

Lithuania is discussing further tax changes to tackle income inequality

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ROMAS LAZUTKA, JEKATERINA NAVICKE, ARUNAS POVILIŪNAS AND LAIMA ZALIMIENE – EUROPEAN SOCIAL POLICY NETWORK

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A new proposal aimed at increasing the marginal personal income tax rate and lowering the pace of increase of tax allowances was put forward by the members of the ruling coalition in late June 2019. The proposal is an important step towards preventing potential adverse effects of the recent tax reform on income inequality and social protection financing.



Description

The members of the ruling coalition of the Lithuanian Parliament put forward a proposal for amending personal income tax (PIT) legislation in late June this year. The proposal aims to adjust the recent tax reform by lowering the pace of increase of tax allowances and increasing the second marginal tax rate of PIT.

The proposal would amend the PIT legislation implemented at the beginning of 2019. This PIT legislation foresaw a gradual increase in the amount and scope of the general tax allowance. The latter was to increase by €100 each year from 2019 to 2021. Moreover, the PIT legislation of early 2019 replaced the single marginal PIT rate of 15% by two rates, of 20% and 27%. It should be mentioned though, that, in parallel to these changes, social insurance contribution (SIC) rates were lowered and capped for those liable for the higher marginal PIT rate.

The new proposal for further amendments to the tax legislation proposes to limit the growth in tax allowances to €50 each year instead of €100. According to the authors of the proposal, the amendment would result in €70 million additional tax revenue in 2020 and €100 million in 2021. Moreover, under the new proposal, the second marginal PIT rate would be increased from 27% to 32%. As a result of this change, according to preliminary estimates by the authors of the proposal, state and municipal budgets would receive around €8 million more in tax revenue in 2020 and around €15

million more in 2021 (see Savickas 2019).

The new proposal, according to its authors, would improve social justice by distributing tax liabilities more proportionally among average and high earners. Moreover, it would enhance funding opportunities for the basic part of pensions and child allowances.



Outlook and commentary

The proposal for further amending the PIT legislation revived a discussion on very important topics for Lithuania: income inequality, redistribution and public sector financing. For a long time, the country has been facing three interrelated challenges: high income inequality, a high income poverty rate, and a poorly funded public sector, especially in the sphere of social protection.

The level of income inequality in Lithuania is one of the highest in the EU. The Gini coefficient (which varies from 0%, perfect equality, to 100%, maximum inequality) increased from 37% in 2016 to 37.6% in 2017 (EU-28 average: 30.8% and 30.7% respectively). Despite the economic upturn, the at-risk-of-poverty rate (EU definition) increased from 21.9% in 2016 to 22.9% in 2017 (the EU-28 average remained broadly unchanged - 17.3% in 2016 and 16.9% in 2017). Among those at an above-average risk

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of poverty are groups targeted by different social protection schemes: children (25.3% versus 19.9% at EU-28 level), people with disabilities (35.1%; EU-28: 20.5%), retired elderly people (36.7%; EU-28: 14.4%) and unemployed people (61.5%; EU-28: 47.8%). The share of gross expenditure on social protection out of total GDP is much lower in Lithuania (11.2% in 2017) than at EU-28 level (18.8%). The share of total receipts from taxes and social contributions in GDP is also much lower: 29.8% versus 40.2% at EU-28 level in 2017.

Under-financed social protection is acknowledged as a problem at the highest governance level in Lithuania. Nevertheless, the latest tax reform implemented at the beginning of 2019 is a move in the opposite direction. It is following a long-standing "small government" approach, i.e. reducing effective taxation and tax revenue. It is estimated that if the recent reform is rolled out in full, the average tax wedge would decrease in Lithuania by 6.26% between 2019 and 2021, benefiting most those previously not entitled to tax allowances and those with the highest earnings. According to the most conservative estimates published on the website of the Ministry of Finance, the effective reduction of PIT and SIC would lower tax revenue by €250 million if implemented in full.

Hence, the reform does not strengthen, but instead weakens the Government's ability to adequately finance social protection, public-sector wages and other public goods. It also benefits those with the highest earnings, which could further boost income inequality. That is a huge problem for Lithuania's future social development. Local experts and international organisations (European Commission, IMF and OECD) highlight the weak ability of

the Lithuanian tax/benefit system to strengthen the public sector, and to reduce poverty and income inequality. They are proposing to raise more resources for social protection and strengthen the redistributive function of the tax system by taxing income more progressively.

The new proposal for revising and improving the recent tax reform is a step forward towards discussing measures which would contribute to reducing inequality, and strengthening social protection and public sector financing. Still, a revision of marginal PIT rates and allowances will not suffice. There are important gaps and potential for tackling inequalities and raising additional revenue through capital and property taxation in Lithuania, emphasised by both international and local experts and institutions.

Further reading

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Author

Romas Lazutka, [Jekaterina Navicke](#), Arunas Poviliūnas and Laima Zalimiene (Vilnius University)

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