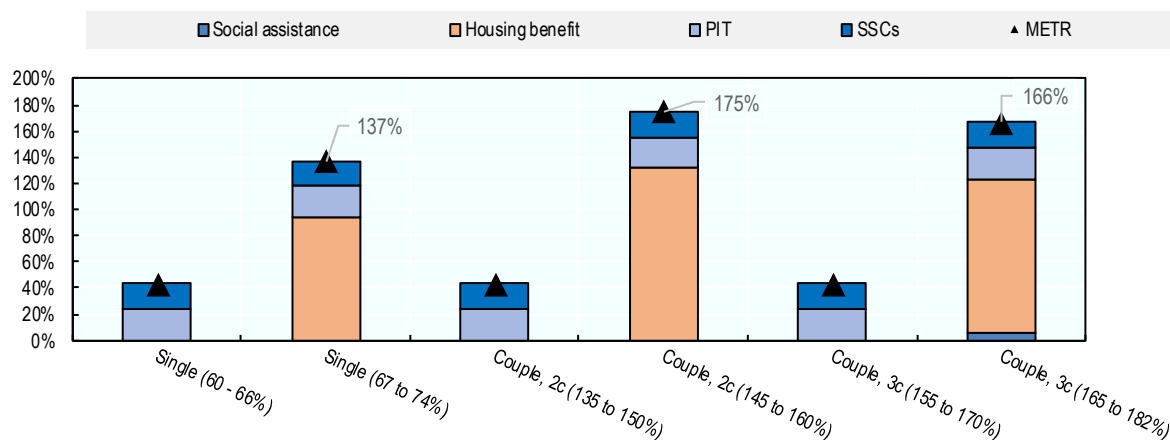
albeit this occurs at higher incomes because larger families continue to receive the housing benefit at higher income levels.

The strong disincentive to increase earnings by 10% at certain income levels could produce poverty traps. What role might HB play in producing a potential poverty trap by disincentivising working more hours? Some families have no financial incentive to increase earnings by 10% at certain income levels because the withdrawal of the housing benefit leads to METRs that are above 100% (i.e. earning more leads to reduced net incomes) (Figure 4.26). For a couple with two children, increasing gross income from 135% to 150% increases net incomes by 8% but the same couple increasing incomes from 145% to 160% decreases net income by 10%. This is a clear disincentive increase earnings produced by the HB. To the extent that families are discouraged by financial incentives, and are aware of the HB loss associated with higher earnings, some families may choose not to increase in their income or not to work more hours in these income ranges. This could lead to reduced levels of work, effort and productivity. This is of greater concern for single persons and two adult families with three children who face high poverty risks in Lithuania (56.4% and 25.6% in 2020 respectively) (Figure 2.11).

One option to reduce the disincentive would be to withdraw the housing benefit gradually as incomes increase and its point of withdrawal could also be reduced. The current withdrawal of the housing benefits produce sharp increases in METRs which mean some families have negative financial incentives to work more. For each of the given 10% increases in earnings shown in Figure 4.26, if 20% of the housing benefit were withdrawn (rather than 100%), the METRs would decline to 62%, 70% and 72% respectively – which, while high, would still provide a positive financial incentive to work. The withdrawal also starts at a high level, which is costly, and so point of withdrawal could also be lowered.

Figure 4.26. The withdrawal of the housing benefit produce large METRs, which may lead to poverty traps for some families

METR decomposition in Lithuania, selected family types who increase their earnings by 10 per cent, 2020



Note: The location is assumed to be Vilnius.

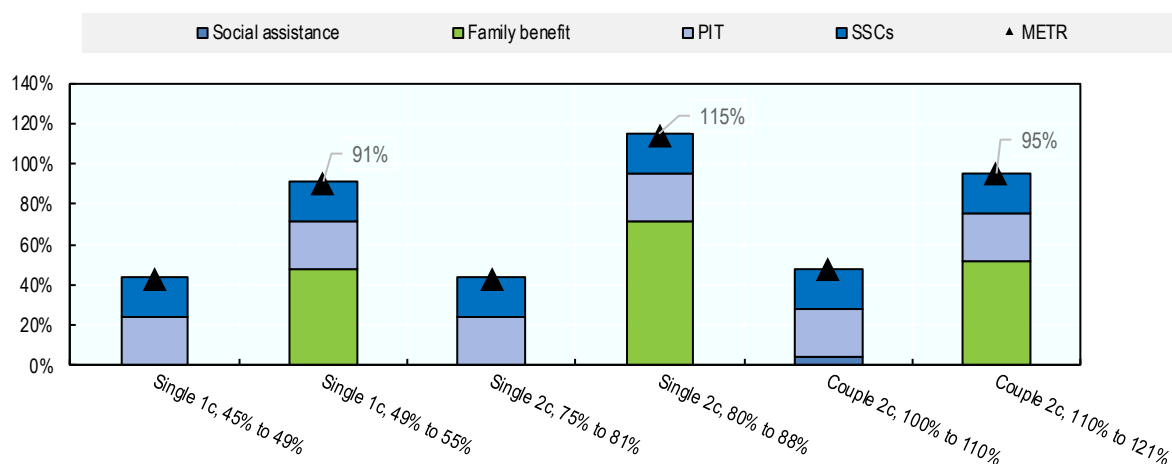
Source: OECD Tax and Benefit model TaxBen.

The withdrawal of the child benefit will produce high METRs for some families that are at high risk of poverty such as single parents. Figure 4.26 models METR decompositions for six family types with different income levels for approximate increases of about 10 per cent at income levels above and below the point at which the family benefit is withdrawn - namely, the child benefit and specifically the additional child benefit. As discussed previously, the poverty risk for single persons with one child (45.2%) is

particularly high in Lithuania and not so high for two adults with two children (11.1%) (Figure 2.11). For a single parent with one child, increasing gross income from 45% to 49% is associated with a METR of 43.3% but increasing gross income from 49% to 55% is associated with a significantly higher METR of 91.0%. For a single parent with two children and a couple with two children, the METRs are even higher at 115% and 95% respectively but these occur at higher income levels owing to larger family size. In general, these high METRs just above and below 100% imply that increasing income by about 10 per cent either slightly increase or decrease net income but, broadly speaking, net income remain approximately unchanged. If families observe and respond to these reduced financial incentives to increase income, work and effort at these income levels, poverty traps may arise where low work incentives keep families ‘trapped’ at low incomes. This is a particular concern for already high at risk of poverty families such as single parents in Lithuania. 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.

Figure 4.27. The withdrawal of child benefits produce large METRs, which may lead to poverty traps for some families

METR decomposition in Lithuania, selected family types who increase their earnings by 10 per cent, 2020



Note: Housing benefit not included.

Source: OECD Tax and Benefit model TaxBen.

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Notes

¹ Since unemployment benefit (UB) has a duration of 9 months in Lithuania, short-term unemployment is defined in this current report as 9 months or less and long-term unemployment longer than that.

² This is true when all variables in the equation are positive.

³ For single parents with two children at 100% of the average wage, the additional child benefit (which is withdrawn at higher incomes), is withdrawn for those in-work but not for those out-of-work, thus causing a decreased work incentive above that of single individuals at 100% of the average wage.

⁴ The reason for the rising work incentive is that after the maximum UB cap, UB remains flat so the increase in UB as a share of gross income as incomes rise is always less than the increase in additional net in-work income as a share of gross income.

⁵ Assumed to be equal to former insured income levels in the OECD TaxBen models.

5

The taxation of self-employed individuals

This chapter focuses on the taxation of self-employed individuals in Lithuania. The chapter begins by considering self-employment trends, the tax rules on self-employment and the characteristics of the self-employed. Next, the tax design and tax burdens of the business certificate and individual-activity regimes are evaluated against each other and standard employment and options for tax reform are presented. Finally, incorporated self-employment under different CIT rates is compared against standard employment and the individual-activity regime.

Introduction

This chapter provides observations on the tax design and options for tax policy reforms in unincorporated and incorporated business regimes in Lithuania. The unincorporated regimes focus on the business certificate (BC) regime and the individual-activity (IA) regime (the taxation of self-employed farmers is briefly reviewed separately). The regimes are evaluated in terms of their tax design, tax rates and tax burdens, tax-induced incentives between organisational forms (including standard employment), interaction (i.e. migration between them) and adherence to principles of good tax policy (i.e. horizontal equity and tax neutrality). The incorporated business regime section focuses on owner managers of closely-held corporations and the tax-induced incentives between distributing profits as dividends and drawing a salary as an employee under both standard and reduced CIT rate regimes. The chapter is based on analysis using a representative sample of the tax record microdata in 2019. The chapter draws from a forthcoming OECD paper on the design of presumptive tax regimes (Mas-Montserrat et al., forthcoming^[1]). The self-employment tax rules refer to the year 2021, unless otherwise stated. For simplicity, the following shorthand acronyms are used regularly throughout this chapter:

1. SE refers to self-employed taxpayers.
2. IA refers to individual-activity taxpayers.
3. BC refers to business certificate taxpayers.

Self-employment trends

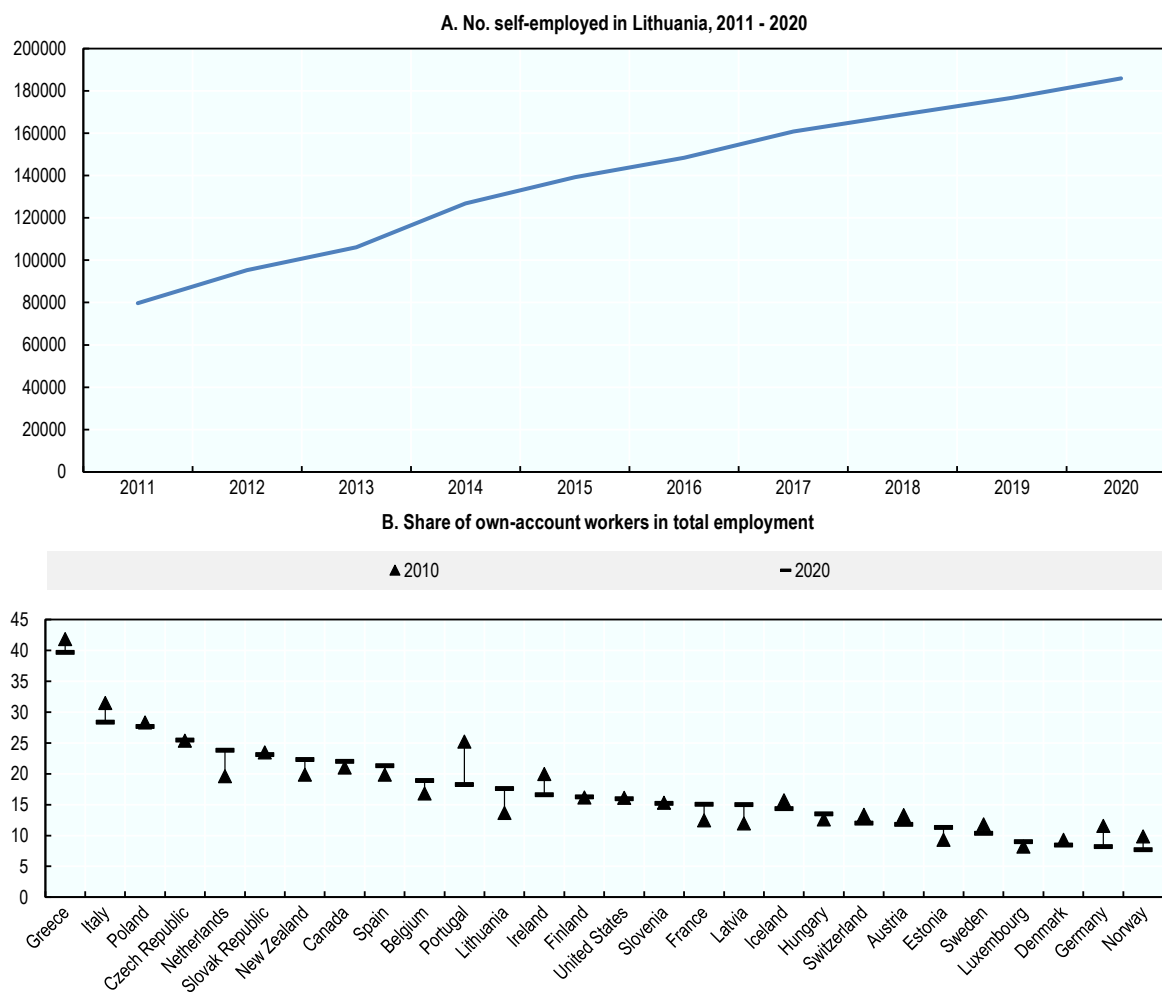
Self-employment has continued to grow (Figure 5.1, Panel A). Own-account workers represent 17.6% of total employment in 2020, which places Lithuania in the middle range of OECD countries (Figure 5.1, Panel B). While there has been no clear trend across the OECD in the share of own-account workers in total employment between 2010 and 2020, there has been a significant increase in Lithuania.

Self-employment numbers are significant. Individual activity in Lithuania refers to unincorporated self-employment (SE) activity from which income is received regularly. There are two main ways of taxing individual SE activity in Lithuania. They are the individual-activity certificate regime (IA regime) and the business certificate regime (BC regime). The number of individuals in the BC regime represents about half of the IA regime in 2019 (88,208 individuals declared having income under the BC regime and 174 124 declared having income under the IA regime).¹ In the IA regime, about one-third of individuals are farmers (116 680 related to non-agricultural income and 57 444 relate to agricultural income). Individuals in the IA and BC regimes combined comprise 18% of employees (there are a total of 1 434 240 individuals with employment income in 2019²). Lithuania has a wide range of other categories which do not belong to self-employed or employed categories, which are outside the scope of the current review. Figure 5.3 provides a stylised overview of the organisational forms considered.

Self-employment PIT revenues

PIT revenues from self-employment are low compared to standard employment. The average PIT paid per person is lowest in the BC regime, followed by agricultural activity in the IA regime and then non-agricultural activity in the IA regime (Figure 5.2). The average PIT paid is significantly lower in all of the SE regimes compared to standard employment.

Figure 5.1. Self-employment is growing

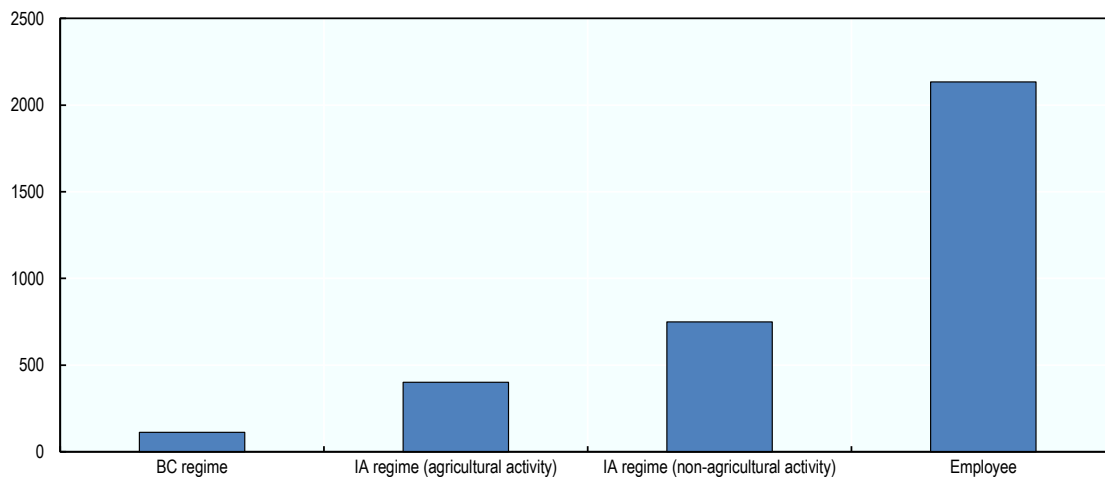


Note: In chart A, self-employed defined as persons carrying out economic activity by certificate and individual enterprises are public and private companies, state-owned and municipal enterprises, foreign affiliates, agricultural and cooperative partnerships, public bodies. In chart B, only countries for which data are available are shown.

Source: Statistics Lithuania. OECD Gender – Entrepreneurship database.

Figure 5.2. PIT revenues from self-employment are low

Average PIT paid per person (EUR), 2019



Note: PIT paid is based on both declarations filed by individuals and on behalf of individuals. BC regime refers to income from individual activities under a business certificate. IA regime (agricultural activity) refers to income from agricultural individual activity under an individual activity certificate. IA regime (non-agricultural activity) refers to income from non-agricultural individual activity under an individual activity certificate. Employees refer to payments made in connection with employment relations or relations in their essence corresponding to employment relations, except certain other payments.

Source: OECD analysis of microdata.

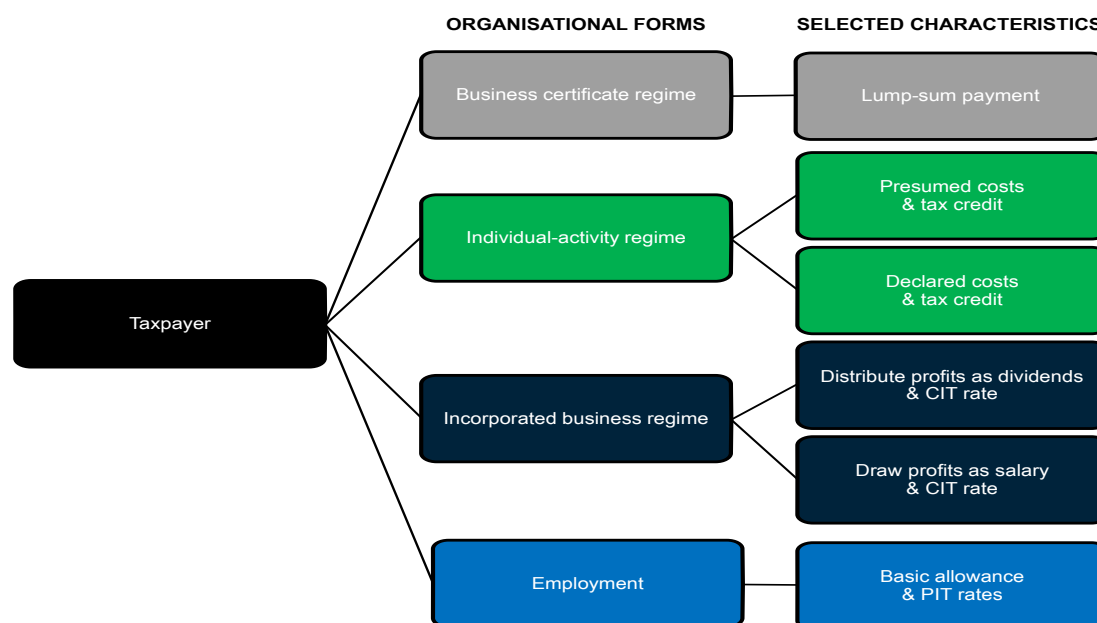
Principles of tax policy design for self-employment

The principle of horizontal equity says that tax and benefit treatment should be aligned across employment forms, but rationales exist for departure from the principle. Equity is the aim that taxation is fair for all taxpayers. Equity can be broken into vertical equity (how individuals with a greater ability to pay should bear proportionately higher tax burdens) and horizontal equity (how similar individuals should face similar tax burdens). This chapter focuses mainly on the latter. The principle of horizontal equity states that tax treatments and benefit entitlements should be broadly aligned across different employment forms (e.g. between employees and the self-employed). However, arguments have been made to justify departures from the principle of horizontal equity in tax treatment beginning with the notion that employment forms face different economic realities in terms of agency over their work, social protections they are afforded and the risk they bear. For example, the job uncertainty, investment loss and competitive pressure of self-employed compared to employment may justify lower tax burdens on the self-employed (Milanez and Bratta, 2019^[21]). Similarly, reduced employment rights and different entitlements may justify lower tax burdens.

The principle of tax neutrality says that tax should not be a factor in organisational form decisions, but non-neutral policies can have justifications. Tax treatment is neutral when similar individuals face the same tax burden and tax is not a factor in the organisational form decision. Neutrality implies that decisions are made on economic merit and not for tax reasons. Departures from horizontal equity tax treatment can have implications for neutrality. For example, greater allowable deductions for self-employed workers relative to employed workers (which is commonly the case across countries including in Lithuania) could lead to false self-employment and inflated deductions. Similarly, lower tax rates on capital income relative to labour income (which is commonly the case across countries including in Lithuania) can encourage the self-employed to incorporate their business and re-characterise labour income as capital

income (Milanez and Bratta, 2019^[2]). Non-neutral policies such as these can however be justified for example on the basis of encouraging economic growth and job creation.

Figure 5.3. Stylised illustration of organisational forms



Source: OECD analysis.

Self-employment tax rules

This section provides an overview of the tax rules for self-employment in the BC and IA regimes compared with standard employment for both PIT and SSCs. The analysis presented for the IA regime includes self-employed farmers and non-farmers. Since the tax rules differ for farmers, farmers are briefly discussed separately at the end of the IA regime section.

PIT rules

Taxpayers in Lithuania can simultaneously belong to several different organisational forms including two self-employment regimes (IA and BC regimes), a standard employment and incorporation (at a standard or reduced CIT rate and then with a choice to pay profits in dividends, in salary or retain in the company). The organisational forms differ in several respects including how income is taxed, deductions, eligibility criteria, record-keeping requirements and the level of government at which taxes are set and collected (Table 5.1). The tax rules described in this section refer to the year 2021. There are other types of self-employment income that exist but which are not considered for the purposes of this report.

