Box 4. Assessment of the tax and pension system reform

On 28 June 2018, the Seimas of the Republic of Lithuania approved the amendments to the Law on Personal Income Tax[1], Law on State Social Insurance[2], Law on the Accumulation of Pensions[3], and other related legal acts. These amendments led to the introduction of new personal income tax rates (20% and 27%) and personal income tax reliefs (for voluntary and larger than 3% contributions to second pillar pension accumulation funds, expenses on the finishing works of buildings and other constructions, vehicle repairs, and child care services), the increase in the size of non-taxable income and the extension of its scope (up to two average monthly wages), consolidation of state social security contributions on the employee's side, setting of a 'floor' and 'ceiling' for state social security contributions (as of 1 July 2018), abandonment of overlapping state social benefits, the increase in social assistance pensions, and the introduction of old-age or disability 'pension bonuses'. The amendments also phased out the transfer of a certain part of state social security contributions to second pillar funds, provided for a possibility to transfer more than 3% to these funds or stop (suspend or terminate) participation in the second pillar altogether, boosted resident involvement in the pension accumulation system, tightened the requirements for pension accumulation fund companies (the requirement to establish a pension asset preservation fund and target age group pension funds, reduction of deductions from pension assets), centralised the pension annuity system and introduced new types of annuities.

The approved amendments are deemed appropriate, however, pressing issues within Lithuania's tax system are not addressed sufficiently. The Bank of Lithuania experts believe that the main problem within the tax system is the inappropriate balance between general government revenue and the scope of the public services (health, social security, education, etc.). For example, in 2016 Lithuania's social security expenditure accounted for a meagre 11.2% of GDP, i.e. far below the average of the new and old EU Member States (13.8% and 19.4% respectively) or the average share of Latvia's, Estonia's and Poland's GDP allocated to social security (14.1%). Inadequate financing lowers the quality of some public services, provides preconditions for 'shadow' activities and corruption, and increases public dissatisfaction. It also prompts emigration. The lack of government sector tax revenues is primarily driven by the large-scale shadow economy and extremely uneven taxation of labour income; thus, the Bank of Lithuania proposes[4] to use the key reform measures to tackle these issues specifically.

Changes in Lithuania's tax and pension system will affect its economy: in 2019-2020 real GDP is expected to expand by a further 0.5 percentage point, while inflation is projected to rise by a further 0.3 percentage point. The increase in non-taxable income, reduction of personal income tax and state social security contribution rates, the rise in social assistance pensions and the introduction of 'pension bonuses' will boost household disposable income. Nevertheless, greater residents' involvement in the second pillar pension accumulation system is expected to put a dampening effect on its growth.

Given the economic cycle, the amendments are considered to reflect a pro-cyclical fiscal policy. Pro-cyclical fiscal policy implies that instead of putting aside revenue received during an economic upswing the government assumes additional liabilities to finance certain areas. The nature of fiscal policy can be judged from the change in the primary structural general government balance and the sign of the output gap.[5] As can be seen in Table A, in its Stability Programme for 2018, the Government of the Republic of Lithuania planned to take up a neutral fiscal policy stance in 2019. However, considering the impact of the adopted amendments, in 2019 Lithuania's fiscal policy is likely to become pro-cyclical.

Table A. General government primary structural balance and the output gap in 2017-2021

Indicator	2017	2018 projection	2019 projection
General government primary structural balance, % of GDP (SP 2018)	0.7	0.6	0.7
Change in the general government primary structural balance, % (SP 2018)	-0.6	-0.1	0.0
General government primary structural balance, % of GDP (after the reform)	0.7	0.6	0.0
Change in the general government primary structural balance, % (SP 2018)	-0.6	-0.1	-0.6
Output gap, %	2.3	2.4	1.8

Sources: Stability Programme for 2018 and Bank of Lithuania calculations.

The approved amendments are not neutral in fiscal terms as they will cause the general government balance to deteriorate by 0.6%, 0.5% and 0.1% of GDP in each year during the projection horizon (2019-2021). The adopted amendments will reduce the state and municipal budget balances and improve the balance of the State Social Insurance Fund; however, the overall general government balance will deteriorate. The decrease in the general government budget (roughly €170-190 million each year) will stem from the increase of non-taxable income and the extension of its scope as well as the future rise in government spending given that the principal part of pensions will be financed with state budget funds.

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[1] Consolidated version of the Republic of Lithuania Law on Personal Income Tax, which will come into force in 2019 (https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/TAIS.171369/sNkIPPXsQP).

[2] Law on the Amendment of Articles 2, 4, 7, 8, 10, 23, 25 and 32 of the Republic of Lithuania Law on State Social Insurance No I-1336 (https://www.e-tar.lt/portal/lt/legalAct/c55830907c4c11e8ae2bfd1913d66d57).

[3] Law on the Amendment of the Republic of Lithuania Law on the Accumulation of Pensions No IX-1691 https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/028b05207b9c11e89188e16a6495e98c?positionInSearchResults=0&searchModelUUID=c0dd9464-97a0-4504-b866-61e44448e723).

[4] Bank of Lithuania presents position regarding tax and pension system reform, Bank of Lithuania Press Release, 18 April 2018 (https://www.lb.lt/en/news/bank-of-lithuania-presents-position-regarding-tax-and-pension-system-reform).

[5] If during a certain year the output gap and the change in the primary structural general government balance are positive, the fiscal policy implemented that year is considered to be countercyclical tightening; if the output gap and the change in the primary structural general government balance are negative, the fiscal policy is considered to be countercyclical easing; if the output gap is positive and the change in the primary structural general government balance is negative, the fiscal policy is considered to be pro-cyclical easing; if the output gap is negative and the change in the primary structural general government balance is positive, the fiscal policy is considered to be pro-cyclical tightening.