ANNEX 3. Reform of the Lithuanian social model: amendments to social security and the tax wedge

Tax revenues from taxation of labour constitute a significant share of government revenue in many EU Member States. In addition to providing government revenue, labour taxes influence the demand and supply of the labour factor. First, the labour tax rate influences the decision of households on whether to participate in the labour market and how many hours to work. Also, taxation on labour is an important factor taken into account when deciding on the desired proportion of income from other sources, e.g., from the shadow economy. From the perspective of labour demand, labour taxes influence the decisions of companies to hire employees. Therefore, the Annex studies direct labour taxation in Lithuania and the EU countries and assesses the impact of tax changes, related to the social model and provisions of the draft budget in 2017.

In monitoring the European economies that are struggling to recover after the economic slowdown, over the past few years it has often been recommended to EU Member States to reduce labour taxation, especially for low income earners (Eurogroup 2014). The main reason behind this proposal is the belief that lower taxation on labour can make the labour market more flexible. Lower taxation on labour also reduces the tax wedge. The tax wedge is the difference between the employer’s total costs of hiring the employee and the employee’s after-tax wage. The average tax on labour could be reduced by widening the tax wedge interval, as the lower limit shows the tax wedge of households earning the lowest income and those with children, while the upper limit reflects the tax wedge of those households that are usually composed of one person and receive a much higher-than-average income. The tax wedge has a particularly significant impact on low income earners. Lower labour taxes could increase their income and incentives to work and thus have a positive influence on the overall state employment level due to the higher elasticity of labour supply with respect to income.

The above-mentioned and other effects of the tax wedge are widely discussed in economic literature. It provides evidence of the growing labour factor demand elasticity, predominantly due to increasing economic integration, growing mobility of companies and the resulting higher sensitivity of employers to labour costs (Lichtner et al., 2014). It is argued that for countries where the employers are subject to a heavy tax burden there is a risk of capital leakage and lower economic activity in the long run. The low marginal tax rate on labour in most cases has a positive effect on the labour supply of lower-income households due to higher elasticity of such households with regard to income (Saëz, 2001). Tax wedge reduction reduces unemployment, because the empirical literature provides evidence that labour taxes strongly correlate with the unemployment rate. For example, it is argued that the unemployment rate in industrialised European countries at the end of the 20th c. was mainly the result of a significant increase in labour taxes and ultimately a higher tax wedge. Similar results are presented in a more recent OECD study, which states that a high tax wedge is one of the most important factors in increasing unemployment, and its reduction by 10 p.p. would allow for a nearly 3 p.p. decrease in unemployment rate in the analysed OECD countries (Bassanini and Duval, 2006).

The effects of the tax wage are indirectly analysed in empirical studies dealing with the impact of fiscal devaluation on the economy. Fiscal devaluation is a policy instrument often recommended by international institutions for countries suffering from competitiveness problems. A classic example is the reduction of social security contributions and compensating the negative effects of this decision on the budget by additional income from increased value-added tax. Such exchange of taxes reduces the tax wedge and its effect on the economy is very similar to that of the depreciation of the nominal exchange rate, if the flexibility of wages is low and markets are competitive enough (Farhi et al., 2011). The findings of these scientific articles generally show a positive effect of fiscal devaluation on short-term and long-term growth of economic activity. As summarised in the European Commission study, most of the empirical study results support the contention that the labour tax reduction and/or exchange by taxation on consumption increases the GDP growth in the long term; however, the magnitude of this effect is also dependent on other factors (European Commission, 2011).

Chart A presents the values and structure of tax wedge in EU Member States in 2014. The tax wedge in Lithuania amounted to around 40 per cent and was close to the EU average. Compared to neighbouring countries, the tax wedge in Estonia and Poland was lower than in Lithuania, while in Latvia it was a little higher. The analysis of the tax wedge structure shows that in Lithuania and Estonia, social security contributions paid by the employer account for the largest share of the tax wedge. However, in Estonia, the remaining share of the tax wedge is comprised of the income tax, while in Lithuania the shares of social security contributions paid by the employee and the income tax are very similar. In Poland, the share of income tax in the tax wedge is the lowest among all EU countries whose data are available, and the major part is comprised of social security contributions paid by the employee. However, tax wedge structure could be less important than its level, if some aspects potentially relevant for assessment of labour taxation in terms of transparency, simplicity and influence of the shadow economy are not taken into account.
The size of the tax wedge is affected by a variety of tax exemptions. For example, in Lithuania, the Law on Income Tax of Individuals (LRS 2002) envisages that for individuals whose annual income before taxes is lower than EUR 11,259 (or EUR 938 per month) non-taxable income (NTI) is applied when calculating the income tax due. The maximum amount of NTI is EUR 2,400 (or EUR 200 per month). For individuals who are raising children under 18, additional NTI of EUR 120 is applied for each child. Therefore, a more accurate distribution of the tax wedge in the EU Member States is presented in Chart B, which takes into account the family situation of households and relative wage in comparison to average wage in the country. In Lithuania the difference of the tax wedge for households consisting of one individual and two individuals with two children is not very large, i.e., the tax wedge range is small enough. A smaller range was registered only in Poland and Romania, while in Estonia and Latvia it is considerably larger. A small wedge range indicates that the share of taxes in total hiring costs and the marginal rate of labour tax in Lithuania barely depends on the taxpayer’s relative earnings and family situation. On the one hand, this is particularly important for low-income households when deciding whether to participate in the labour market and how much to work. On the other hand, a narrow wedge interval shows a rather stable marginal rate of labour tax and the low-progressive (proportional) labour taxation, which does not reduce incentives to seek higher incomes for higher-income households already participating in the labour market.