Table 5.1. Overview of tax characteristics by organisational form

Regime	Selected characteristics	Tax rates & taxable income bands
1. Individual-activity certificate (IA regime)	<ul style="list-style-type: none"> -Taxable individual certificate income. -Tax credit (maximum of 10%). -Presumed cost deduction of 30% of income (optional). -SSCs are deductible from the PIT base. -Retain and report tax records (quarterly or annually). -May hire employees. -Must issue VAT receipts or other receipts to customers. 	5% (EUR 0 – 20 000). 5% - 15% (EUR 20 000 – 35 000). 15% (>EUR 35 000).
2. Business certificate regime (BC regime)	<ul style="list-style-type: none"> -Limited to certain business activities. -Limited to annual revenues cap of EUR 45,000. -SSCs are not deductible from PIT base. -No tax credit and no presumed expenses. -Taxpayers only need report turnover and not costs. -Tax liability set by and allocated to municipalities. -May not hire employees. 	Fixed lump-sum PIT payment.
3. Standard employment contracts	<ul style="list-style-type: none"> -Basic allowance. -SSCs not deductible from PIT base. 	20% (up to 60 monthly AW ¹). 32% (> 60 monthly AW ¹).
4. Incorporation	-Business chooses the form to realise their return	Standard CIT rate is 15% Reduced CIT rates of 5% and 0% Tax rate on dividends is 15%

Note: (1) AW refers to the SODRA average wage. The Several non-standard tax reliefs apply to the self-employed (these also apply to employment) including contributions to 3rd pillar pension funds, life insurance contributions, and certain 2nd pillar pension contributions and certain payments for studies.

Source: Sodra; VMI.

In the IA regime, the PIT rate is increasing. Under the IA regime, the PIT rate is applied to taxable income. The PIT rate ranges from 5% for taxable incomes up to EUR 20 000 to 15% for taxable incomes above EUR 35 000 (Table 5.1). The average effective PIT rate increases between taxable income of EUR 20 000 and EUR 35 000 as a result of the design (discussed later, see Figure 5.15).

In the IA regime, individuals can choose between declaring expenses and a presumed cost deduction. When taxing IA, all incomes related to IA are combined. Taxable IA income is calculated by deducting IA-related deductions. Deductions include IA-related expenses, non-taxable income, previous losses and SSCs (including health SSCs). Furthermore, IA taxpayers can choose between declaring actual expenses and opting for a presumed cost deduction of 30% of IA income (which includes SSCs and health SSCs).

In the IA regime, SSCs are deductible from the PIT base. For Lithuanian employees, SSCs are not deductible from the PIT base (in contrast to most OECD countries). For IA taxpayers, SSCs are deductible. For BC taxpayers, SSCs are not deductible (as are any other expenses for BC activities).

In the BC regime, individuals pay a fixed lump-sum payment. The tax liability is a fixed lump-sum PIT payment that is paid in advance when a taxpayer purchases the business certificate.

In the BC regime, the municipalities set the lump-sum payment and receive the PIT revenues. The amount of the lump-sum payment under the BC regime is set by the municipalities and is allocated to municipality budgets. In contrast, PIT revenues on other SE and employment income are set by central government (and allocated between central and local government).

The BC regime has an annual revenue cap. To be eligible for the BC regime, taxpayers must have annual revenues below EUR 45 000. Annual revenue exceeding the cap is taxed under the IA regime. The cap is equal to the VAT threshold in Lithuania so BC taxpayers usually do not have to register for VAT.

Annual revenues include income from all activities with business certificate combined, except for rent from residential property, which is calculated separately.

Eligibility for the BC regime is limited to certain activities. To be eligible for the BC regime, taxpayers must operate in a specified list of activities set periodically by the government. Each activity requires a separate business certificate. The certificate is only valid for a specified location and time.

SSC rules

SSC rates for the self-employed are lower than for employees, particularly for the business certificate regime. Total SSC rates are highest for employees (21.29%), IA taxpayers (19.5%) followed by BC taxpayers (15.7%) (Table 5.2). When employer SSCs are excluded (which relate to unemployment, occupational accident and diseases and social tax), SSC rates are the same for employees and IA taxpayers. For BC taxpayers, SSC rates are lower as sickness and maternity SSCs are not included.

Table 5.2. SSC rates by organisational form

	IA regime	BC regime	Employee
Total SSC rates	19.5	15.7	21.29
<i>Of which:</i>			
Excluding employer SSC rates	19.5	15.7	19.5
Pension SSC rate	8.72	8.72	8.72
Sickness SSC rate	2.09		2.09
Maternity SSC rate	1.71		1.71
Unemployment SSC rate			(1.31)
Occupational accidents and diseases SSC rate			(0.16)
Health SSC rate	6.98	6.98	6.98
Social tax			(0.32)

Note: Employer SSCs are shown in brackets. Since 2021, self-employed persons at retirement age, receiving the old-age pension or with lost working capacity are exempt from paying SSCs.

Source: Sodra.

The SSC base for the self-employed is narrower than for employees, particularly for the business certificate regime. SSCs due are calculated by applying SSC rates (Table 5.2) to the SSC base. The SSC base is insurable income and differs by organisational form (Table 5.3). In the IA regime, the SSC base is 90% of taxable IA income (before SSCs are deducted). For health SSCs in the IA regime, there is an SSC floor so that insurable income cannot fall below the MMW. In the BC regime, insurable income is set at the MMW for pension SSCs and health SSCs (i.e. these are the only two SSC rates that apply to the BC). An SSC floor and ceiling apply to employees but not to the SE regimes (except for the health SSC in the IA regime).

Table 5.3. SSC tax base by organisational form

IA regime	BC regime	Employee
- Insurable income set at 90% of taxable individual activity income. - SSC floor for health SSCs. ¹	- Insurable income set at MMW (for pension SSCs and health SSCs).	- Insurable income set at gross wage and benefits. - SSC floor. ² - SSC ceiling. ³

Note: 1. In the IA regime, for calculating health SSCs, there is an SSC floor such that insurable income cannot fall below MMW. 2. For calculating SSCs for employees, there is an employer SSC floor such that insurable income cannot be below MMW. If an employee's income is below the MMW, employers pay the difference. 3. For employees, there is an SSC ceiling at incomes of 60 monthly AW in 2021. Above 60 monthly AW, there is a 0% contribution rate.

Source: Sodra.

The characteristics of the self-employed

Before considering the BC and IA regime in detail, this section provides an overview the income distributions and demographic characteristics across the regimes based on the microdata.

Applying the microdata to self-employment

Self-employed taxpayers are defined in the microdata as those with meaningful self-employment activity. To identify taxpayers with meaningful self-employment activity, self-employed taxpayers (SE) are defined as are non-pensioners (i.e. have no pension income) with SE income representing at least 15% of employment wage income plus SE income (Table 5.4). On this basis, there are 5,660 SE (8% of the three categories of taxpayers). Of these, 62% derive all of their income from SE and 38% from a combination of SE income and employment income. The SE group is further divided into the IA regime (64%) and BC regime (36%).

Comparing single income source groups is a useful empirical simplification. Since PIT applies to a wide range of incomes (e.g. employment, self-employment, dividends etc), a useful empirical simplification is to compare taxpayer groups with a single income source such as comparing ‘pure employees’ (i.e. employees with only employment income) with ‘pure self-employed’ (i.e. self-employed with only self-employment income).

Table 5.4. Defining self-employment in the microdata

Category	Definition	Number	%
Total sample	Total number of taxpayers in the sample.	100 616	
	Total number of households in the sample.	46 011	
Sampling frame	Total excluding taxpayers with no pension, employment or self-employment income.	71 741	100%
<i>Of which:</i>			
Pensioners	Total pension income (pension benefit + private pension + disability pension) is positive.	27 400	38%
Employees	Not a pensioner, employment income is positive & self-employment share <15% of employment plus self-employment income.	38 681	54%
Self-employed	Non-pensioner and self-employment income share is ≥15%.	5 660	8%
<i>Of which:</i>			
IA regime	Taxpayers with an individual-activity certificate.	3 649	64%
Pure	Individual-activity taxpayers with only self-employment income.	1 011	
BC regime	Taxpayers with a business certificate.	2 038	36%
Pure	Business certificate taxpayers with only self-employment income.	815	

Note: For the purposes of the analysis, taxpayers are divided into employees, self-employed and pensioners depending on their income source. The number of taxpayers in the categories do not sum to the total because a large number of taxpayers have no employment, SE or pension income (28 875). This may partly be explained as they are young and part of a household (mean age is 22 vs 43 in the general sample), they have other benefit sources not included or they represent data errors. If employment income were not set to be positive, the number of employees would be 67 556 and the numbers would sum correctly. The number of SE in the two regimes slightly exceeds the total number of SE individuals because taxpayers can be in more than one regime simultaneously.

Source: OECD analysis of microdata.

Self-employed incomes

Incomes are higher in the individual-activity regime than the business certificate regime due the cap on business certificate income. The income distribution of the two SE regimes is similar for most of the distribution but diverge at the highest incomes (Figure 5.4, Panel A), reflecting the smaller number of outlying high incomes in the BC regime (this is ensured by the BC regime annual revenue cap). Below the cap, BC taxpayers have modestly higher incomes for most of the distribution (Figure 5.4, Panel B). The IA regime has higher income inequality, reflected in a higher P80/20 ratio of 14 compared to 9 in the BC regime. IA and BC income refer to SE income derived under those regimes respectively and employee income refers to gross wage employment income.

However, when an adjustment is made for outliers and time spent working, business certificate taxpayers have higher self-employment income on average than individual activity taxpayers. IA taxpayers have higher mean SE income than BC taxpayers (+64%). A more appropriate comparison across the two regimes using median income shows that 'pure' BC taxpayers (i.e. SE income derived only from the BC regime) have 30% higher income than 'pure' IA taxpayers (i.e. SE income derived only from the IA regime). Furthermore, adjusting for the fact that BC taxpayers work about one-third less than the IA self-employed throughout the year (as proxied by the median number of months worked, see note Table 5.5), BC incomes are almost twice as high (+95%).

Compared to business certificate taxpayers, individual activity taxpayers earn higher average incomes from other sources such as employment and capital income. Other income sources tend to be higher on average in the IA regime including employment income (+23%) and dividends, interest and royalty income (+39%).

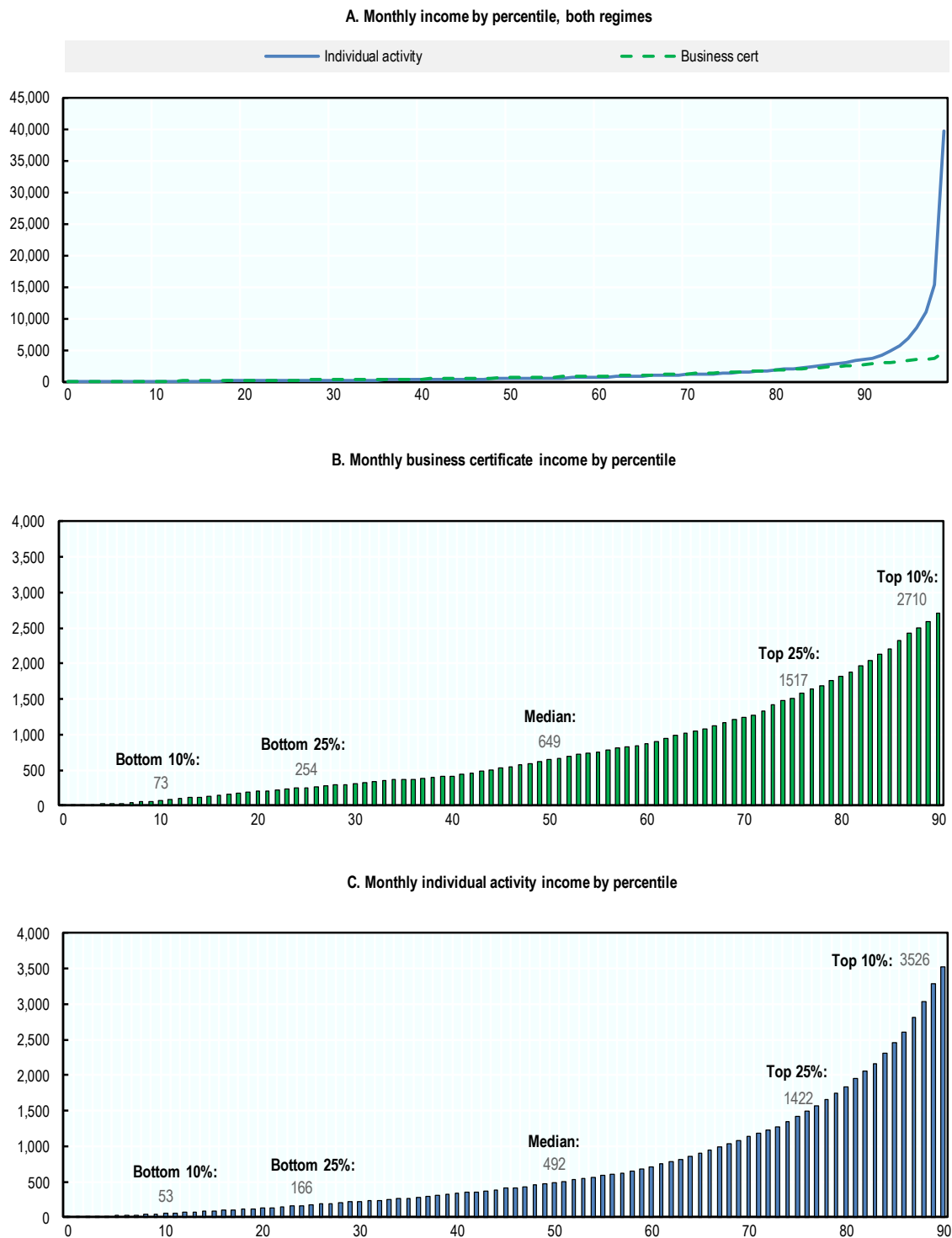
Table 5.5. Incomes by regime

Average gross monthly incomes, by income source and self-employment regime

	IA regime	BC regime	% Difference
Self-employment income			
Mean	1 656	1 010	64%
Median	484	630	-23%
Median for 'pure self-employment'**	419	708	-40%
Median adjusted for months-worked*	484	945	-49%
Other income sources			
Employment (mean)	297	241	23%
Financial (mean)	142	180	-21%
Rental (mean)	15	16	-6%
Dividend, interest and royalty (mean)	32	23	39%
Other (mean)	285	74	285%

Note: The IA, BC and employee groups include 3 649, 2 038 and 38 681 unique individuals respectively. For each of the respective regimes, self-employment income refers to income from individual activity only and business certificate only. *Self-employment months worked per year adjusted provides an indication of median income given the time spent working. It is calculated by multiplying median monthly income by 12 to give annual income and then dividing by the median number of months worked per year in that regime (which are 12.0 and 8.0 months in the individual activity and business certificate regimes respectively). **Pure self-employed refers to the self-employed with only self-employment income i.e. all other incomes are excluded (other incomes include employment, financial, rental, dividends, interest, royalties and other incomes). Source: OECD analysis of microdata.

Figure 5.4. Self-employment income distributions, by regime in 2019



Note: Mean value calculated in each percentile so the figures do not correspond precisely to Table 5.5.

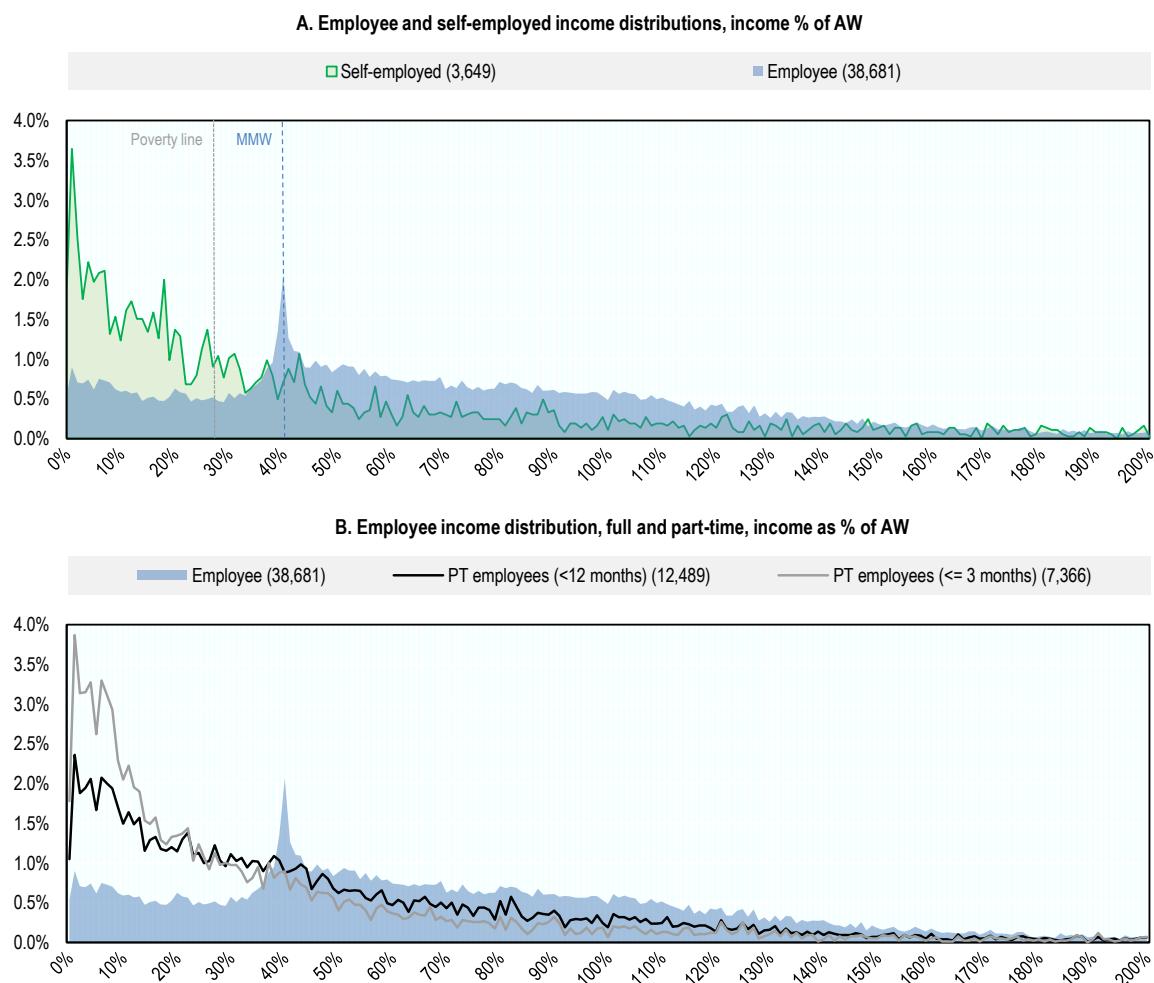
Source: OECD analysis of microdata.

A high share of SE may be at risk of poverty. The IA taxpayer income distribution is positively skewed with many SE earning low incomes (Figure 5.5, Panel A). IA incomes are significantly below employee incomes. Half of IA taxpayers (54%) earn below the MMW compared to just one-quarter (25%) of employees. There is income bunching among employees at the MMW (Figure 5.5, Panel A).

A high share of part-time employees report very low incomes. Part-time (PT) employees³ working less than 12 months of the year and 3 months or less of the year earn much less than employees generally (Figure 5.5, Panel B). The share of PT employees in the former and latter groups earning below 10% of the AW is 20% and 32% respectively. Of taxpayers with both employment and SE income, about 1 in 5 are PT employed (19%) according to the microdata. 2% are employed for 3 months of the year and have average income of EUR 753 (employment and SE income) vs EUR 2,187 for FT (i.e. 12 months of the year).

Figure 5.5. Self-employed and employee income distributions

% of taxpayers, by income as a % of AW



Note: The minimum monthly wage (MMW) is EUR 555 in 2019. The average wage refers to the gross average wage from employment in 2021 calculated by the OECD secretariat. The self-employed and employee income distribution refers to total self-employment income and gross employment income respectively. The self-employed and employee groups are as defined in Table 5.5. The part-time employee groups refer to employees who work a number of months in the year which is less than 12 and 3 or less respectively.

Source: OECD analysis of microdata.

Self-employed demographics

Compared to employees, the self-employed are more likely to be male and married. Compared to employees, the SE are on average more likely to be male (+7% p.p.) and married (+9% p.p.) (Table 5.6). The age distribution and family structure between SE and employment are broadly similar.

The two self-employment regimes are broadly demographically similar, although business certificate taxpayers are more likely on average to be older, female, married and work part-time. Comparing between the two SE regimes, BC taxpayers are modestly more likely than IA taxpayers to be female (+4% p.p.) and married (+5% p.p.) (Table 5.6). BC taxpayers are more likely to work part-time (a median of 8 months annually compared to 12 months in the IA regime, see note from Table 5.5). BC taxpayers are older on average as group because there are less BC taxpayers under the age of 35 compared to the IA regime. The demographic characteristics of the SE regimes, and particularly the BC regime, have some similarities to the typical demographics of second-earners (as discussed previously, second-earners in Lithuania have strong work incentives at long-unemployment spells beyond 12 months). There is little statistical difference in family size and the prevalence of reported disability between the two SE regimes.

Table 5.6. Demographic characteristics by regime

	IA regime	BC regime	Employees
% female	42%	46%	50%
% single	29%	21%	32%
% married	59%	64%	53%
% disabled	6%	6%	4%
% older (≥ 60 years)	6%	7%	7%
% younger (< 35 years)	34%	26%	34%
% full-time employed	22%	19%	67%
Number in family household			
1	16%	16%	18%
2	18%	18%	19%
3	23%	25%	25%
4	23%	23%	22%
5	10%	10%	9%

Note: The IA, BC and employee groups include 3,649, 2,038 and 38,681 unique individuals respectively. Full-time employed refers to full-time employees.

Source: OECD analysis of microdata.

Business certificate regime

This section provides discussion, observations and recommendations on the design of the business certificate (BC) regime and its interaction with the individual-activity (IA) regime and standard employment. Its adherence to tax policy principles is discussed followed by the design of eligibility criteria, the determination of the tax liability, the role of migration from the regime and tax rate design. This section draws from a forthcoming OECD paper on the design of presumptive tax regimes (Mas-Montserrat et al., forthcoming^[1]).

Eligibility design

The business certificate regime is a presumptive tax regime since it is not based on actual taxable income but rather on a presumed tax base. Presumptive tax regimes differ on the method used to make

that presumption. In general, presumptive tax regimes do not aim to raise significant amounts of tax revenues but instead to improve tax compliance over the long term. This may justify tax revenue collection costs that exceed the tax revenues collected in the short term (Engelschalk, 2007^[3]).

Revenue eligibility caps keep compliance costs low for taxpayers and enforcement costs low for tax admins but revenue measures can be relatively easily manipulated. Presumptive regimes commonly operate eligibility caps based on revenues (Thuronyi, 2004^[4]). The design of revenue caps are simple, which keep compliance costs low for taxpayers and enforcement costs low for the tax admin. On the other hand, reported business revenues are relatively easy for taxpayers to manipulate.

The revenue cap influences the numbers of taxpayers in the self-employment regimes which in turn affects the levels of tax revenues and tax transparency for the authorities. Since SE move between regimes, the level at which the revenue cap is set will influence the numbers of SE in each regime, which in turn has tax policy implications. A high cap mechanically implies more BC taxpayers which means lower tax and compliance burdens for SEs but reduced tax revenues and information available for the authorities (Table 5.7) (BC taxpayers do not have to report costs reducing transparency and monitoring capabilities for the tax administration). Inversely, a lower cap implies more IA taxpayers which means higher tax and compliance burdens for SEs and increased tax revenues and transparency for the authorities (Table 5.7).

The revenue cap should be aligned and evolve with the capacity of the tax admin. From a tax admin perspective, the tax affairs of IA taxpayers are likely to have greater complexity and administrative burden than BC taxpayers (e.g. they report more information such as business costs on a more regular basis). Therefore, policies that shift the SE from the BC to the IA regime may increase the administrative burden on the tax admin (and vice versa). An example of such a policy is reducing the BC regime revenue eligibility cap (Table 5.7). Consequently, policies that shift the SE to the IA regime should be done with regard to the current and evolving capacity and capability of the tax admin to effectively manage and monitor the expected increase in the number of IA taxpayers arising from that policy.

Table 5.7. Stylised tax implications of adjusting the BC regime eligibility revenue cap

	Higher revenue cap	Lower revenue cap
Shifts self-employed to	BC regime	IA regime
Taxpayer tax burden	↓	↑
Taxpayer compliance burden	↓	↑
Tax admin burden	↓	↑
Tax admin revenues (PIT & SSCs)	↓	↑

Note: For the purposes of this stylised example, tax admin transparency refers to reduced transparency in the BC regime because SEs do not need to report costs relative to the IA regime. Tax admin capacity refers to the reduced burden on the tax admin when the share of BC taxpayers (who have less complex tax affairs to manage) is greater than the share of IA taxpayers.

Source: OECD analysis.

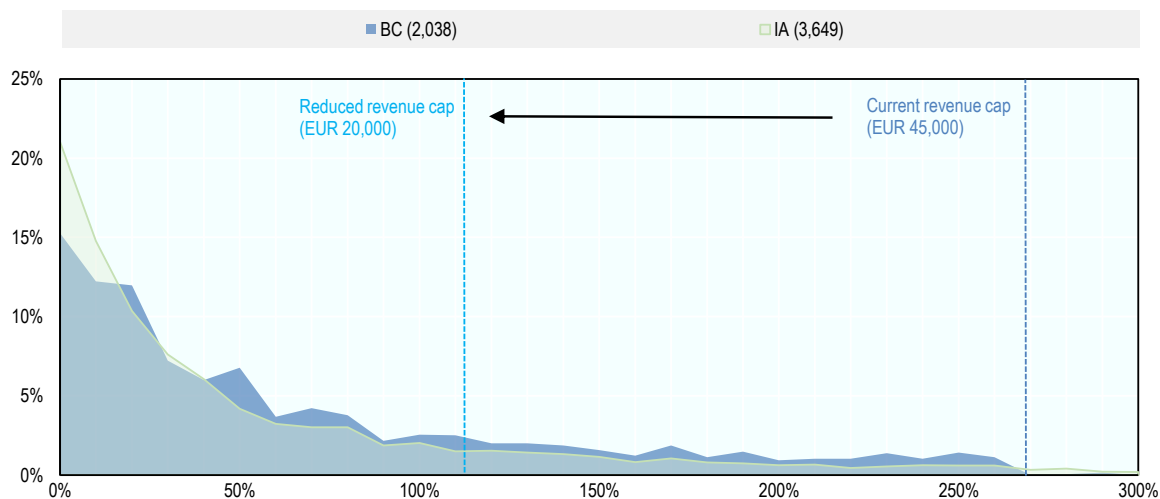
The revenue cap may be too high, resulting in too many business certificate taxpayers and too few individual activity taxpayers (and lost tax revenues). The BC regime revenue cap is high in the context of the SE income distribution. 92% of IA regime SE have incomes below the cap and by design 100% of BC regime SE have incomes below the cap (Figure 5.6). Compared to selected presumptive regimes internationally (in USD PPP), the cap for the BC regime (USD 97 826) is above comparable regimes for unincorporated self-employed in Hungary (*KATA regime*, USD 77 499), similar to Italy (*régime forfaitaire*, USD 99 335) but below France (*régime du micro-entrepreneur*, USD 242 926). If the cap were cut to EUR 20000, about 20% of BC taxpayers would enter the IA regime (assuming no income responses to the cut). Given the wide tax burden gap between regimes (Figure 5.10), the cap should not be set too high as

it extends BC eligibility too widely and reduces the standard IA regime thus undermining horizontal equity and tax revenues.

A high share of low-income SE in the IA regime may raise design rationale questions for the BC regime. Over half of IA taxpayers (54%) have incomes of 30% of AW or less. This may raise questions of the design rationale and targeting of the BC regime to the extent that it is aimed at supporting low-income SE in entering SE and growing as businesses with the eventual intention of migrating to the IA regime. Income comparisons between the regimes will also be affected by the BC regime being restricted to certain activities.

Figure 5.6. The business certificate revenue eligibility cap is high

Self-employment income distributions, IA and BC regimes



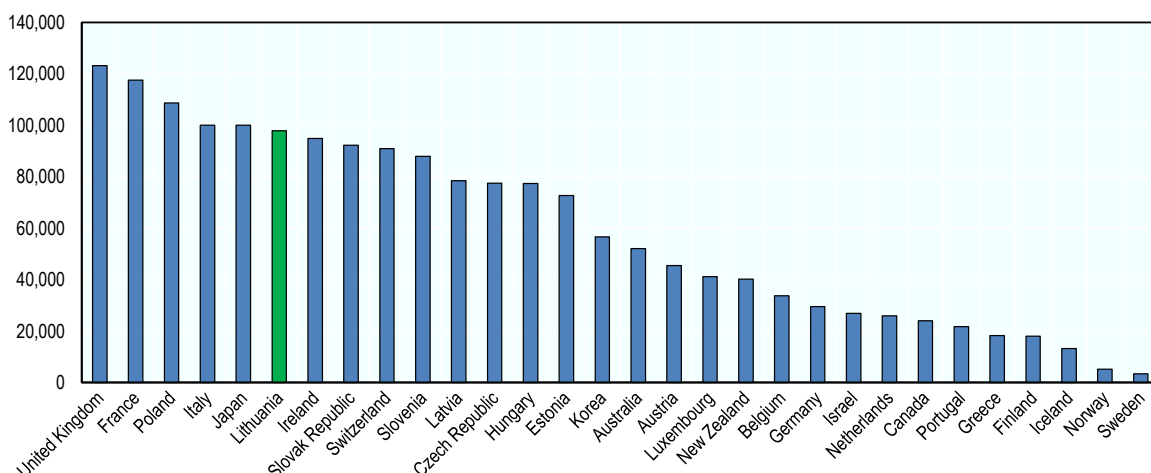
Note: SE income refers to total SE income in each regime. Low-income IA taxpayers may simultaneously hold business certificates.

Source: OECD analysis of microdata.

The alignment of the business certificate cap with the VAT threshold comes with advantages and drawbacks. The VAT registration threshold in Lithuania is high in international comparison (Figure 5.7). A case for alignment is that SE that have the capability to comply with VAT-related accounting and administration should also be able to maintain records and calculate their taxable profits under a standard regime (i.e. the IA regime). However, alignment implies that changes to PIT and VAT policy can jointly impact the regime. For example, VAT or PIT simplification measures or improvements in VAT refunds could make the IA regime more attractive, thus likely reducing the number of SE opting for the BC regime.

Figure 5.7. The VAT threshold is comparatively high

VAT registration thresholds expressed in USD, 2021



Note: Exchange rates for conversion into USD are Purchase Parity Rates (PPPs) for GDP 2021.

Source: OECD tax database.

The business certificate sector eligibility criteria has the potential to produce vertical and horizontal inequities that might introduce competitive distortions. The BC regime is only available to SE operating in certain specified business activities, which could produce inequities. First, BC taxpayers with different turnover and costs but in the same sectors will face the same tax liability ('vertical inequity'). Second, IA taxpayers that perform similar activities to BC taxpayers that are ineligible for the BC regime might have similar profits but face different tax burdens ('horizontal inequity'). Third, taxpayers with similar profits just above and below the revenue cap but in different regimes would face different tax burdens ('horizontal inequity') (see Figure 5.9). An estimation of the extent of taxpayers that would be exposed to these various inequity risks could be investigated in the microdata.

Good practice suggests that revenue caps should generally be inflation-indexed. When the eligibility criteria is revenue, good practice is to index the cap to inflation to prevent erosion over time (Thuronyi, 2004^[4]) (Bird and Wallace, 2004^[5]). Given currently high levels of inflation, non-indexation will shift SE from the BC to the IA regime. As this report recommends to lower the revenue eligibility cap, the cap could be lowered and subsequently inflation-indexed.

Tax liability design

The business certificate's lump-sum payment has advantages, principally its simplicity. There are several approaches to determining the tax liability in presumptive tax regimes including applying lump-sum payments and tax rates. The lump-sum payment operated in the BC regime has several advantages (The **average effective tax wedge in the business certificate is far below that of employees at all incomes.** The average effective tax wedge for employees always exceeds those of both self-employment regimes driven by higher employee and employer SSCs at low incomes (Figure 5.10, Panel C) and significantly higher PIT rates (Figure 5.10, Panel A).

Average effective tax wedges are high at very low incomes across several organisational forms driven by different SSC floors. At very low incomes between 0 - 10% of AW (not shown in Figure 5.10), the average tax wedges are similarly high across all organisational forms due to different SSC floors. In

the BC regime, the average tax wedge is 71% (due to the minimum SSC base set at MMW and the lump-sum payment), in the IA regime 63% (due to the minimum health SSC floor) and for employees 70% (due to the employer SSC floor). Note that the employer SSC floor does not apply to all SE because not all SE are obliged to pay SSCs (e.g. SE that have reached retirement age, SE receiving the social insurance old-age pension).

Figure 5.11) as follows:

1. It is transparent and predictable, resulting in low compliance costs for taxpayers and low enforcement costs for the tax admin.
2. It is a low payment in relative and absolute terms, which helps encourage informal workers to enter the regime and to ensure voluntary compliance.
3. Since the tax is set by the municipalities, there is no computation cost for BC taxpayers.
4. Since BC taxpayers do not have to declare costs (only turnover), the administrative costs of record-keeping and accounting are low.
5. It avoids creating disincentives for businesses to grow since the tax payment remains fixed as income increases.

The lump-sum payment has several drawbacks, particularly its regressivity.

1. It is regressive and places a higher tax burden on the poorest SE by treating all taxpayers equally regardless of their income and ability to pay.
2. It is regressive relative to alternative approaches to determining tax liability in presumptive regimes. A lump-sum payment is regressive relative to a lump-sum payment that is differentiated by sector of activity or within turnover bands. It is also regressive relative to proportional or progressive tax rates levied on turnover. While such alternatives can improve progressivity they also come with several drawbacks including increased complexity.
3. A fixed amount may not allow for the tax burden to fluctuate when economic activity and incomes drops thus creating cash flow challenges (ILO, 2021^[6]). However, the government can opt to make periodic adjustments to the amount.
4. It may create an entry barrier for businesses that do not make profits as losses cannot be offset against future liabilities.
5. Given the population of lump-sum payments in countries that implement them, they may be difficult to abolish (Bucci, 2020^[7]).

An alternative to the lump-sum payment approach is a proportional tax rate on turnover. Compared to the lump-sum payment, a proportional tax rate results in a tax liability that is linear relative to revenue, making it less regressive than the lump-sum payment. Since taxpayers in the BC regime already declare turnover (but not costs), the operation of a proportional tax rate on turnover would add a minimal tax compliance burden in terms of computing the tax liability. However, proportional tax rates have drawbacks including that reported turnover measures are relatively easy to manipulate, which introduces non-compliance risk.

The proportional tax rate on turnover could vary by business sector profitability. Differentiated tax rates across sectors would allow levying a higher rate on the activities that are on average more profitable. This would prevent highly profitable businesses facing a low presumptive tax burden who would face a tax-induced incentive to remain in the BC regime and not migrate into the IA regime. On the other hand, differentiated sector tax rates are based on average profitability rates which means that high profit business in a sector with low average profits will not be highly taxed. Differentiated sector tax rates also produce a tax-induced incentive for businesses to reclassify their sectoral status to more lightly taxed sectors.

Table 5.8. The business certificate's lump-sum payment has several advantages

Approaches to determining tax liability in presumptive regimes, selected advantages and drawbacks

	Advantages	Drawbacks
Lump-sum amount	<ul style="list-style-type: none"> - Transparent & predictable - Low relative & absolute amounts - Low computation cost - Low administrative burden - Low disincentives to grow 	<ul style="list-style-type: none"> - High tax burden on poorest - Less regressive options exist - May not allow for economic fluctuations - Possible barrier for loss-making firms - Challenging to abolish
Proportional tax rate on turnover	<ul style="list-style-type: none"> - Less regressive linear tax liability - Low computation cost 	<ul style="list-style-type: none"> - Turnover is easy to manipulate - May not capture profitability well - Can discourage investment if applied to indicators (e.g. no. employees)

Source: Adapted from forthcoming OECD research on presumptive regimes.

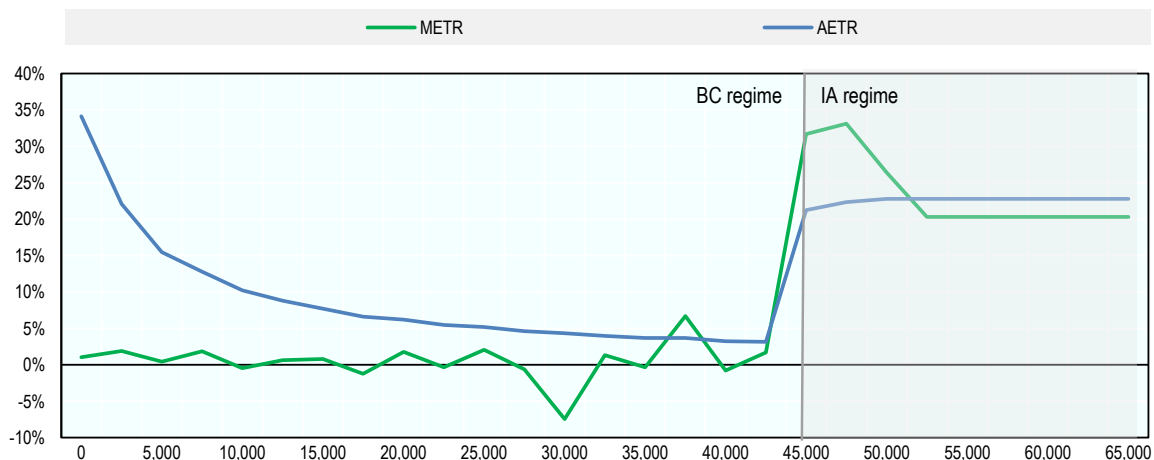
Migration from the business certificate regime

The design of the tax system should provide businesses with an incentive to migrate from the business certificate to the individual-activity regime. A smooth transition from a presumptive to a standard regime might be achieved by introducing simplified tax provisions and administrative procedures in the standard regime (e.g. reduced rates, simplified accounting, simplification of VAT-related administrative procedures) (Engelschalk, 2007^[3]). However, such features might need to be time-limited to prevent potential disadvantages such as bunching effects and artificial closing and reopening of business activities.

However, a sharp rise in the marginal tax wedge as taxpayer's transition to the individual-activity regime is likely to deter migration. Up to the BC regime eligibility cap, METRs remain flat and close to zero as taxes remain unchanged with higher incomes (Figure 5.8) (the fluctuation in the METRs is due to fluctuations in the average PIT reported on the tax records within the income bands and sample size issues). Once the cap is reached, the SE enter the IA regime and then face higher METRs (Figure 5.8) due to higher SSCs and a progressive PIT (see Figure 5.10).

Figure 5.8. There is little incentive to migrate from the BC regime

Marginal and average effective tax wedges, calculated separately for the BC and IA regimes above and below the BC regime revenue cap respectively, based on tax rules applied to microdata



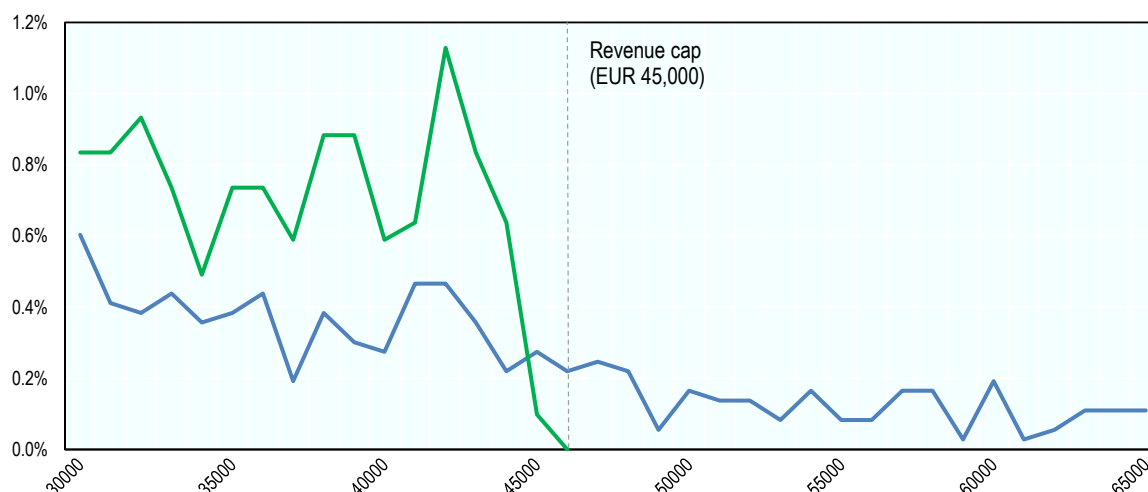
Note: Marginal and effective tax rates are calculated for the BC and IA regimes below and above the EUR 45 000 revenue cap respectively. Self-employment incomes are shown in bands of EUR 2 500. The hypothetical IA regime average effective tax wedges (AETR) and marginal effective tax wedges (METR) are calculated based on the tax rules using IA self-employment income from the tax records for taxpayers who opt for the presumed cost deduction and have only self-employment income. In the BC regime, the AETR and METR are calculated using business certificate PIT paid and business certificate income on the tax records in addition to a hypothetical calculation of SSCs.

Source: OECD analysis of microdata.

Income bunching below the business certificate eligibility cap reflects the disincentive to migrate to the individual-activity regime and the administrative burden of VAT registration. The share of BC self-employed spikes just below the BC regime cap and VAT threshold of EUR 45 000 (Figure 5.9). This suggests that some BC taxpayers may be under-reporting incomes to avoid VAT registration or the IA regime or a combination of both. BC taxpayers that exceeded the threshold would migrate to the IA regime and face higher average and marginal tax burdens in this income range (Figure 5.8) in addition to higher administrative burdens associated with VAT compliance. If taxpayers were to suppress reported incomes, which they have an incentive to do, there could be additional undetected income bunching. The sample tax record data indicate that 3.9% of BC report SE income between EUR 40 000 and EUR 45 000, which implies approximately 3 500 taxpayers nationally in that income range.⁴ The share of IA taxpayers is greater between EUR 40 000 and EUR 45 000 than it is between EUR 45 000 and EUR 50 000 (Figure 5.9), suggesting that some IA taxpayers could be misreporting incomes to avoid VAT registration. These interpretations remain suggestive rather than conclusive in the absence of the larger sample size of the full tax record data and multivariate analysis that controls for multiple variables. As further work, longitudinal tax record data could be employed to track and identify the type of self-employed that switch from the BC to the IA regime (and vice versa) and the role of the tax burden in that decision.