The development of the tax wedge in Lithuania may be divided into three major periods (Chart C). The first one covers the period from 2000 to 2003, during which the tax wedge decreased from around 38 per cent to 34 per cent. The main reason for this decrease was rapid acceleration of wage growth after the Russian financial crisis; however, the annual growth rate of employer social security contributions and revenue from personal income tax was much slower. Such development, among other factors, could have been a result of the increase in shadow economy during the economic recession. This statement is supported by Schneider’s (2002) estimates of shadow economy. These estimates show that the average size of the shadow economy in 2000–2001 was higher, when compared to the period of 1990–1993. The second period covers 2004–2008, during which the tax wedge remained essentially stable and amounted to 35 per cent. Other macroeconomic data shows that during this period, Lithuania’s GDP was growing very rapidly, followed by a significant increase in government revenues, although there were no essential changes in tax rates. Tax rates and the list of tax payers were substantially revised in 2009: individuals receiving income from sports activities, performing activities, or under copyright contracts were included in social security. In addition, in 2009, employer social security contributions were separated from personal income tax (the personal income tax rate of 24% was divided into 15% personal income tax and 9% social security contribution). These were the main reasons behind the increase in collected social security contributions in 2009, despite the drop by one sixth in compensation of employees during the economic downturn. This resulted in a rise of the tax wedge to around 40 per cent in 2009, which remained essentially unchanged until now.
In the nearest years, the size of the tax wedge will be significantly affected by changes in labour income taxation, which are already approved or are planned to be approved by the Seimas of the Republic of Lithuania. The most important changes include:

- in 2017, the employer social security contribution rate will be decreased by 0.5 p.p. for budgetary institutions and the Bank of Lithuania: in September 2016 the Parliament adopted a Law (LRS 2016a), which established a long-term employment benefit fund. The Law stipulates that employers, with the exception of budgetary institutions and the Bank of Lithuania, pay contributions of 0.5 per cent into the long-term employment benefit fund;
- the draft State Social Insurance Fund Budget for 2017 (LRS 2016b) proposes to reduce the general pension, sickness and maternity, and unemployment insurance contribution rate to 27.3 per cent (compared to 27.8% in 2016) by changing the rates for individual types of social insurance:
  - old-age pension social insurance rate would be reduced from 23.3 p.p. to 22.3 p.p.;
  - unemployment insurance rate would be increased from 1.1 p.p. to 1.6 p.p.;
  - the shares of maternity and sickness social insurance and compulsory health insurance in the general rate would be 3.4 p.p. and 3.0 p.p. respectively, i.e., they would not change in 2017;  
- NTI will increase in 2017: in December 2016 the Parliament agreed on changes in the Law on Personal Income Tax (LRS 2016c) and increased the general NTI from EUR 200 to 310 and additional NTI for children from EUR 120 to 200 is proposed along with a proportionate increase of individual NTIs for the disabled depending on the level of disability.

The calculations indicate that the proposed amendments would reduce the tax wedge in 2017. However, as it is evident from Chart C, which presents the projected development of the tax wedge, this decrease will be small and will amount to around 1 p.p.

In summary, it can be stated that the size of the tax wage in Lithuania currently amounts to around 40 per cent and is very close to the EU average. However, it will decrease slightly in 2017 due to the already-approved or planned amendments of labour income taxation by the Seimas of the Republic of Lithuania. However, according to the results of empirical research, greater reduction of the tax wage could be beneficial to the country’s economy in several aspects. First, a smaller tax wedge could reduce the risk of capital leakage in the context of increasing mobility of companies and growing economic integration among countries. Second, expanding the range of the tax wedge could potentially reduce the marginal labour tax rate and contribute to the greater well-being of lower income households. The range of the tax wedge in Lithuania is one of the smallest compared to other EU Member States (smaller only in Poland and Romania). Third, quicker reduction of the tax wedge and labour taxation would allow for faster growth of economic activity in the long run.

Literature