Figure 5.9. There may be income bunching below the business certificate regime cap

% self-employed, by regime and self-employment income



Note: Based on 3 649 IA and 2 038 BC self-employed. Incomes are in bands of EUR 1 000.

Source: OECD analysis of microdata.

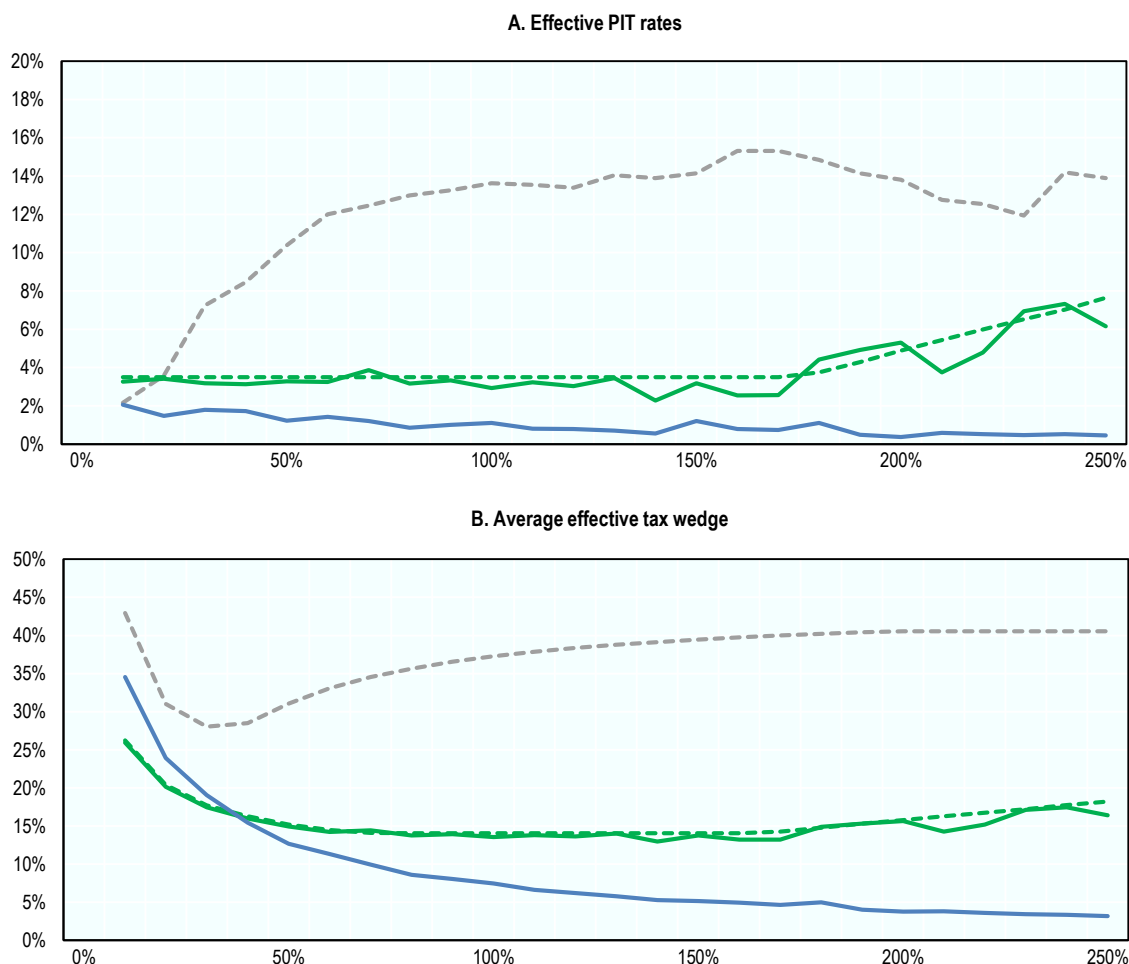
The tax burden in the business certificate regime is low relative to standard employment and individual activity (except at low incomes)

Effective PIT rates in the business certificate regime are below those in the individual activity regime across the income distribution based on the tax record data. In the BC regime, average effective PIT rates (i.e. business certificate PIT paid as a share of business certificate income on the tax records) are lower than the IA regime across all gross incomes (Figure 5.10).

However, a relatively high SSC floor in the business certificate regime implies that low-income self-employed could prefer the individual activity regime. Due to a relatively high SSC floor in the BC regime (the base is set at the MMW), the average tax wedge under the BC regime is higher than under the IA regime at low incomes (below 30% of AW) but becomes progressively lower at higher incomes (comparing Figure 5.10, Panels A and B) (note that very low incomes are not shown but examined later in Figure 5.12). This occurs because SSCs are calculated as a share of income in the IA regime and PIT rates increase at higher incomes whereas SSCs and PIT remain flat in the BC regime leading to a decline in the average tax wedge. These tax burdens imply that the self-employed may prefer the IA regime at low incomes and the BC regime at middle and higher incomes up the revenue cap of EUR 45 000. Since many SE earn low incomes (47% of IA SE earn incomes less than 30% of the employee AW based on the microdata), a significant share of low-income SE may prefer the IA regime at low incomes. In the IA regime, both hypothetical and empirical PIT and average tax wedges are calculated for robustness based on the tax rules and the tax record data respectively (see note in Figure 5.10). The IA regime calculations are based on self-employed who opt for the presumed cost deduction (see note in Figure 5.10).

Figure 5.10. Business certificate self-employed face low tax burdens, except at low incomes

Average tax rates, by organisational form



Note: Note that the tax wedges are based on gross income for employees and self-employment income for the self-employed. Incomes are shown as a share of the employee AW in 2021 and are divided down into 10% bands. Incomes start at 10% of the AW. The employee PIT rate is calculated as PIT as a share of total employment wage income based on the tax records. The employee average tax wedge is calculated using the *Taxing Wages 2021* model as employee SSCs are not available in the tax record data. The hypothetical individual activity self-employment PIT rate and average tax wedges are calculated based on the tax rules using self-employment income from the tax records and for those who opt for the presumed cost deduction. The empirical individual activity self-employment PIT rate and average tax wedge are based on the PIT variable in the tax records (SSCs are not available in the tax records so the SSC rules are used) for those who opt for the presumed cost deduction and with self-employment income. In the BC regime, the effective PIT rate is the business certificate PIT paid on the tax records as a share of income from business certificate income. In the IA and BC regime, the PIT rate is calculated using the 'tin' and 'tbl' variables as a share of individual activity and business certificate income respectively. In a small number of cases in the business certificate regime, the sample size is too small to calculate the average tax rate within an income band so the average tax rate is assumed that of the previous band.

Source: OECD analysis of microdata.

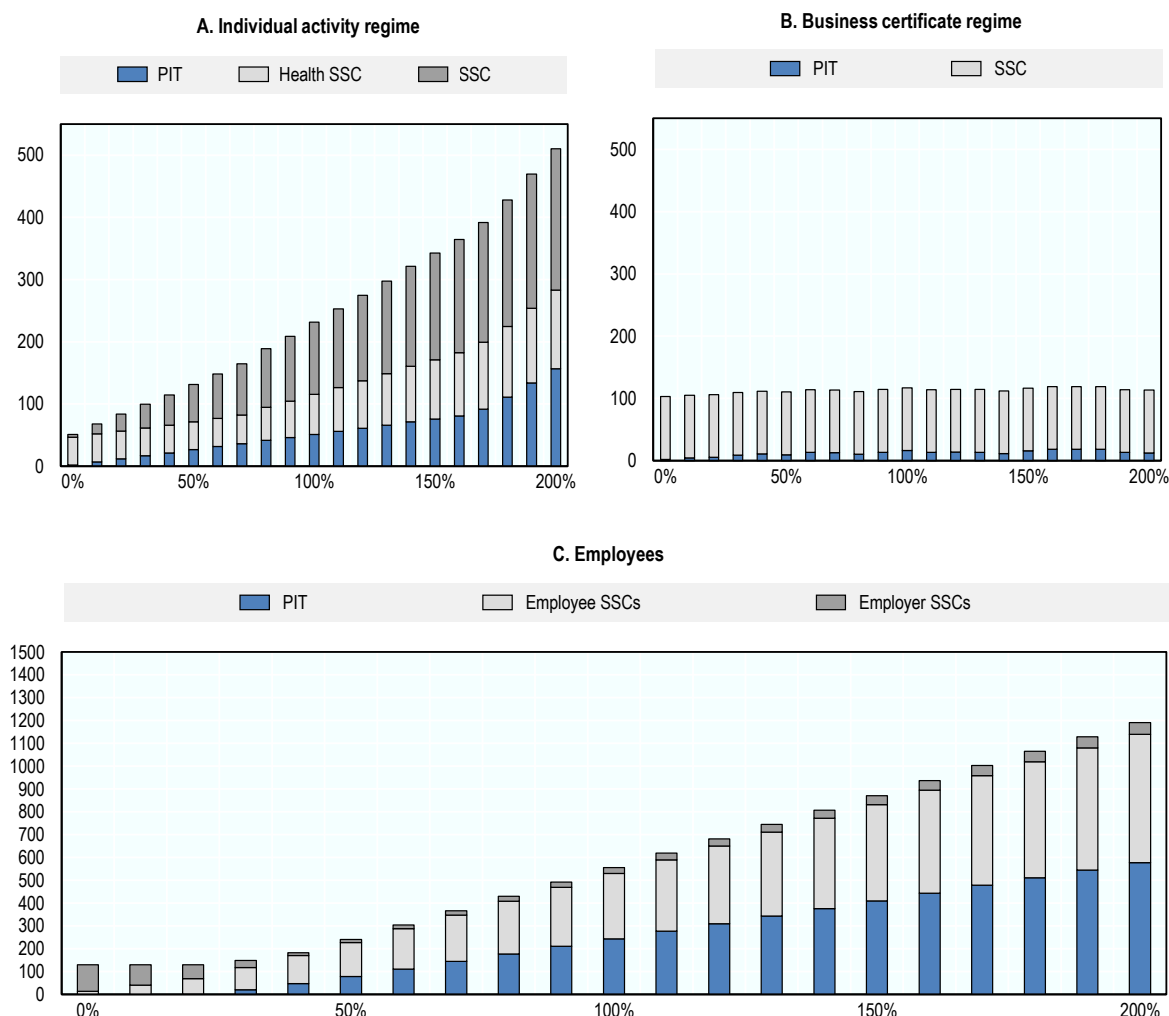
The average effective tax wedge in the business certificate is far below that of employees at all incomes. The average effective tax wedge for employees always exceeds those of both self-employment regimes driven by higher employee and employer SSCs at low incomes (Figure 5.10, Panel C) and significantly higher PIT rates (Figure 5.10, Panel A).

Average effective tax wedges are high at very low incomes across several organisational forms driven by different SSC floors. At very low incomes between 0 - 10% of AW (not shown in Figure 5.10),

the average tax wedges are similarly high across all organisational forms due to different SSC floors. In the BC regime, the average tax wedge is 71% (due to the minimum SSC base set at MMW and the lump-sum payment), in the IA regime 63% (due to the minimum health SSC floor) and for employees 70% (due to the employer SSC floor). Note that the employer SSC floor does not apply to all SE because not all SE are obliged to pay SSCs (e.g. SE that have reached retirement age, SE receiving the social insurance old-age pension).

Figure 5.11. The drivers of the average tax wedge by regime

PIT and SSCs (in EUR) by regime, incomes from 0 – 200% of AW



Note: Notes for Figure 5.10 apply. In charts A and B, PIT reported on the tax records are used. In chart C, PIT is calculated using *Taxing Wages 2021* model.

Source: OECD analysis of microdata.

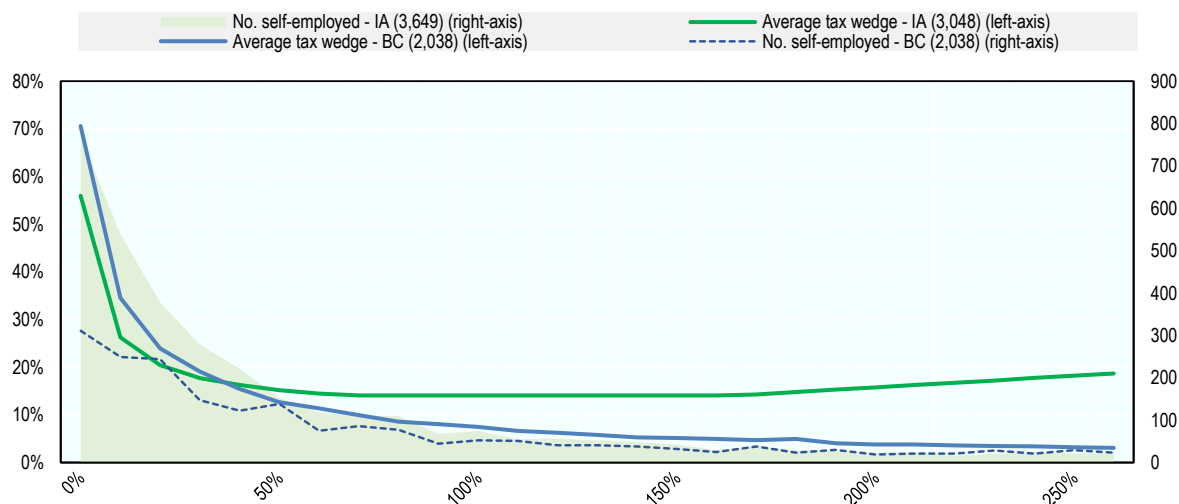
The income distribution shows that the lowest income self-employed prefer the standard individual-activity regime to the business certificate regime. As shown in Figure 5.12, the higher average tax wedge in the BC regime relative to the IA regime at low incomes could lead to the lowest income SE preferring the standard IA regime to the presumptive BC regime. When the income distribution of the IA and BC regimes is overlaid alongside the average tax wedges in the two regimes, a high share of the lowest income self-employed are in the IA regime both in absolute terms and relative to the numbers

in the BC regime (Figure 5.12). This may suggest that some SE are choosing the IA regime over the BC regime to avail of a lower tax burden. A range of other factors may play a role in the low-income SE opting for the IA regime including restrictive eligibility criteria for entering the BC regime such as the list of eligible activities.

The tax burden on the lowest income self-employed is high relative to reported self-employment incomes. Although the tax wedge is higher in the BC than the IA regime at low incomes, it remains high in both regimes, which could produce a disincentive for the SE to formalise their business in either regime. There is however a tax vacation for new IA taxpayers to encourage formal work. The high tax wedges may also be a result of low reported SE incomes. The absolute PIT and SSCs are quite low. If the true incomes of the SE were higher than those reported, which could be the case in some cases given relatively high reported informality in Lithuania generally, the true tax burdens faced by the SE would be lower.

Figure 5.12. Most of the lowest income self-employed opt for the individual-activity regime

The average tax wedge and the number of self-employed, by self-employment regime and income



Source: OECD analysis of microdata.

Illustrative simulations of reform options

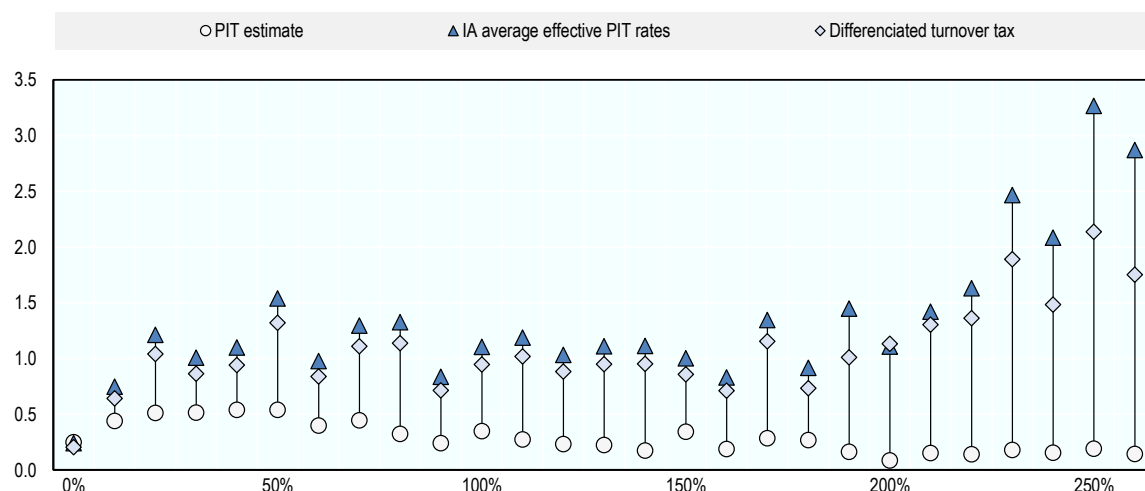
Aligning the average PIT rates in the business certificate regime with those in the individual-activity regime would raise average effective PIT rates and PIT revenues. An illustrative indication of PIT revenues in the BC regime can be estimated across the income distribution by applying the average PIT rates in Figure 5.12 to the total BC income of EUR 823 million in 2019 (see note in Figure 5.13). This approach gives a reasonable estimated PIT revenues of EUR 7.8 million compared to actual BC PIT revenues of EUR 8.5 million in 2019. To give an indication of aligning the tax burden between regimes, the average effective PIT rates in the IA regime can be applied to total BC income by income band, which shows that average PIT rates would increase across the income distribution and PIT revenues would increase by a factor of 4.7 (Figure 5.13).

An illustrative simulation of a low proportional tax rate on turnover in the business certificate regime serves to highlight that the existing lump-sum payment amount produces very low tax effective rates in the regime. To illustrate the proportional tax rate approach in the BC regime, a 3% tax rate levied on BC turnover would raise the effective PIT rate on BC taxpayers across all incomes and increase PIT revenues by a factor of over 3 (Figure 5.13) (note that PIT revenues are not increasing with

higher average PIT rates at higher incomes due to fewer BC taxpayers at higher incomes). The proportional tax rate on turnover serves to highlight how even a low proportional tax rate on turnover would substantially increase effective PIT rates and PIT revenues compared to the existing approach.

Figure 5.13. Illustrative options for raising the tax burden in the business certificate regime

PIT revenue, by the business certificate income, under different simulations (applying the average PIT rates from the individual-activity regime and a 3% turnover tax)



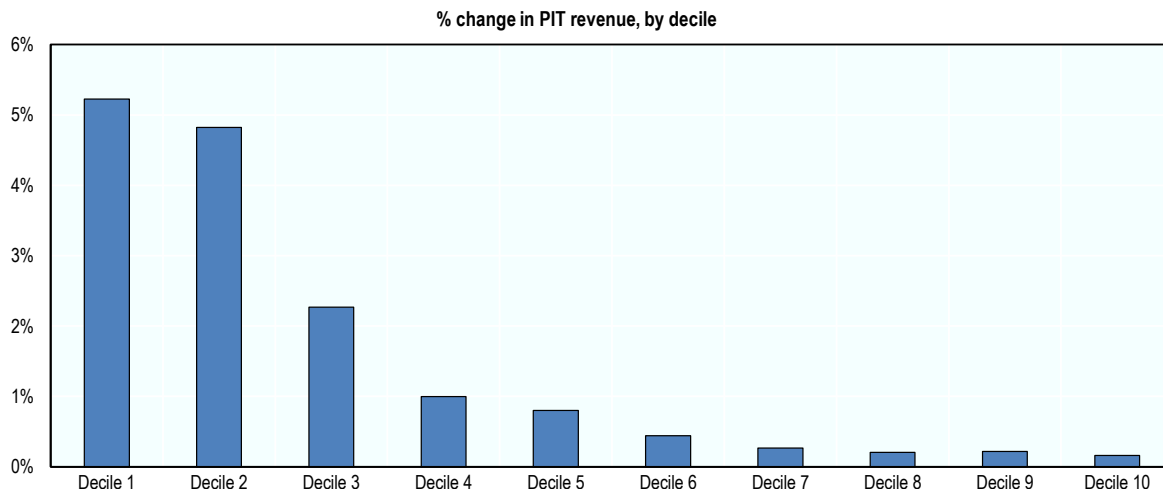
Note: Since the tax record data is based on a sample, BC incomes are 'grossed-up' to the national level using the total BC income of EUR 823 million in 2019 based on the Budget Revenue Report 2021. First, to estimate PIT revenues in the BC regime, average PIT rates in Figure 5.12 are applied to the BC income by income band for incomes between 0 and 260% of AW (which represents 97% of BC income; sample size restricts average PIT rates above 260% of AW). PIT revenues in the BC regime are estimated at EUR 7.8 million compared to actual PIT revenues of EUR 8.5 million in 2019. Second, average PIT rates in the IA regime in Figure 5.12 are applied to BC income across the same income bands (e.g. for many income bands at a rate of 3.5% as PIT is calculated on taxable income and assuming a presumed cost deduction of 30%). Third, a 3% turnover rate is applied to BC income.

Source: Budget Revenue Report 2021, Ministry of Finance of the Republic of Lithuania. OECD analysis of microdata.

Replacing the fixed lump-sum payment in the BC regime with a 3% proportional tax rate on turnover would increase total PIT revenues by 0.5%. According to modelling in EUROMOD, the reform would produce relatively high increases in PIT revenues in lower equivalised household disposable income deciles (Figure 5.14). This is partly because most BC taxpayers earn very low incomes and pay very low PIT. The reform would increase income inequality by 0.0556 percentage points as measured by the S80/S20 ratio.

Figure 5.14. Introducing a proportional tax rate on turnover in the BC regime could raise PIT revenues

Simulating the introduction of a 3% proportional tax rate on turnover in the BC regime to replace the fixed lump-sum payment



Note: Deciles refer to equivalised total household disposable income. PIT refers to total PIT paid from all income sources (i.e. including employment income and SE income).

Source: Simulations performed by the EUROMOD team of the European Commission's Joint Research Centre (JRC).

Adherence of the business certificate regime to tax policy principles and tax liability reform options

The business certificate regime violates the principle of horizontal equity. The BC regime has very low tax burdens on taxpayers with similar incomes relative to the IA regime (Figure 5.10). This violates the principle of horizontal equity which states that similar (in this case, on the basis of income) SE taxpayers should be taxed similarly. The departure from the horizontal equity principle in the BC regime requires a justifying rationale. It follows that the significant tax burden differential between the regimes requires a correspondingly significant justifying rationale. A rationale may be that BC taxpayers face different economic realities to other SE forms that justify a lower tax burden. However, this does not seem to be supported based on broadly similar demographic characteristics between the SE regimes (Table 5.5 and Table 5.6) and higher median incomes in the BC regime when adjustments are made for time spent working (Table 5.4).

The departure from horizontal equity has implications for tax neutrality. The current design of the BC regime is likely to violate the principle of tax neutrality by influencing organisational form decisions. IA taxpayers have a tax-induced incentive to reclassify their sector of activity to fit those eligible for the BC regime and to suppress their income below the BC cap. Employees have a tax-induced incentive to reclassify as SE and enter the BC regime. These tax arbitrage opportunities risk higher numbers of taxpayers entering the BC regime than would otherwise be the case, which could undermine tax revenues and equity by placing a higher tax burden on employees. The costs of this tax arbitrage produced by the BC regime design should be weighed against the justification for non-neutrality including encouraging the growth of small business and formality.

The revenue eligibility cap could be reduced to target only micro-businesses. The revenue cap is high relative to SE incomes. 92% of IA regime SE have incomes below the cap and by design 100% of BC

regime SE have incomes below the cap (Figure 5.6). For example, a reduced cap to 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 also be considered based on the income distribution). This would raise PIT and SSC revenues and increase transparency for the tax admin (i.e. as costs are not reported in the business certificate).

There are several reform options for raising taxes in the business certificate regime including the following.

1. **Increase the lump-sum payment.** The existing tax liability approach used in the BC regime of a lump-sum PIT payment set by the municipalities could be increased at the level of the municipalities. In this case, the current design would be retained and only the PIT payment would be increased.
2. **Increase the lump-sum payment and incorporate SSCs within the payment, although this approach has limitations.** In presumptive regimes, a single tax payment often incorporates SSCs. Including SSCs in a single payment can reduce administrative costs and support tax compliance. Empirical evidence has found that a presumptive tax regime can induce businesses to formalise with the tax administration without necessarily formalising its employees in the social security system (Teixeira, 2021^[8]) (Díaz et al., 2018^[9]). In the BC regime, the lump-sum payment does not include SSCs, which are calculated separately. As part of increasing the lump-sum PIT payment, the SSC contributions for the BC regime could be consolidated within the lump-sum tax payment. This would have the advantage of simplifying the compliance burden on BC taxpayers. On the other hand, including SSCs within the lump-sum payment would more explicitly break the link between SSCs paid and benefits received, which is an argument for keeping SSCs outside of the presumptive regime. This approach would also raise the question of whether the SSCs should be collected at the local or government level.
3. **Replace the lump-sum payment with a proportional tax on turnover and align the tax burden with the individual-activity regime.** The lump-sum PIT amount could be replaced with a proportional tax on turnover over the medium-term. The tax burden could be more closely aligned with the tax burden in the IA regime to reduce vertical inequity and arbitrage opportunities. The tax burden would not necessarily need to be exactly aligned with that of the IA regime but reducing the tax burden gap would reduce tax arbitrage opportunities. The appropriate tax burden and tax rates could be set based on an evaluation of the profitability of SE businesses in Lithuania. If profitability differs across sectors, a sector-based approach could be considered.
4. **Administrative and accounting training may help to smooth the transition to the individual-activity regime.** The BC regime is only valid for a specific time. A BC can be issued for a maximum of one year but can be as short as 5 days. Business certificates can then be renewed. When regimes have eligibility periods such as the BC regime, providing supports such as book-keeping or accounting training may help taxpayers to transition to the IA regime (Engelschalk, 2007^[31]).

Individual-activity regime

This section provides discussion, observations and recommendations on the design of the individual-activity (IA) regime and its interaction with standard employment. Its adherence to tax policy principles is discussed followed by the design of eligibility criteria, the determination of the tax liability, the role of migration from the regime and tax rate design. The analysis presented for the IA regime includes self-employed farmers and non-farmers. Since the tax rules differ for farmers, farmers are briefly discussed separately at the end of this section.

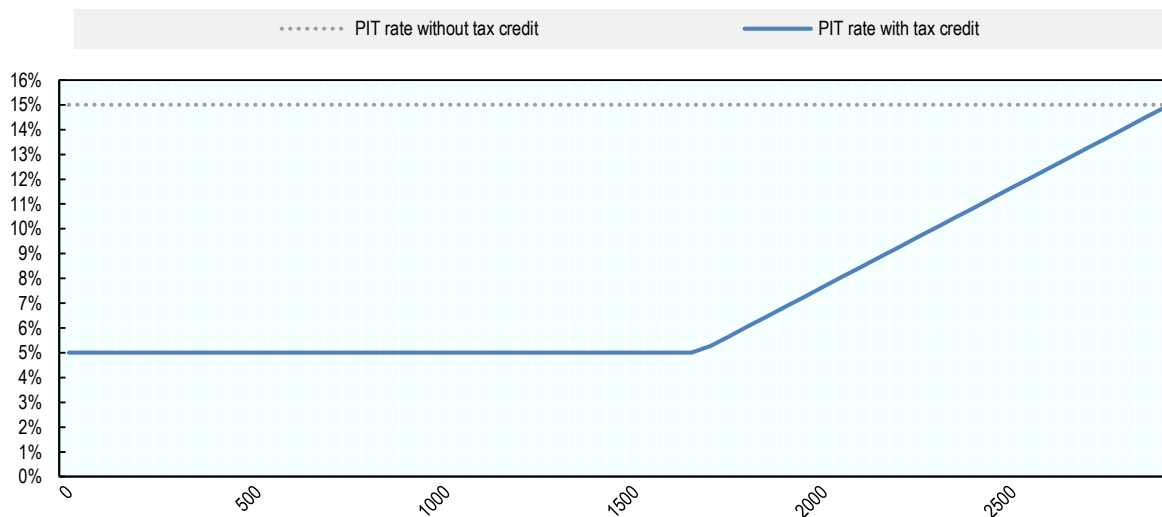
Design of the tax credit

In the IA regime, a tax credit is available that cuts the effective PIT rate, particularly for those on lower and middle incomes. Under the IA regime, a tax credit is available based on taxable IA income where there is a legal distinction between taxable income and taxable IA income. The latter is more narrowly defined to include only income and exemptions related specifically to IA (i.e. other income such as income from BC and other exemptions unrelated to IA are excluded). The formula for calculating the tax credit (see equation 1) includes y_{setx} which is annual IA taxable income and $\mathbb{1}$ which is an identifier set equal to 1 if y_{setx} exceeds EUR 20 000 and 0 otherwise. As a share of IA taxable income, the tax credit is 10% for taxable incomes up to EUR 20 000 and steadily reduced thereafter until it no longer applies at EUR 35 000. Without the tax credit, an IA taxpayer pays an effective tax rate of 15% on taxable IA income. For those with taxable income below EUR 20 000 where the full tax credit applies, the effective tax rate is reduced to 5%. For those with higher taxable income between EUR 20 000 and EUR 35 000, the effective tax rate is higher ranging from 5 to 15%.

$$(1): \text{Tax credit} = y_{setx} \cdot \max \left\{ 0.1 - \left(\frac{2}{300\,000} (y_{setx} - 20\,000) \right) \mathbb{1}_{y_{setx} \geq 20\,000}; 0 \right\}$$

Figure 5.15. Due to the tax credit, IA self-employed with taxable income below EUR 20,000 will face a 5% PIT rate

PIT rate with and without the tax credit, by monthly taxable income



Source: Lithuania Ministry of Finance.

In the IA regime, statutory PIT rates are always lower than in standard employment. As a result of the tax credit, the statutory PIT rate in the IA regime ranges from 5% for incomes up to EUR 20 000 to 15% for incomes above EUR 35 000. Statutory PIT rates for employees are always higher at 20% up to 60 monthly AW (i.e. EUR 104 278 in 2020) and 32% above that. Effective PIT rates on IA taxpayers are also lower at most incomes (see Figure 5.17, Panel A).

The IA regime PIT design will produce 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).

Design of presumptive cost deduction

The presumed cost deduction does not appear to be sufficiently generous to be preferred to declaring actual costs. The presumed cost deduction includes SSC payments that IA taxpayers are required to pay. IA regime SSC rates of 19.5% levied on 63% of gross earnings imply effective SSC rates of 12.3% on gross income. Consequently, the presumptive cost deduction can be represented in two separate deduction components - SSCs (12.3% of gross income) and a standard deduction (17.7% of gross income). The latter deduction component corresponds to the input costs of operating a business. Actual costs faced by small individual SE may exceed 17.7% of income. Indeed, a 30% presumptive cost deduction is low when compared with selected OECD countries (it ranges from 34 – 70% in France and from 14 – 60% in Italy conditional on economic activity⁵).

However, a majority opt for the presumed cost deduction, which presents a puzzle. Take-up of the presumed cost deduction is high among IA taxpayers (83%) compared to those opting for declaring deductions (17%). One reason could be the increased admin and compliance costs associated of maintaining tax and accounting records that can be disproportionately burdensome for smaller SEs. A further reason is that a majority of IA taxpayers are non-VAT registered (over 9 in 10 report income below the VAT threshold) and therefore cannot benefit from VAT deductions by declaring deductions. Indeed, IA taxpayers with incomes above the VAT threshold opt for the presumed cost deduction less on average. Additionally, few SEs may make tax losses that can then be carried forward to reduce future taxes, which would increase the incentive to declare actual costs. From a non-compliance perspective, it is possible that the presumed cost deduction is chosen as a means to under-report income and minimise information provided to the tax admin instead of declaring actual costs and invoices which would increase information available to the tax admin and might allow for detecting such sales suppression. As a stylised example, if an SE opts for the presumed cost deduction and suppresses sales at the same rate as shadow economy as a share of GDP (i.e. 23% in 2021),⁶ taxable income would be the same as if they declared actual costs of 46% of gross income. Therefore, in a high informality SE environment reflected in sales suppression, the presumed cost deduction provides an effective deduction that exceeds 30% of income.

Design of SSCs

IA taxpayers can deduct SSCs to reduce their tax burden whereas employees cannot deduct SSCs.

The non-deductibility of SSCs from the PIT base for employees implies that employees face higher tax burdens relative to IA taxpayers who can deduct SSCs from gross income (either implicitly through the presumed cost deduction or explicitly by declaring actual costs).

IA taxpayers face the same statutory SSC rates as employees. In the IA regime, the total SSC rate is 19.5%, which is comprised of a general SSC rate of 12.52% (that covers pension, sickness and maternity) and a health SSC rate of 6.98% (Table 5.2). The IA SSC rate is above the BC regime (15.7%) and the same as for employees when employer SSCs are excluded (i.e. 19.5%).

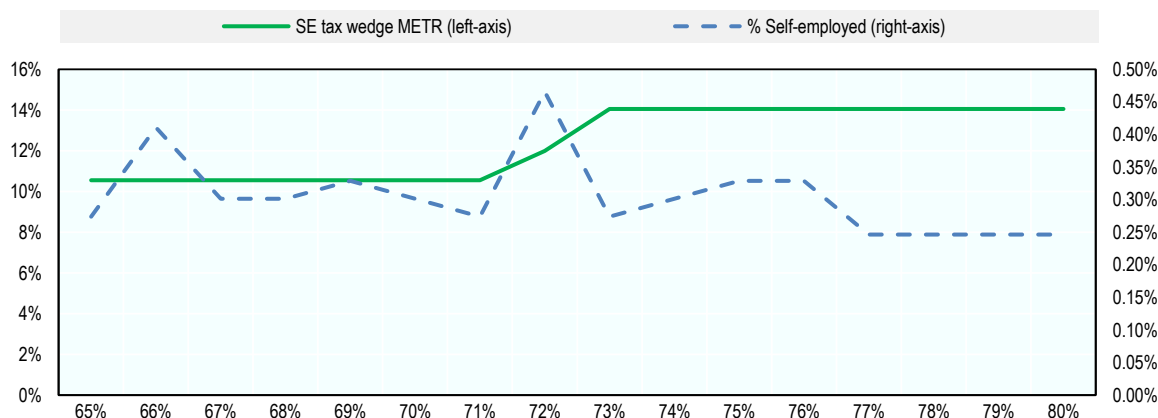
However, IA taxpayers face a narrower SSC base than employees which results in significantly lower effective SSC rates. In the IA regime, the SSC base is 90% of taxable IA income (before SSCs are deducted). For IA taxpayers that claim the presumed cost deduction of 30%, which is most IA taxpayers (83%), the effective SSC base is then 63% of gross income. For IA taxpayers that opt to declare expenses the effective SSC base could be even lower. By contrast, employees pay employee SSCs on 100% of their gross income. The employee SSC base is not reduced by the BA that employees claim.

Compared to employees, the SSC ceiling for IA taxpayers is introduced at a lower income and is more broadly applied (it covers health SSCs) which cuts the tax burden on high-income self-employed relative to high-income employees. For employees, the employee SSC ceiling is 5 annual AW since 2021 and the ceiling excludes health SSCs. In the IA regime, the SSC ceilings is lower at 3.6 annual AW in 2022 and the ceiling applies to health SSCs (unlike for employees) (note that the SSC ceiling

cannot apply to the BC regime as it exceeds the BC regime income eligibility cap). For IA taxpayers, the SSC ceilings produce a gradual reduction in the AETR and a sharp fall in the METR at about 384% of the AW which would not occur in the absence of the SSC ceilings. For employees, the SSC ceiling occurs later at 482% of AW and does not change the AETR because it coincides with the simultaneous introduction of the top PIT rate.

Figure 5.16. Income bunching among SE may be occurring as the health SSC floor expires

Individual activity self-employed and the marginal tax wedge, by gross income as % of AW



Note: There are 3 649 individual activity self-employed in the sample in total and 178 in the above income range.

Source: OECD analysis of microdata.

The expiration of the health SSC floor produces an increased marginal tax wedge but few IA taxpayers appear to respond to it. As the health SSC floor is lifted in the IA regime and there is an increase in the marginal tax wedge, there is some evidence of SE income bunching but it is very limited in terms of the share of SE (Figure 5.16).

There may be scope to harmonise SSC and health SSC payments on a monthly basis in the IA regime. 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 (assuming automated or directly deducted payments with no additional tax compliance burden for taxpayers) would have 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.

The tax burden in the IA regime is low relative to employment

Most IA taxpayers face an effective PIT rate of 3.5%, far below that of employees. With regard to the PIT base, IA taxpayers pay PIT on taxable income reduced by deductions (presumptive or declared) whereas employees pay PIT on gross income reduced by the basic allowance. This results in IA taxpayers having higher effective PIT rates than employees at low incomes below about one-third of AW (i.e. the BA means low-income employees pay no PIT) but higher effective PIT rates above that (Figure 5.17, Panel A). Most employees across the income distribution face high and flat effective PIT rates (Figure 5.17, Panel A). For example, effective PIT rates for employees are 9% at 1/2 the AW, 16% at the AW and 20% at twice the AW (Figure 5.17, Panel A). With the exception of low incomes where the BA exempts employees from paying any PIT, IA taxpayers face significantly lower effective PIT rates at all incomes.

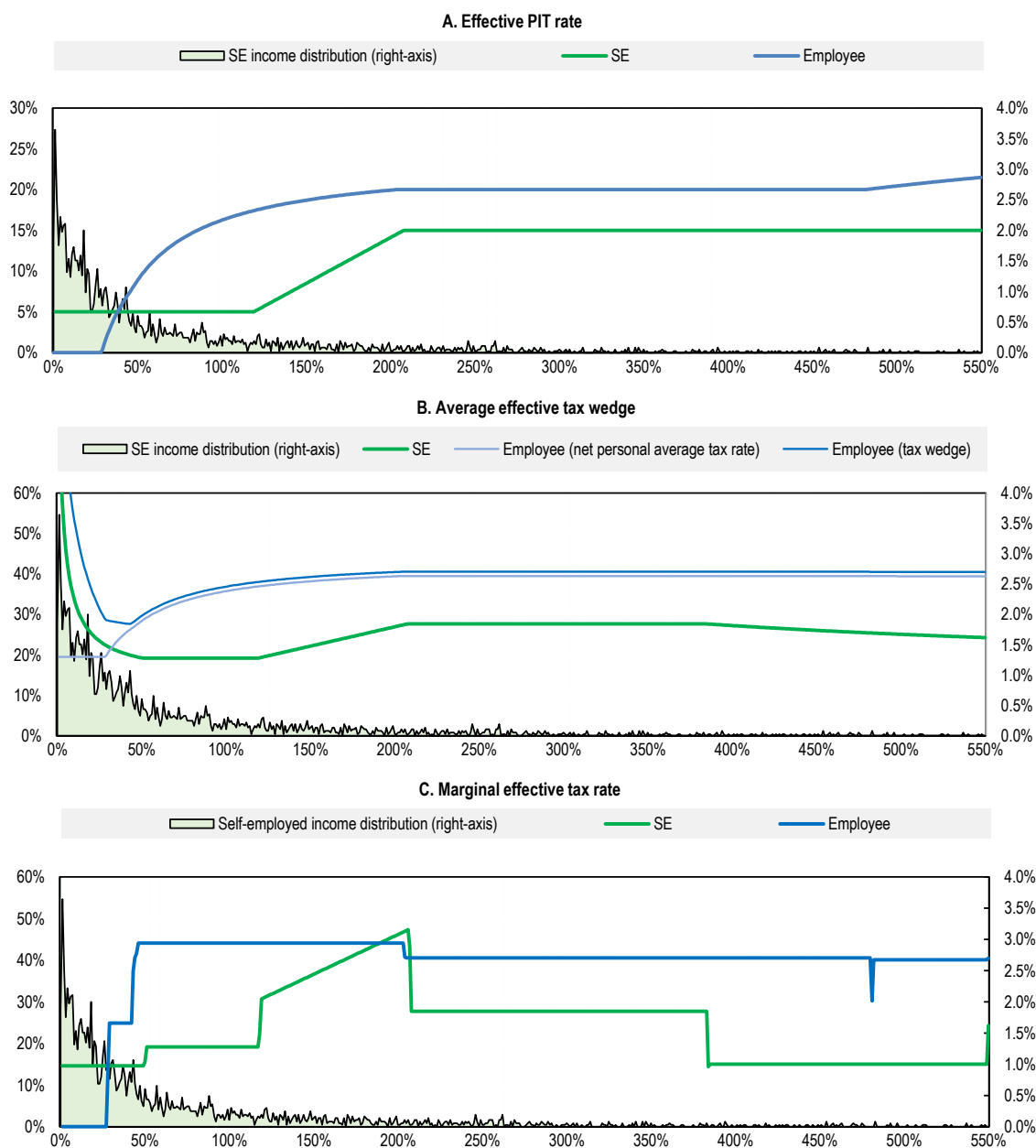
IA taxpayers face an average effective tax wedge lower than employees at all incomes. While the shape of the average tax wedge across the income distribution is similar between IA and employees (i.e. it is relatively compressed and flat), it is significantly lower for IA, particularly at incomes above half the AW. The IA tax wedge ranges from about 1/3 to 2/3 of the employee tax wedge for most of the distribution (Figure 5.17, Panel B). In other words, between 50% and 150% of the AW, the employee tax wedge is about 21 percentage points higher than the IA tax wedge. At low incomes, the IA tax wedge is relatively higher due to the health SSC floor but it remains below that of employees. Due to the BA and the exclusion of employer SSCs, the net personal average tax rate (NPATR) for employees is below the IA average tax wedge up to about 1/4 of the AW.

The microdata confirm that PIT rates and average effective tax rates are lower for IA taxpayers than employees. Compared to the previous hypothetical models (Figure 5.17), when microdata is used to calculate the effective PIT rate and AETR (average effective tax wedge as calculated in Figure 5.18) similar patterns emerge – IA taxpayers face lower tax burdens than employees (Figure 5.18) (for the purposes of the analysis, only 84% of IA that opt for the presumed cost deduction are included and the AETR for employees is calculated using *Taxing Wages 2021*, see note (Figure 5.18).

High-income IA taxpayers face rising METRs as the tax credit tapers. For employees, the first spike in the METR (marginal tax wedge as calculated in Figure 5.18) occurs as employees first start to pay PIT and the second spike occurs as the max BA starts to taper-out. Since many employees earn incomes at 1/3 and 1/2 the AW, the income-bunching risk from high METRs is greater. For the IA, over the same income range, the METR is by contrast relatively flat (with a modest increase as the health SSC floor expires) suggesting limited incentives to distort behaviour (Figure 5.17, Panel C). At higher incomes however, the design of the SE regime produces elevated METRs. As the tax credit is tapered at taxable income of EUR 20 000 (i.e. 170% of AW), the IA METR jumps and steadily rises before dropping as the tax credit expires (at EUR 35 000 i.e. 297% of AW). The METR drops further at 384% of AW as the SSC ceiling is introduced.

Figure 5.17. Hypothetical modelling of the tax rules show that the IA tax burden is low relative to employment

Effective tax rates and SE income distribution (right-axis), self-employed (individual activity) vs employees (single individual with no children), by gross income as a share of the average wage

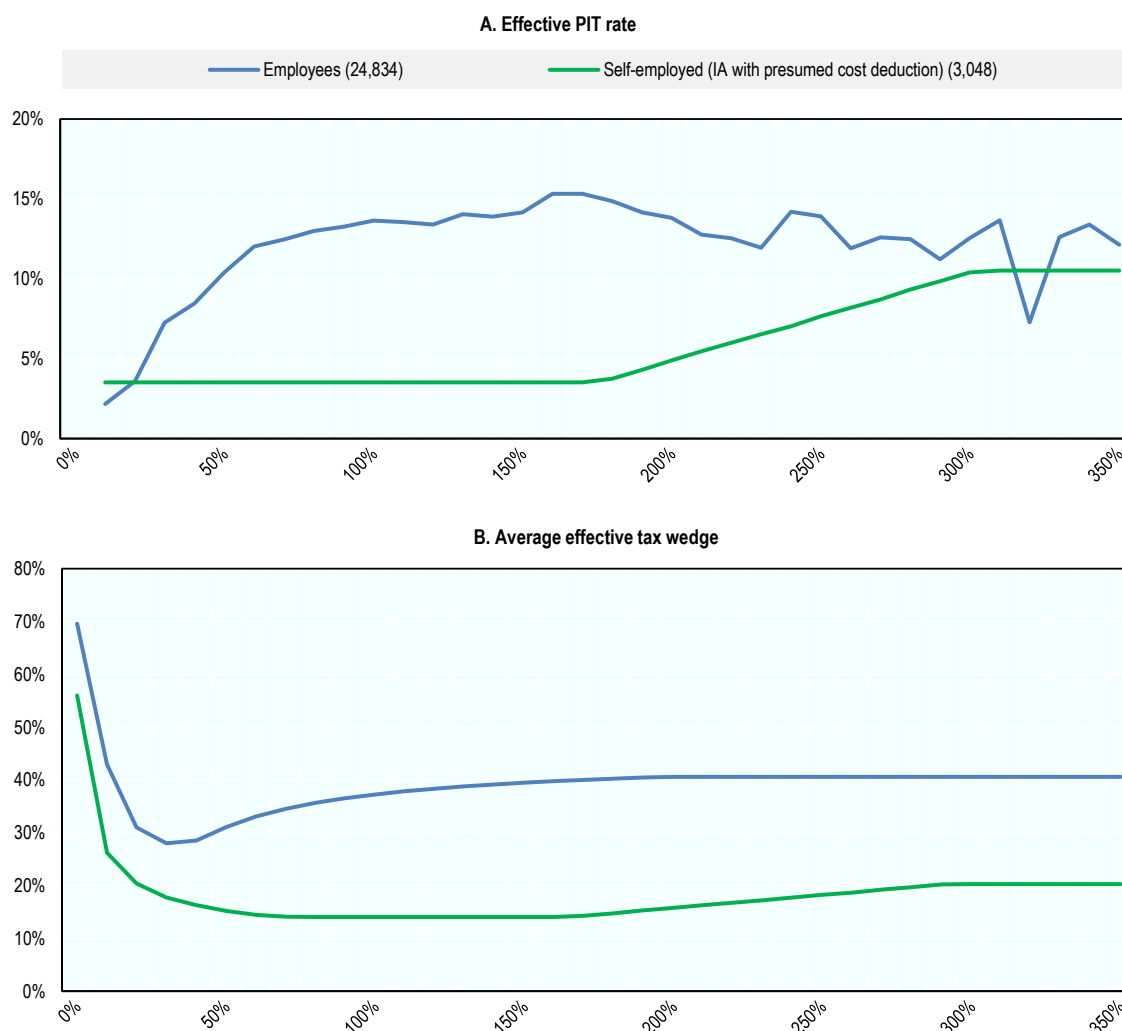


Note: The average wage refers to the gross average wage from employment in 2021 calculated by the OECD secretariat. Chart B starts at 10% of AW due to very high AETRs for the self-employed due to health SSC floor. SSC and health SSC ceilings for the individual activity SE are 3.6 annual AW in 2022 and 5 annual AW since for employees since 2021 (excluding health SSCs). For both employees and IA, the PIT rate is calculated as PIT as a share of gross income. For IA, total SSCs include SSCs plus health SSCs. For IA, the average tax wedge is calculated as PIT and total SSCs divided by total labour costs (i.e. gross income plus total SSCs). For employees, the average tax wedge is calculated as PIT, employee SSCs and employer SSCs divided by total labour costs (i.e. gross income plus employer SSCs). For employees, the net personal average tax rate (NPATR) is calculated as PIT and total SSC divided by gross income. For SE, the marginal effective tax wedge (METR) is calculated as the part of the increase of labour costs (gross income plus total SSCs) that is paid in PIT and total SSCs. The increase refers to a one percentage-point increase in gross income as a share of AW. The SE income distribution refers to a tax record sample of 3,649 taxpayers in 2019 (including those with incomes from sources other than self-employment).

Source: OECD hypothetical model of self-employment; OECD Taxing Wages; OECD analysis of microdata.

Figure 5.18. Tax microdata modelling confirm that IA face low tax burdens relative to employment

Effective tax rates, employees vs individual activity self-employed (who opt for presumed cost deduction), by gross income as a % of AW, based on tax record microdata



Note: The average wage refers to the gross average wage from employment in 2021 calculated by the OECD secretariat. For employees, the PIT rate is based on the PIT variable in the tax record data as a share of total employment income. For employees, the average tax wedge is calculated hypothetically using OECD Taxing Wages (as some SSCs are unavailable in the microdata). For employees, the average tax wedge is calculated as PIT, employee SSCs and employer SSCs divided by total labour costs (i.e. gross income plus employer SSCs). For SE, the average tax wedge is calculated as PIT and total SSCs divided by total labour costs (i.e. gross income plus total SSCs). Based on 24,834 employees. Based on 3,048 individual activity self-employed that opt for the presumed cost deduction. Of these, 84% avail of the presumed cost deduction. When the self-employed not availing of the presumed deduction are included, the effective PIT rate is more variable owing to higher costs (which could be due to losses, inter alia). Individual activity self-employed have income sources other than self-employment.

Source: OECD analysis of microdata.

The IA regime design and the self-employment income distribution

Few IA taxpayers will face high METRs so disincentives to progress in work will be limited. The increasing METRs in the IA regime will reduce incentives to progress in work. However, few IA taxpayers

earn incomes within the income range where METRs are high (Figure 5.18) so the negative impacts will be limited.

Similarly, as few higher income SE earn sufficient income to face higher PIT rates, the progressivity introduced by the tax credit will be limited. The tax credit design cannot achieve the goal of promoting progressivity because it does not appear to have been designed to reflect the actual IA income distribution (Figure 5.18). In the IA regime, a majority (85%) face an effective PIT rate on gross income of 3.5% with only a minority (4%) facing the 10.5% PIT rate on gross income or a rate in-between (8%) (Figure 5.18, Panel A).⁷

Adherence of the individual-activity regime to tax policy principles

The IA regime design may produce horizontal inequity (i.e. IA taxpayers with similar incomes to employees face lower tax burdens). 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, they may be unequitable.

The IA regime may not be tax neutral (i.e. it may encourage tax arbitrage from employment to SE). The aforementioned design features of the IA regime may violate tax neutrality as the tax design encourages employees to reclassify as SE to avail of a reduced tax burden. For example, an employee may be able to do the same work for their employer at a reduced tax burden by incorporating as an IA taxpayer. This tax arbitrage opportunity risks higher numbers of employees entering the IA regime than would otherwise be the case, potentially undermining tax revenues by placing a higher tax burden on the employee taxpaying population.

Justifying rationale exist for some departure from these principles for the SE but they should be weighed against arbitrage and tax revenue risks. Justifying rationale for why SE may be taxed lower than similar income employees could include that the authorities prefer to encourage small business growth, SE face greater job uncertainty in addition to reduced employment and entitlement rights. These rationale should be weighed against the likelihood and tax revenue risks of tax arbitrage opportunities produced by the tax burden differentials between the organisational forms.

Reform options

A number of tax policy reforms could be considered. To mitigate against the aforementioned challenges of horizontal inequity and tax non-neutrality between the IA regime and employment, there is a scope for tax policy reform. While perfect alignment of the tax burden between the IA regime and employment may not be preferable (given justifying rationale for lower burdens on SE) or indeed politically feasible, tax policies that reduce misalignment will reduce the challenges of horizontal inequity and tax non-neutrality. A number of such tax policy reforms that could be considered are as follows:

1. **Raise the PIT rate in the IA regime to better align with the PIT rate faced by employees.** 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. This could be achieved by reforming the tax credit design by cutting the tax credit threshold (i.e. currently EUR 20 000) or the tax credit (i.e. currently 10%).
2. **The appropriate PIT rate could set based on an evaluation of profits in the IA regime, but the data availability for a rigorous evaluation may be lacking.** An evaluation of profitability or the ability to pay might be challenging given the high take-up of the presumptive cost deduction which, from the perspective of data availability, implies that the tax admin likely has limited tax record information on

the costs of business operations in the IA regime. An analysis of IA taxpayers that do declare actual tax returns is likely to suffer from selection bias so that a representative evaluation would be challenging.

3. **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. One option could be to set the IA SSC base at 100% of taxable income instead of 90% of taxable income so that the effective SSC base becomes 70% of gross income. In this case, IA taxpayers would continue to pay lower SSCs as they face the same statutory SSC rates as employees.
4. **Align the SSC deductibility rules between the IA regime and employment.** To reflect the costs of inputs in operating a business, IA taxpayers can deduct costs. The employee equivalent is the costs of going to work which form part of the rationale for a basic allowance. However, IA taxpayers can further deduct SSCs (presumed or declared) whereas employees cannot, which implies reduced tax burdens for IA taxpayers. 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 pension benefits of employees could continue to remain untaxed (as employees have effectively already been taxed through higher PIT).
5. **The SSC ceiling design between SE and employees could be equalised 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, albeit the SSC revenue impact would be limited as few IA have very high incomes. Aligning the SSC ceiling would reduce arbitrage opportunities for high-income employees to incorporate as 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.
6. **The IA regime tax credit design should be aligned with the SE income distribution in mind.** The tax credit in the IA regime could be better designed. From the perspective of achieving PIT progressivity, too few IA taxpayers report incomes within the income range where it has been set. From the perspective of incentives, of the few taxpayers that it affects, a rising METR may discourage business growth.
7. **Consideration could be given to abolishing the presumptive cost deduction as it weakens the tax admin's capacity to successfully monitor and enforce compliance.** Despite the presumed cost deduction seeming insufficiently generously to be preferred to declaring actual costs, more than 4 in 5 IA taxpayers (83%) opt for it based on an estimate from the microdata. 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 where costs are 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 (13%⁸). This lack of information may weaken the tax admin's capacity to successfully monitor and tackle compliance in the IA regime.
8. **There may be a tax-induced incentive to switch from employment to self-employment as incomes increase.** If taxpayers responded to the net personal average tax rate (Figure 5.17, Panel B), they would face a tax-induced incentive to be employed at incomes up to about 1/4 of the AW and to enter the IA regime once income increased beyond that. The income distribution data show significant shares of part-time (PT) employees in this income range (Figure 5.5). Although a high share of PT employees report very low incomes, this does not necessarily imply that they face poverty risks

as they have high incomes on per month basis. For example, it could be speculated that some employees intentionally work PT and report low incomes to avail of a lower tax burden and then switch to more lightly taxed SE when income rises. Such an organisational arrangement is made possible by the tax rules which allow individuals to simultaneously be employed, have a business certificate and an individual certificate. However, the extent of this arbitrage behaviour remains unclear in the absence of a more comprehensive analysis of switching between organisational forms using longitudinal microdata. We leave this for future work.

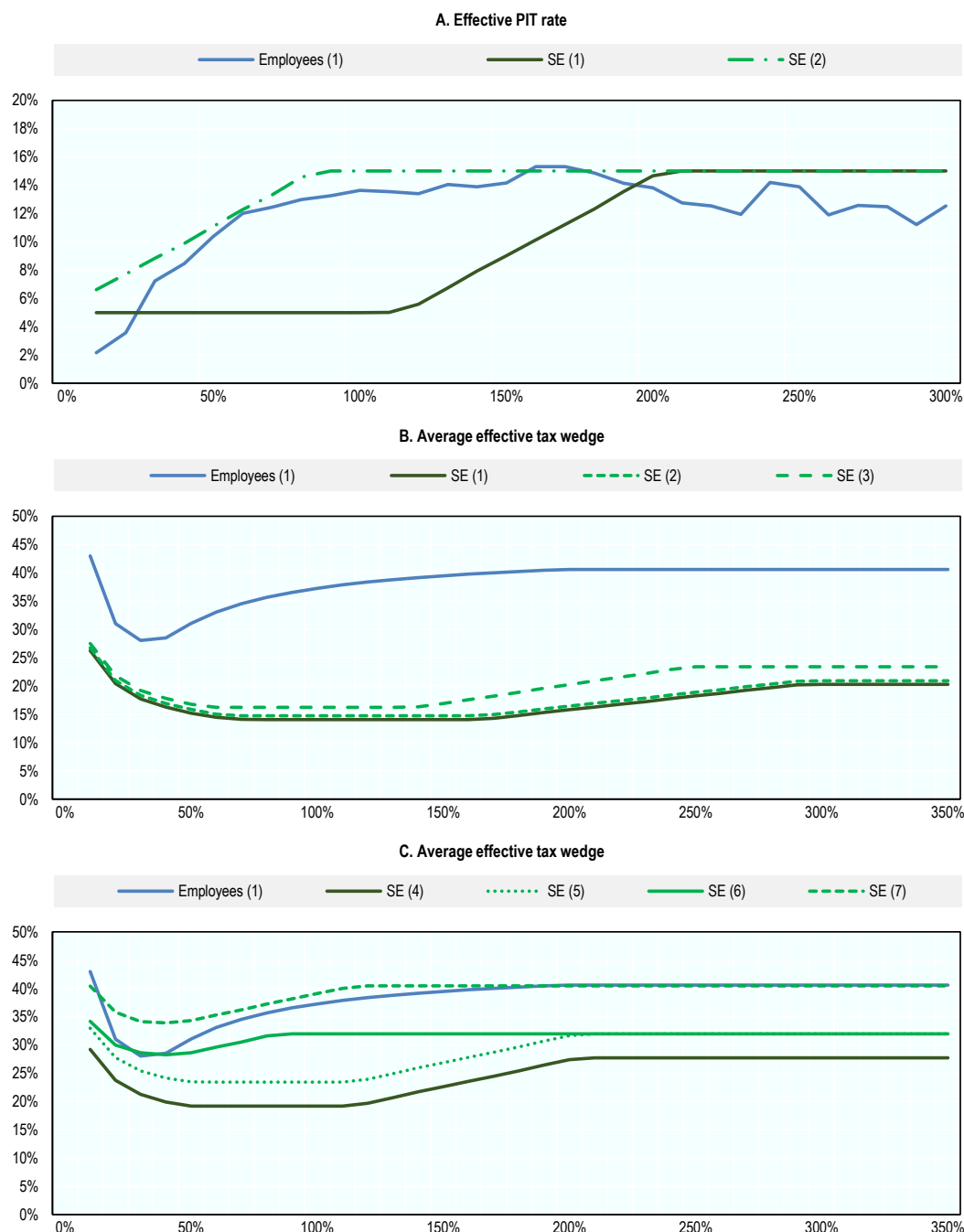
Simulating reforms

The tax burdens in the IA regime can be simulated and compared with employment for several potential tax reforms by applying the SE tax rules to income and taxes on the microdata. SE face lower tax rates than employees because they can deduct business costs from their income (for employees, the costs are already borne by their employer). To account for this difference methodologically and improve comparability, IA costs are set at zero (i.e. the presumed cost deduction is reduced from 30% to 0%). Note that this raises the tax burden on IA thus narrowing the gap with employees). The simulation informs the extent of the tax burden alignment between IA taxpayers and employees on several tax reform options as follows:

1. **Cutting the tax credit threshold to zero would broadly align the PIT burden with employees.** The effective PIT rate for the IA would broadly align with employees if the tax credit (TC) threshold was reduced from EUR 20 000 to EUR 0 (Figure 5.19, Panel A). This occurs as a TC threshold of zero corresponds to a PIT rate of 5% from when income is first earned that then steadily increases up to a PIT rate of 15% (if the TC were not set to zero, the PIT rate is flat at 5% up to 170% of the AW).
2. **Removing the deductibility of SSCs from the IA regime would modestly raise the tax burden, particularly on high earners.** Employees cannot deduct SSCs from the PIT base. If non-deductibility of SSCs were extended to IA taxpayers that opt for the presumptive cost deduction (i.e. implying a presumptive cost deduction of 17.7%), it would modestly raise the IA tax burden across the income distribution, notably at higher incomes when the health SSC floor has expired (Figure 5.19, Panel B, SE (3), see Figure notes).
3. **Broadening the IA SSC base would not alter the tax burden significantly.** If the IA SSC base was broadened from 90% to 100% of taxable income, the tax burden would increase but only very modestly (Figure 5.19, Panel B, SE (2), see Figure notes).
4. **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.** Increasing the PIT rate to 20% would shift the IA tax burden upwards relatively uniformly across the income distribution (Figure 5.19, Panel C, SE (5), see Figure notes) (following the methodology to increase comparability in chart A, chart C sets the presumptive cost deduction to zero, SE (4)). The distributional pattern of the tax burden would remain similar.
5. **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 to 20% and simultaneously cutting the TC threshold to zero (Figure 5.19, Panel C, SE (6), see Figure notes) would better align the distributional shape of the tax burden with employees. On top of the PIT rate increase, the TC threshold cut raises the tax burden between about 50% and 150% of AW. This tax reform would reduce tax arbitrage opportunities between the IA regime and standard employment.
6. **Aligning the tax burden with employees might require substantial increase in PIT rates which may not be desirable.** Increasing the PIT to 30% and cutting the TC threshold to EUR 5 000 is one option for broadly align with the tax burden for employees. A higher PIT rate is needed to compensate for the tax credit of 10% (even when the tax credit threshold is cut to zero). However, exact alignment may not be desirable (given justifying rationale for lower tax burdens among the self-employed).

Figure 5.19. The effective tax rate gap between self-employed and employees could be narrowed

Simulating effective tax rates using the tax record microdata, employees vs individual activity self-employed (who opt for presumed cost deduction), by gross income as a % of AW



Note: In all charts, employees refer to employees with only employment income (24,834 taxpayers in the microdata) and SE refers to individual-activity self-employed who opt for the presumed cost deduction (3,048 taxpayers). In chart A, the employee PIT rate is PIT as a share of total employment income in the microdata. In charts B and C, the employee average effective tax wedge (AETR) is calculated using the OECD Taxing Wages model (since employee SSCs are not available in the microdata).

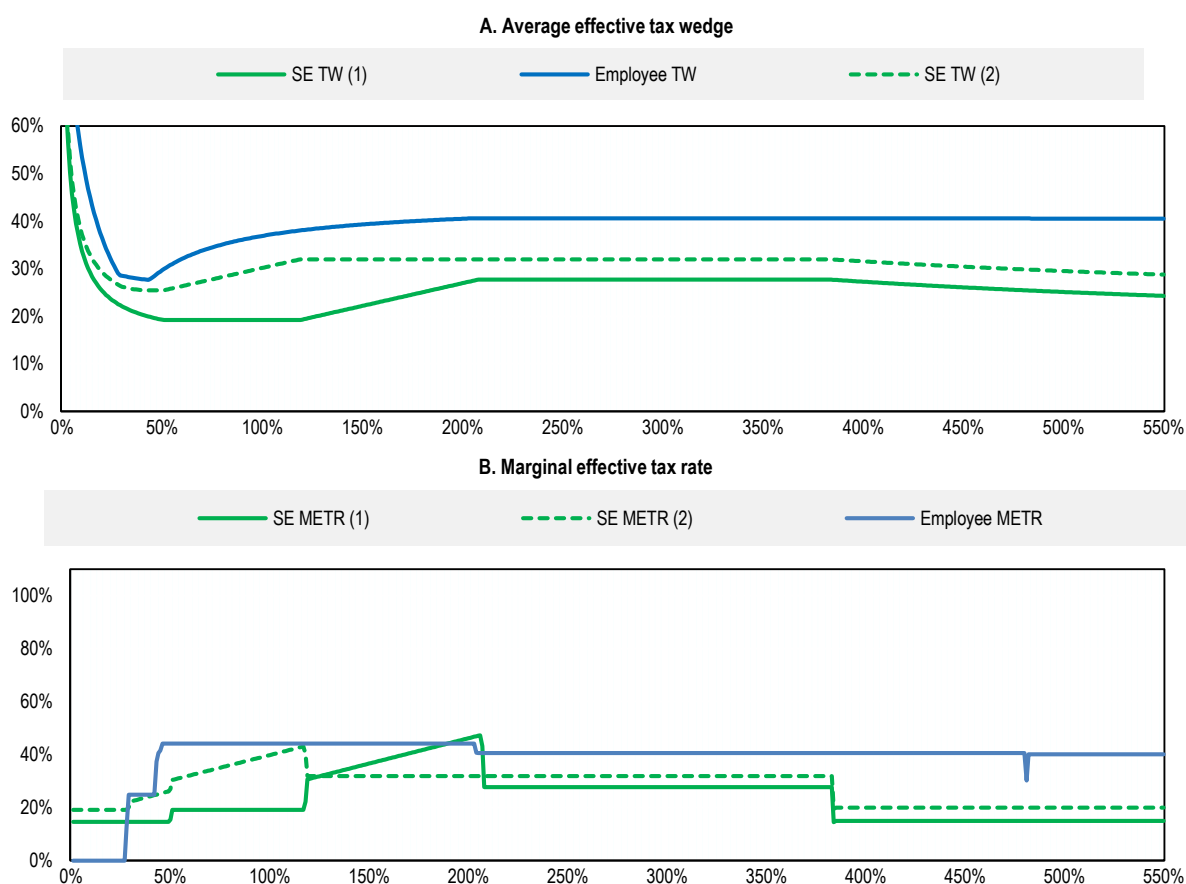
Simulation parameters: Chart A: SE (1) sets the presumed cost deduction (PCD) to 0. SE (2) sets PCD to 0, the PIT rate a 15% and the tax credit threshold (TC) to 0. Chart B: SE (1) sets PCD at 30%. SE (2) sets PCD at 30% and the SSC base at 100% of taxable income. SE (3) sets PCD at 17.7%. Chart C: SE (4) sets PCD at 0%. SE (5) sets PCD at 0%, PIT rate at 20% & TC at EUR 20,000. SE (6) PCD at 0%, PIT rate at 20% & TC at EUR 0. SE (7) PCD at 0%, PIT rate at 30% & TC at EUR 5 000.

Source: OECD analysis of microdata.

Hypothetical modelling applying the SE tax rules confirms that raising the PIT rate and cutting the tax credit threshold would significantly reduce the tax burden gap with employment. Using the same methodology from Figure 5.19 to improve comparability between the IA regime and employment (i.e. setting presumptive cost deduction to zero) but applying a hypothetical modelling analysis using the SE tax rules shows that raising PIT to 20%, cutting the TC threshold to EUR 5 000 and aligning the SSC ceilings would significantly reduce the tax burden gap with employment (Figure 5.20). The reform does not significantly change the magnitude of the METRs but rather shifts them to different income levels.

Figure 5.20. Increasing the PIT rate and reducing the tax credit would reduce tax arbitrage opportunities

Hypothetical simulation of the tax burden, increasing PIT to 20%, cutting the tax credit threshold to EUR 5,000 and aligning SSC ceilings, IA taxpayers and employees



Note: The hypothetical model follows the same approach as described in the notes in Figure 5.17. The hypothetical model has the advantage of modelling the SSC ceilings at higher incomes as it is not restricted to the sample microdata which is limited by sample size. It is also suitable to model METRs. PCD set at 0% for comparability. SE (1) shows PIT rate of 15% and TC threshold at EUR 20 000. SE (2) shows PIT rate at 20% and TC threshold at EUR 5 000. The SSC ceiling for SSCs and health SSCs used is EUR 64 676 in 2022.

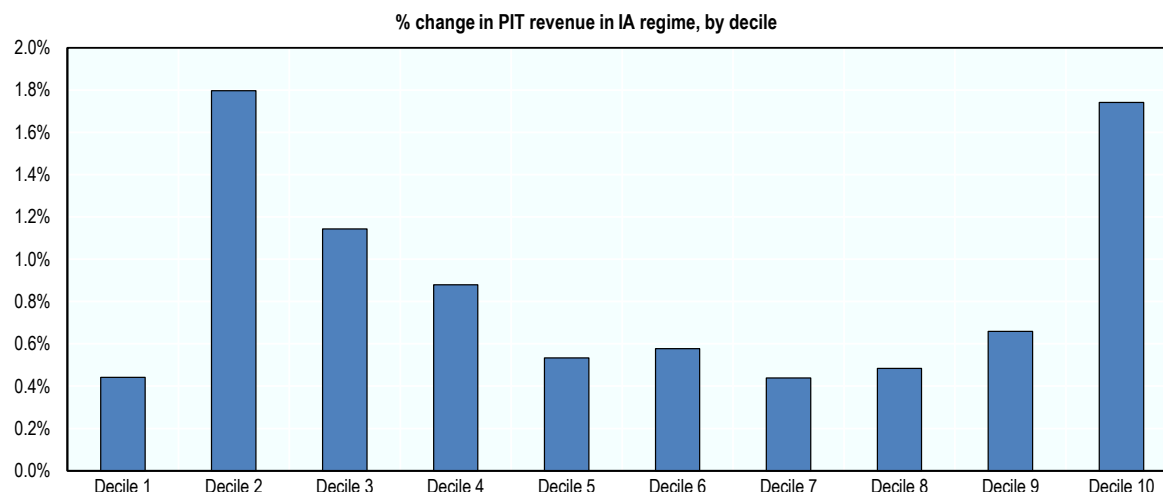
Source: OECD hypothetical SE model.

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% and modestly reduce income inequality (by 0.0123 percentage points based on the S80/S20 ratio). According to

modelling using EUROMOD, the reform would produce relatively high increases in total PIT revenues in both the bottom and top equivalised household disposable income deciles (Figure 5.21). The result reflects the low PIT paid by many IA taxpayers and the IA regime income distribution whereby most SE earn low incomes in the lower deciles, and a few earn very high incomes in the top deciles.

Figure 5.21. Raising PIT rates in the IA regime could increase PIT revenues

Simulating an increase in the IA regime PIT rate from 15% to 20% and a cut in the tax credit threshold from EUR 20 000 to EUR 5 000



Note: Deciles refer to equivalised total household disposable income. PIT refers to total PIT paid from all income sources (i.e. including employment income and SE income).

Source: Simulations performed by the EUROMOD team of the European Commission's Joint Research Centre (JRC).

Self-employed farmers

This section briefly describes the taxation of self-employed farmers. SE farmers are defined as persons working under agricultural individual activity income. SE farmers comprise 1/3 of IA taxpayers in 2019. A detailed examination of the taxation of SE farmers goes beyond the scope of this report, which we leave for future work.

Self-employed farmers have relatively high and varied income sources compared to non-farmer SE. Farmers have higher average SE income and, as such, are more likely to be VAT registered than non-farmer SEs (Table 5.9).

Table 5.9. Average incomes by income source, self-employed farmers and non-farmers

	% not VAT registered	Farming income	SE income	Employment income	Financial income	Rental income	Dividend income	Other income
Non-farmers (2 609)	95%	0	1 283	287	132	11	29	49
Farmers (1 040)	83%	2 561	2 800	323	165	26	40	879

Note: Farmers are defined as persons working under agricultural individual activity income.

Source: OECD analysis of microdata.

The tax rules for self-employed farmers are generous. SE farmers face the same PIT and SSC rates as in the IA regime provided that they are VAT registered (i.e. have revenue above EUR 45 000) and have large agricultural holdings (i.e. at or above 4 Economic Size Units) (Table 5.10). Farmers that are not VAT registered (and are not obliged to register for VAT) are exempt from PIT. Farmers face an SSC rate of 12.52% on their income when the agricultural holding is 4 Economic Size Units (ESUs) or greater. They also have an SSC base of 90% of taxable income and an annual SSC cap applies. Farmers below the VAT registration threshold face the same SSC rate of 12.52% but the SSC base is narrower at 12 MMS and there is no SSC cap. Small farmers with agricultural holdings (i.e. less than 4 ESUs) are not subject to SSCs but are subject to health SSCs.

Table 5.10. Summary of self-employment tax rules for farmers

Size of agricultural holding	VAT registered	Non-VAT registered
PIT		
	-PIT rules apply as per IA regime	-Exempt from PIT
SSCs		
> 4 ESU	-SSC rate is 12.52% -SSC base is 90% of taxable income -SSC annual cap applies	-SSC rate is 12.52% -SSC base is 12 MMS
< 4 ESU	-Do not pay SSCs	
Health SSCs		
> 4 ESU	-SSC rate is 6.98% -SSC base is 90% of taxable income before the deduction of SSCs -SSC annual cap applies	
> 2 ESU	-SSC rate is 6.98% -SSC base is MMS	
< 2 ESU	-SSC rate is 2.33% -SSC base is MMS	

Note: Farmers are defined as persons working under agricultural individual activity income. Agricultural tax rules relate to the year 2022. Non-VAT registered refers to persons that are not registered for VAT and are not obliged to register for VAT. ESU refers to economic size units.

Source: OECD analysis of IBFD database.

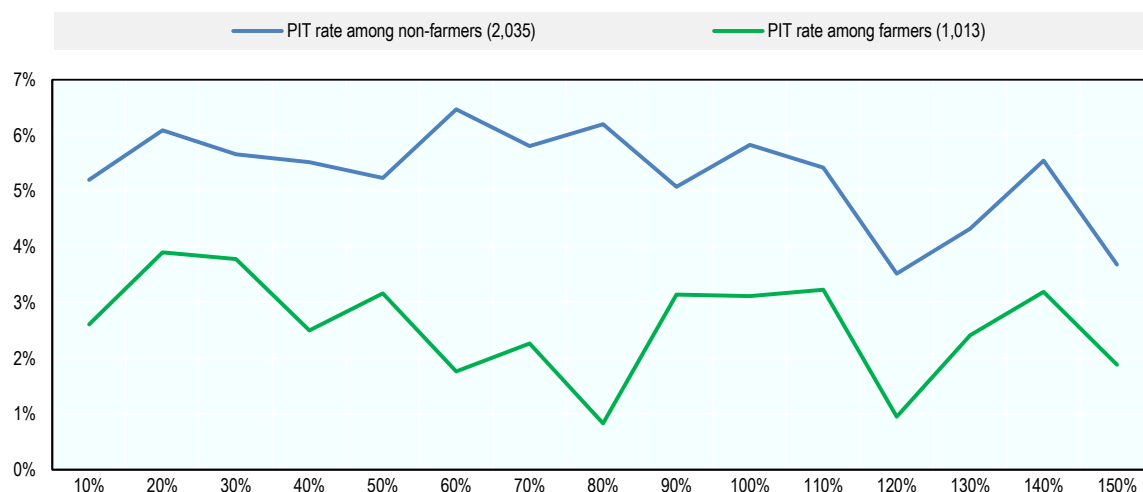
Most farmers will be exempt from PIT and face narrowed SSC bases. Since most SE farmers are not VAT registered (Table 5.9), a majority of SE farmers will be exempt from PIT and face a narrowed SSC base (relative to SE farmers that are VAT registered). Farmers that are not VAT registered and have smaller agricultural holdings (i.e. less than 4 ESUs) will face even lower tax burdens (as they are exempt from PIT and SSCs and only pay health SSCs on the MMS, see Table 5.10).

Self-employed farmers pay relatively less PIT as a share of total income. An indication of the reduced PIT burden (albeit somewhat crude) faced by farmers can be obtained by comparing the PIT paid as a share of total income across a range of income sources (including employment income, self-employment

income, dividend income and others) on the tax records (Figure 5.22).⁹ The data show that, compared to non-farmer SEs, farmers pay less PIT as a share of total income. As further investigation of the SE farmer tax burden goes beyond the scope of this report, we leave this for future work.

Figure 5.22. The PIT burden on farmers

PIT paid as a share of total income from various sources reported on the tax records, farmers and non-farmers



Note: The PIT rate is the PIT paid as a share of total self-employment income on the tax records. Total income refers to employment income, total self-employment income, financial income, rental income, dividend income, interest income, royalty income and other income.

Source: OECD analysis of microdata.

Closely-held corporations

Closely-held corporation modelling framework

An unincorporated individual can organise as an incorporated business and choose the form to realise their return. Drawing from a hypothetical modelling framework, this section provides observations on the tax-induced incentives to incorporate as a closely-held corporation and the choice between distributing profits as dividends and drawing profits as a salary relative to self-employment. The tax system plays a role in producing tax incentives between different business forms. The SE can choose to incorporate their business or not (note that incorporated businesses aimed at the SE in Lithuania include sole proprietorships and small partnerships). Since this is a discrete decision, the tax-induced incentive faced by the SE is well-captured by the average effective tax rate. For employees and unincorporated businesses, income is taxed as active (labour or individual) income. On the other hand, individuals who organise as incorporated businesses can choose the form to realise their returns. Labour income can be converted into capital income, such as dividends or capital gains. An individual that incorporates their business can become an owner-manager of a closely-held corporation. In closely-held corporations (hereafter corporations), profits can be distributed as dividends or the owner-manager takes a salary as an employee.

The tax-induced incentives to incorporate can be examined using a hypothetical framework. In the corporation case, profits are net of costs (i.e. the costs of doing business have already been deducted) unlike the IA case where costs can be assumed to equal to the 30% presumed cost deduction. To make profits of the SE comparable with the corporation, IA costs are set to zero (i.e. taxable income is now equal

to gross income). The average tax wedge can then be compared between the IA (with adjusted profits) and the corporation under three cases as follows:

1. The company distributes all profits as dividends.
2. An owner-manager draws all profits as a salary.
3. The company distributes $x\%$ as a salary and $1-x\%$ as dividends.

In case 1, the average effective tax rate on dividends is a flat 27.75% as calculated based on equation (1) (i.e. the standard CIT rate and the tax rate on dividends are both 15%¹⁰).

$$(1) \text{ CIT} + [(1 - \text{CIT}) * (\text{Dividend tax rate})]$$

In case 2, the tax wedge is the same as for an employee.¹¹ In case 3, the average tax wedge is a weighted average of the tax wedge on salary and the tax burden on dividends.

The hypothetical framework makes several assumptions and should be interpreted with caution. A limitation of the analysis is that it compares the IA who pay SSCs (and will eventually receive SSC benefits in the future) with owner-managers who receive company profits in dividends and do not pay SSCs (and will not receive SSC benefits in the future). Given the tax advantages of SSC benefits, SE may be even more preferable to incorporation. If however the owner-manager pays herself a salary as an employee and distributes the remaining profit as dividends, the comparison remains consistent. A further limitation is that closely-held corporations do not have to distribute profits as dividends immediately but can instead opt to retain profits for distribution in the future.

Standard CIT rate

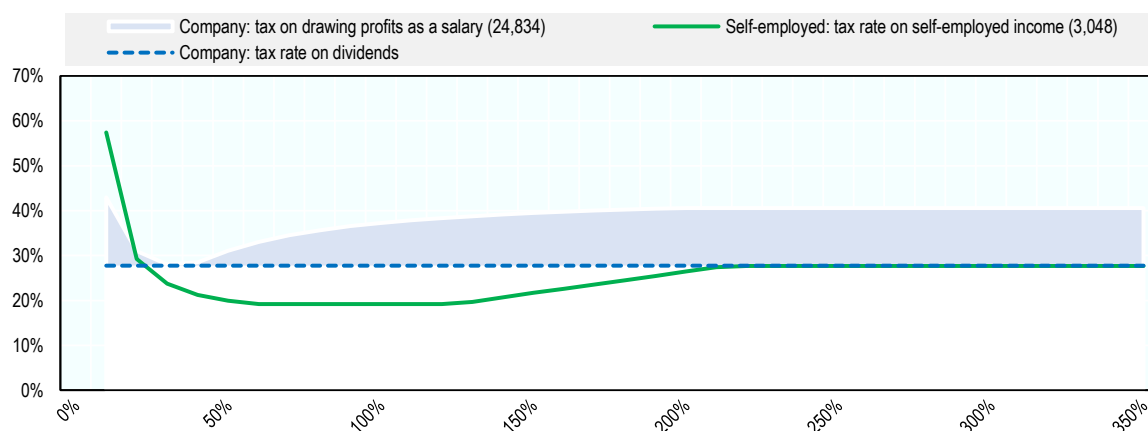
Closely held-corporations that face the standard 15% CIT rate have a tax-induced incentive to distribute profits as dividends relative to the owner-manager taking a salary. The shaded area in Figure 5.23 represents the set of weighted average tax wedges between taking profits 100% as salary versus 100% as distributed dividends. The tax-induced incentive is to distribute profits as dividends at most gross incomes (Figure 5.23). The incentive to distribute profits as dividends relative to taking a salary rises modestly as incomes rise (i.e. the gap between the average tax wedge on taking a salary and the tax burden on dividends widens). Under these tax incentives, we might expect that most closely-held corporations facing a 15% CIT rate would choose to distribute profits as dividends relative to taking a salary as an employee and that corporations with larger profits would be even more likely to do so.

There is a tax-induced incentive to be self-employed relative to incorporation at middle incomes but not at very low incomes. For an individual who can choose between SE in the IA regime and incorporating their business (at the standard 5% CIT rate and distributing profits as dividends), the average tax wedge suggests the following tax-induced incentives (Figure 5.23):

1. **At low incomes** (below 20% of the AW), **incorporation is preferable**. The IA average tax burden is higher due mainly to the SSC health floor.
2. At middle incomes (between 20% and 200% of the AW i.e. half of IA taxpayers), **SE is preferable**.
3. At high incomes (above 200% of the AW), **taxpayers are indifferent between organisational forms**.

Figure 5.23. There is a tax-induced incentive to become self-employment at middle incomes

Average effective tax wedge, incorporated and unincorporated (individual activity) businesses



Note: Assumes the standard CIT rate of 15%. For individual activity self-employed, the presumed cost deduction of 30% is set to 0%. Incomes from 0 – 350% of AW.

Source: OECD analysis of microdata.

Reduced CIT rate

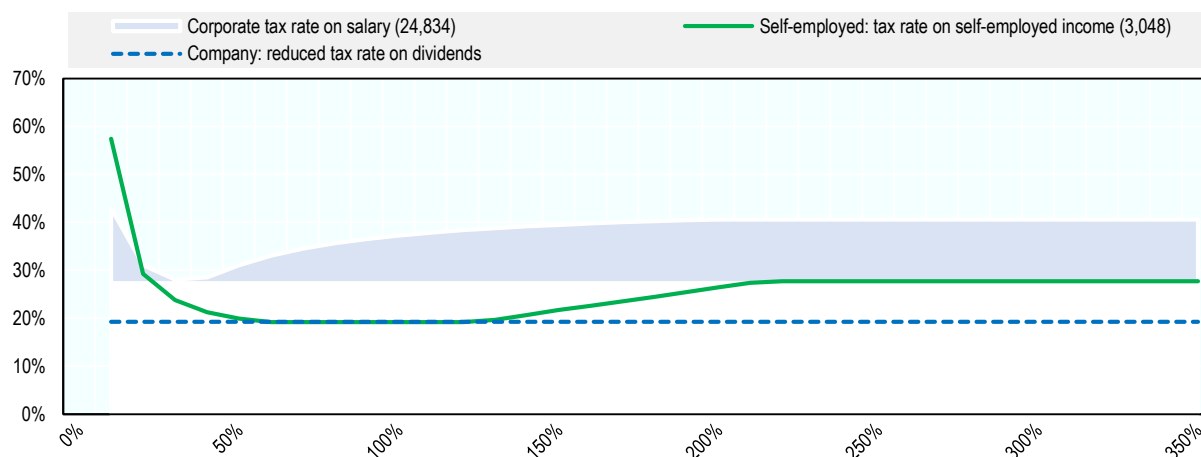
A reduced 0% or 5% CIT rate applies to certain micro companies (i.e. those with up to an average of 10 employees and annual income of up to EUR 300 000, inter alia) and agricultural companies. The 0% CIT rate is applied for newly registered micro companies only for the first tax period. With regard to eligibility for the reduced CIT rate, the annual income cap of EUR 300 000 (1780% of AW) appears to be quite high based on the IA income distribution (Figure 5.15). This may point to a significant share of companies availing of the reduced rather than the standard CIT rate. Under a 5% CIT rate, the overall tax burden on dividends is 19.25% (applying equation 1), which shifts the overall flat tax rate on dividends downwards (Figure 5.24).

Self-employed taxpayers at low and high incomes have a tax-induced incentive to incorporate and distribute profits as dividends. For an individual who can choose between SE in the IA regime and incorporating their business (at a reduced 5% CIT rate and distributing profits as dividends), the average tax wedge suggests the following tax-induced incentives (Figure 5.24):

1. **At low incomes** (below 60% of AW i.e. most IA taxpayers), **incorporation is preferable** (to avoid the SE health SSC floor).
2. **At middle-incomes** (between 60% and 120% of AW), **taxpayers are indifferent between organisational forms** (i.e. the average tax wedges are almost the same at 19.20% vs 19.25% respectively).
3. **At high-incomes** (starting from 120% of AW), there is a gradually increasing incentive to incorporate. Beyond 200% of AW, **incorporation is preferred**.

Figure 5.24. There is an incentive to incorporate under the reduced CIT rate

Average effective tax wedge



Note: Assumes a reduced CIT rate of 5%. For individual activity self-employed (SE), the presumed cost deduction of 30% is set to 0%. Incomes from 0 – 350% of AW.

Source: OECD analysis of microdata.

Reform options

Consideration could be given to raising the dividend tax rate to reduce tax arbitrage, but further work is needed. 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 be reviewed in the context of tax arbitrage. 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.

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Notes

¹ These data, which were provided by Lithuania's Ministry of Finance, are based on declarations filed by individuals and on behalf of individuals in 2019.

² Employment income refers to payments made in connection with employment relations or relations in their essence corresponding to employment relations, except certain other payments.

³ Part-time refers to working less than 12 months of the year. This is therefore different than part-time defined as those working less than 40 hours a week.

⁴ Based on 89 000 business certificate self-employed in 2020.

⁵ In France, presumed expenses are computed with the following rates: 70% for reselling or lodging activities; 50% for commercial and crafting activities and 34% for liberal professions. In Italy, presumed profitability range between 86% and 40% depending on the sector, which implies that presumed expenses vary between 14% and 60% of gross income (Regulation: Allegato 4, Legge 190, 23 dicembre 2014 <https://www.gazzettaufficiale.it/eli/id/2014/12/29/14G00203/sq>).

⁶ SEE Riga Shadow Economy Index estimates shadow economy in Lithuania at 23% of GDP in 2021.

⁷ Based on a tax record sample of 3,649 self-employed taxpayers in 2019.

⁸ Based on there being no SE business cost information for 83% of 308 000 IA taxpayers and 100% of 89 000 BC taxpayers (i.e. a total of 344 640 SE business with no cost information).

⁹ Note that SSC data for the self-employed are not available in the tax record data at the time of writing of this report.

¹⁰ The corporation tax rate is 15%. A zero rate or a reduced 5% rate can apply under incentive legislation. The average effective tax rate and marginal effective tax rate are the same assuming profits are excluded on all costs, no other provisions are claimed and there is not CIT allowance.

¹¹ Note that comparability with the net SE income could be modestly improved by adjusting the salary paid to the owner-manager to account for the total labour costs faced by the employer. In practice, this could be done by obtaining a new gross income level equal to total labour costs divided by 1.0179 (*i.e. gross income = (total labour costs) / (1 + employer SSC + payroll taxes)*). This simplifying assumption ignores the minimum amounts below the threshold. However, the impact of the adjustment on salary is very modest and it does not change the analysis so it is left unadjusted for simplicity.

Annex A. Methodological notes

Methodology

Different definitions of the average wage for employee and self-employed are used in the report.

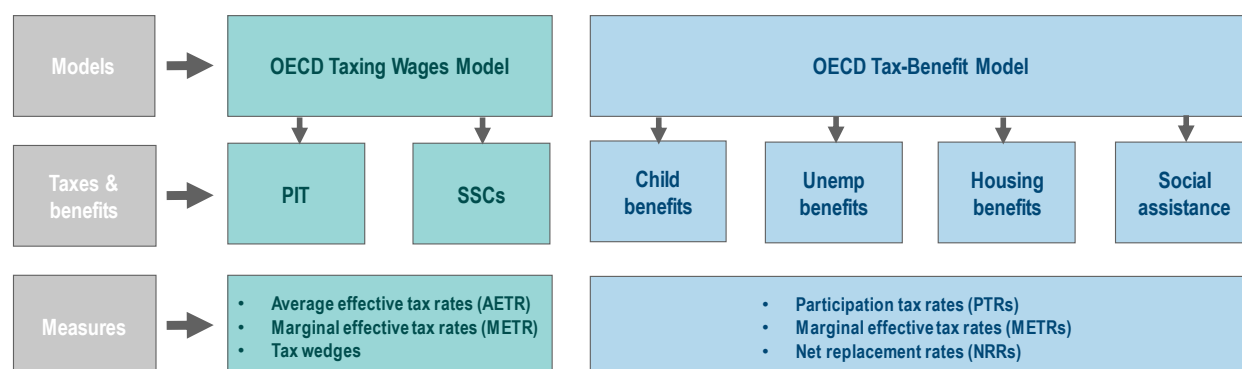
For the purposes of this report, the employee annual gross average wage (AW) is EUR 16 844 in Lithuania in 2021 based on OECD Taxing Wages, unless otherwise stated (this AW was provided by Lithuania to the OECD in late 2020 and is approximately representative of the period late 2020 / early 2021). The employee AW is used for comparisons in the self-employment chapter as it is the AW used to calculate the employee tax burden elsewhere in the report. The self-employed AW is calculated as the mean gross monthly self-employment income from the IA and BC regimes respectively based on the sample microdata (see Figure 5.5 and Table 5.4). An official gross monthly AW in Lithuania is published every quarter by Statistics Lithuania.

The microdata in this report is based on an anonymised representative sample of the tax and benefit administrative data in 2019 provided to the OECD by Lithuania as part of this project.

The unit of analysis in the microdata are individual taxpayers. The sample data represent 100 616 taxpayers in 46 011 households. The microdata includes a range of variables related to incomes (including employment, self-employment, pensions, financial, dividends, royalties and rental), taxes, benefits and demographics (including age, gender, marital status, and family structure).

The OECD Taxing Wages and Tax-Benefit models are used as part of this report. PIT and SSCs are examined using the OECD Taxing Wages Model (Figure A A.1.). Child benefits, unemployment benefits, housing benefits and social assistance topics are examined under the OECD Tax-Benefit Model. The Taxing Wage model allows for investigating average and marginal effective tax rates and the tax wedge while the Tax-Benefit allows for additional investigations of the participation tax rate (PTR), marginal effective tax rates (METRs) which include the loss of benefits and net replacement rates (NRR).

Figure A A.1. Methodological structure



Source: *Taxing Wages 2021*. OECD Tax-Benefit Models 2020 and 2021.

The tax burden and tax progressivity for different family types is assessed using OECD Taxing Wages models. The OECD Taxing Wages assesses the tax burden using the tax wedge indicator for 8

family types across the income distribution.¹ The tax wedge, the primary indicator in OECD TW, measures the difference between the labour costs to the employer and the corresponding net take-home pay of the employee. It is calculated as the sum of PIT and SSCs paid by employees and employers, minus cash benefits received, as a proportion of the total labour costs for employers as follows: Tax wedge = (PIT + employee SSCs + employer SSCs + payroll SSC - benefits) / (Gross Wage Earnings + employer SSCs + payroll SSCs i.e. labour costs).

The Tax-Benefit model includes several assumptions and limitations. PTRs in TaxBen are calculated on the working-age population currently out of work, not in education, not in receipt of public pensions or maternity benefits for a range of assumed wage levels when working full-time. OECD TaxBen calculates gross and net in-work and out-of-work incomes on a comparable basis across countries. Taxes, benefits and net incomes are determined for a month but shown on an annual basis (i.e. multiplied by 12). The analysis assumes unchanged income over the year. Benefits exclude benefits ‘in-kind’ such as free school meals, subsidized transport and free health care. The results do not account for the cost of formal child care arrangements and implicitly assume that parents have access to free informal childcare.

Table A A.1. Benefits in Lithuania and comparison countries

Benefits that are contributory, means-tested and taxable respectively (yes/no) and the average wage, Lithuania and selected OECD countries in 2020

	Lithuania	Germany	Estonia	Latvia	Poland	Slovenia	Hungary	Slovak Rep
1. Unemployment ben	Yes, No, No	Yes, No, No	Yes, No, Yes	Yes, No, No	Yes, No, Yes	Yes, No, Yes	Yes, No, Yes	Yes, No, No
2. Social assistance ben	No, Yes, No	No, Yes, No	No, Yes, No	No, Yes, No	No, Yes, No	No, Yes, No	No, Yes, No	No, Yes, No
3. Family ben	No, Yes(1), No	No, No, No	No, No, Yes(2)	No, No, No	No, Yes, No	No, Yes, No	No, No, No	No, No, No
4. Housing ben	No, Yes, No	No, Yes, No	None	No, Yes, No	No, Yes, No	No, Yes, No	None	None
Average wage (EUR)	16 426	52 104	16 637	12 913	13 330(3)	20 424	13 935	13 200

Note: Average wage is based on OECD secretariat calculations in 2020. Table displays some selected main benefits in Lithuania but not all benefits (such as social insurance maternity/paternity benefits, childcare benefits and sickness benefits). Unemployment benefit refers to unemployment insurance benefit. Social assistance refers to unemployment social assistance in Germany and Estonia. Family benefit generally means child benefit. (1) In Lithuania, the additional child benefit is means-tested but the universal child benefit is not. (2) In Estonia, parental benefit is taxable. (3) Poland national currency converted to EUR using 2022 exchange rate. In Germany, unemployment benefit refers to Arbeitslosengeld I and Arbeitslosengeld II and housing benefit comes under unemployment II. In Estonia, unemployment insurance benefit (töötuskindlustushüvitis) is taxable but unemployment assistance benefit (töötutoetus) is not taxable. In Latvia, unemployment insurance benefit (Zasilek dla bezrobotnych) is taxable but the solidarity allowance (Dodatek solidarnościowy) is not taxable. In Slovenia, unemployment insurance benefit (Zavarovanje za primer brezposelnosti) is taxable and financial social assistance (denarna socialna pomoč) is not taxable. In Hungary, family benefit refers to family allowance (családi pótlék).

Source: OECD TaxBen Models for Lithuania, Germany, Estonia, Latvia, Poland and Slovenia.

The report focuses on the tax wedge indicator to analyse the impact of Lithuania’s tax system on work incentives. Lithuania decided to shift virtually all SSCs to the employee coupled with partly financing social insurance pensions through the PIT (see page 62). These changes imply that the net personal average tax rate (NPATR), which takes PITs and employee SSCs into account but not employer SSCs, is similar to the tax wedge, which incorporates all taxes (Box 4.3).² Comparative analysis across OECD countries would produce a higher NPATR for Lithuania than for other countries where the mix between employee and employer SSCs is more balanced, which could bias the interpretation of the results. The analysis therefore prioritises the use of the tax wedge over the NPATR. However, given the employee is primarily interested in take-home pay net of taxes, there are cases where the NPATR remains a useful

indicator in that it provides a cleaner indication of the labour tax burden and the incentives to participate in the labour market faced by employees.

Lithuania is compared with Baltic countries and some other OECD countries. The Baltic countries of Estonia and Latvia make good comparisons based on a mix of living standards, proximity and the countries' respective tax and benefit systems. Table A.A.1 shows the AW and selected benefits for comparison countries and whether the benefits are contributory, means-tested or taxable (indicated by yes or no).

Financial measures of work incentive

Participation tax rates, replacement rates and marginal tax rates measure the financial disincentive to work produced by the tax and benefit system. To measure the employment and effort margins described in Figure A A.2. , a number of financial incentive measures are useful including PTRs, METRs and NRRs. PTRs measure the financial disincentive to work. Specifically, PTRs measure the proportion of gross earnings lost in tax or reduced benefits as an individual moves from unemployment to work. The PTR calculation (equation 1) is equal to one minus the financial gain to working as a proportion of gross earnings. In equation 1, Y_{netIW} and Y_{netOW} represent net income in-work and out-of-work and $Y_{grossIW}$ and $Y_{grossOW}$ represent gross income in-work and out-of-work. $Y_{grossOW}$ is zero for an unemployed individual because benefits such as unemployment are not captured in $Y_{grossOW}$ so the denominator becomes simply $Y_{grossIW}$. Since the second term calculates the additional income from moving into work (as a share of gross income), one minus this amount is the proportion of gross income lost (through additional taxes or lost benefits). Second, METRs measure the financial disincentive to working more or the effective tax burden to which additional earnings are subject to (equation 2). METRs measures what part of additional earnings is 'taxed away' through the combined effect of increasing tax and decreasing benefit. Comparing equations (1) and (2) shows that the METR is effectively the same as the PTR except that the out-of-work income (which is zero for the unemployed) is now replaced with a lower level of in-work income. The METR then measures the transition from one level of in-work income (state A) to a higher level of in-work income (state B) compared to the PTR that measures the transition from out-of-work to in-work. The structural similarity of the equations is useful in considering the most appropriate inclusion of employer SSCs in PTRs and METRs (see Box 4.3). Third, the NRR measures an individual's out-of-work income as a share of their in-work-income (equation 3).

Figure A A.2. Financial incentive measures

$$(1) PTR = 1 - \frac{Y_{netIW} - Y_{netOW}}{Y_{grossIW} - Y_{grossOW}} = 1 - \frac{Y_{netIW} - Y_{netOW}}{Y_{grossIW}}$$

$$(2) METR = 1 - \frac{Y_{netB} - Y_{netA}}{Y_{grossB} - Y_{grossA}}$$

$$(3) NRR = \frac{Y_{netOW}}{Y_{netIW}}$$

Interpreting participation tax rates

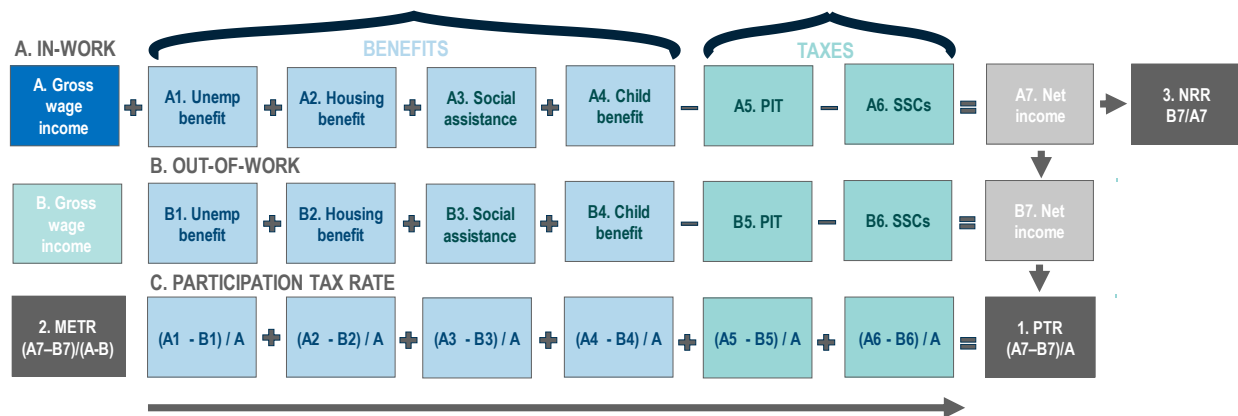
The participation tax rate measures the incentives to enter work produced by the tax and benefit system. Figure A A.3. provides a diagrammatic illustration for calculating the financial measures in Figure A A.2. . Figure A A.3. shows that PTRs can be conceptualised as the difference between net

income in-work and out-of-work as a share of gross wage income. The PTR can be further decomposed into tax and benefit components as a share of gross wage income. The PTR tell us about the role of the tax and benefit system in individual incentives by measuring how much is taxed away and lost in benefits as an individual moves from unemployment to work (or perhaps more simply the proportion of gross earnings lost in more tax and less benefits). Since PTRs are calculated as a share of wages, PTRs will only accurately represent the incentives faced by unemployed individuals that, as part of their decision to enter work, incorporate what they could hypothetically earn if they were in work. However, if an unemployed individual adopts as a conceptual benchmark their net out-of-work income (and disregards their hypothetical in-work gross income), then the incentive they respond to would be better measured by a straightforward proportion of the additional net income that they would gain from working (for further discussion and an example, see Figure 4.21). Figure A A.3. also illustrates how the NRR can be calculated as net income out-of-work as a share of net income in-work and the METR by replacing out-of-work gross income with a lower level of in-work income.

Work attractiveness as measured by the PTR is only increased by tax and benefit cuts that widen the gap between net income in-work and out-of-work. Since the PTR measures the difference in net income in and out of work, lower taxes or reduced benefits will not increase work incentive if they are provided equally for the employed and unemployed. For example, universal child benefit or housing benefit provided to families regardless of employment status will have no impact on incentives as measured by the PTR. Instead, work attractiveness will only increase if the gap between net income in-work and out-of-work is widened.

PTR and METR financial measures have caveats including that they do not examine dynamic affects and so complementing them with mobility analysis is important. To what extent are low paying job stepping stones to better careers? The static nature of financial measures such as PTRs and METRs is that they do not capture dynamic effects such as whether a low-paid job may be seen as a steppingstone to a better career . While policymakers are rightly concerned about high at-risk-of-poverty rates for some groups, it is often wrongly assumed that the same individual stay poor. On the contrary, in many countries the membership of the so-called poor is in constant flux – that poor people this year are not necessarily the poor people next year. The extent of this flux is captured by income mobility (who moves up and down the income ladder over time), which is then an important complement to such financial measure analysis. In addition, it could be that certain policies affect the pattern of mobility by acting as a ‘mobility lever’ to help move lower income workers up the income ladder over time (Mitnik et al., 2015^[1]). For example, extending the duration of unemployment benefit could provide low-income workers with more time to find a job that matches skills that then leads to a better job and upward mobility. Such a dynamic process is not captured in what would be measured as a high PTR and a low work incentive. A further dynamic process not captured by these financial measures is that individuals may respond differently to time-limited incentives. Building further on the unemployment benefit example described above, the incentive to work is unlikely to remain constant (as predicted by a PTR) over time-limited unemployment spells durations. In Lithuania, the PTR is the same during unemployment durations between 6 and 9 months, although the likelihood and intensity with which the unemployed try to find a job likely increases during those final months.

Figure A A.3. A diagrammatic illustration for calculating financial measures



Source: OECD analysis.

Avenues of future research in the tax microdata

1. **Investigate the extent of switching between the SE regimes caused by tax-induced incentives using longitudinal microdata.** There may be an incentive for the lowest income self-employed to be in the IA regime and then switch to the BC regime at higher incomes. Various SSC floors create relatively high tax burdens on the lowest income SE (in both regimes) and employees, which discourage entry to formal employment. Many SE earn very low incomes. At low incomes, the tax burden on IA taxpayers is below that of the BC (due to the BC SSC floor) which might induce SE to opt for the IA at low incomes and switch to the BC as incomes rise (when then BC is more lightly taxed).
2. **Investigate the extent of switching between part-time employment and the IA regime caused by tax-induced incentives using longitudinal microdata.** If taxpayers responded to the net personal average tax rate, they would face a tax-induced incentive to be employed at incomes up to about 1/4 of the AW and to enter the IA regime once income increased beyond that. The income distribution data show significant shares of part-time (PT) employees in this income range. Although a high share of PT employees report low very low incomes, this does not necessarily imply that they face poverty risks as they have high incomes on per month basis. For example, it could be speculated that some employees intentionally work PT and report low incomes to avail of a lower tax burden and then switch to more lightly taxed SE when income rises. Such an organisational arrangement is made possible by the tax rules which allow individuals to simultaneously be employed, be in the BC regime and the IA regime. However, the extent of this arbitrage behaviour remains unclear in the absence of a more comprehensive analysis of switching between organisational forms using longitudinal microdata. We leave this for future work.
3. **The extent to which the sector eligibility restrictions produce inequity could be measured using the microdata.** Horizontal inequity could be investigated by applying propensity score matching techniques to identify, compare and track an artificial control group of ineligible IA regime taxpayers conducting similar activities to eligible BC taxpayers.
4. **An evaluation of profits in the IA regime could be undertaken in the microdata to support setting appropriate taxes rates and to strengthening information for enforcement, but such an evaluation would face challenges.** An evaluation of profitability and the ability to pay might be challenging given the high take-up of the presumptive cost deduction which, from the perspective of data availability, implies that the tax admin likely has limited tax record information on the costs of business operations in the IA regime.

5. **Track the poverty risks of elderly families** following the death of a spouse over time using the tax microdata given the old-age gender gap and retirement income cliff.

Undertake analysis to establish why two-thirds of registered unemployed are not receiving benefits and whether it is attributable to insufficient SSC contributions, incorrect records or other factors.

References

Mitnik, P. et al. (2015), “New Estimates of Intergenerational Mobility Using Administrative Data”. [1]

Notes

¹ The OECD Taxing Wages Family Types are as follows: Single no children 67 (% AW); Single no children 100 (% AW); Single no children 167 (% AW); Single 2 children 67 (% AW); Married 2 children 100-0 (% AW); Married 2 children 100-67 (% AW); Married 2 children 100-100 (% AW); Married no children 100-67 (% AW).

² The personal average tax rate is the term used when the personal income tax and employee social security contributions are expressed as a percentage of gross wage earnings. The net personal average tax rate corresponds to the above measure net of cash benefits.

OECD Tax Policy Reviews

LITHUANIA

This report is part of the *OECD Tax Policy Reviews* publication series. The Reviews are intended to provide independent, comprehensive and comparative assessments of OECD member and non-member countries' tax systems as well as concrete recommendations for tax policy reform. This report provides a comprehensive assessment of Lithuania's tax and benefit system and recommendations for tax reform. It outlines the country's key economic and tax challenges and assesses the effects of taxation on employment. A special focus is given to the taxation of self-employed individuals.



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