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Toward A Sustainable and Inclusive Consolidation in Lithuania: Past Experience and What is Needed Going Forward

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**Toward A Sustainable and Inclusive Consolidation in Lithuania:
Past Experience and What is Needed Going Forward**

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Abstract

This paper reviews Lithuania's fiscal consolidation since 2009, assesses the contribution of
revenue and expenditure to the consolidation, evaluates the quality of measures, and draws
lessons for the future. It finds that, despite having the lowest revenue-to-GDP ratio in the EU,
Lithuania's fiscal adjustment has so far relied mainly on expenditure measures, with the quality
of measures deteriorating over time. The analysis also suggests that Lithuania's tax system, in
comparison with other EU countries and regional peers, is skewed toward labor and consumption
taxes, and plays a more limited role in income redistribution, especially in the upper income
brackets. The paper argues therefore that there is ample scope to implement high quality revenue
measures in order to complete the fiscal adjustment in the medium term in a sustainable and
inclusive manner.

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I. INTRODUCTION

Lithuania has undertaken significant fiscal adjustment to date. It implemented fiscal measures amounting to some 17 percent of GDP during 2009–12, about half of which were frontloaded in 2009.[2] This has brought the fiscal deficit down from a peak of 9.4 percent of GDP in 2009 to an estimated 3.2 percent of GDP in 2012. The country's public debt is estimated at around 40.7 percent of GDP as of end-2012, up from 15.5 percent of GDP at the end of 2008.

To fully rebuild fiscal buffers, further fiscal adjustment is needed. As a small open economy, Lithuania remains vulnerable to external shocks. In the context of its currency board arrangement (CBA), countercyclical fiscal policy is the main policy tool available to help manage the economic cycle. Rebuilding fiscal buffers (i.e., reducing the deficit and public debt) will allow Lithuania to effectively use countercyclical fiscal policy in future economic downtowns. In addition, fiscal space is needed to address medium- and long-term pressures on public finances from population aging, which are expected to add 6 percent of GDP to public expenditures by 2060. This is much larger than the estimated costs for Latvia (3 percent) and Estonia (0 percent).[3] For these reasons, structural fiscal deficits and public debt need to be further reduced.[4] Staff estimates that further fiscal adjustments of about 2 percent of GDP are needed to complete the adjustment and meet the authorities' medium-term objective of a small structural deficit.

The purpose of this paper is to set out options for completing the fiscal adjustment. We do so by quantifying the composition of measures so far, comparing Lithuania's revenues and expenditures with regional peers and other EU countries. We also review the relative role of expenditures and revenues in reducing income inequality. The analysis shows that Lithuania's fiscal adjustment so far has mainly relied on expenditure measures, with the quality of measures deteriorating over time. More importantly, Lithuania's revenue-to-GDP ratio is low compared with EU peers, in fact the lowest in the EU in 2011. Thus, the paper argues that it is appropriate to shift the focus of future consolidation from expenditure to revenue. Such measures can be designed to limit distortions and enhance progressivity, while providing a stable source of revenue. At the same time, any base-broadening tax reforms can only be effective in terms of revenue generation if supported by a well functioning revenue administration that is able to efficiently collect and administer taxes.

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[2] Large amount of fiscal measures were needed in 2009 to contain the deterioration in the fiscal deficit due to strong procyclicity of revenue (see Box 2 in the (IMF Country Report 11/287) 2011 Article IV Consultation Staff Report for the Republic of Lithuania).

[3] See Figure 9 in Velculescu, D. (2010) "Some Uncomfortable Arithmetic Regarding Europe's Public Finances", *International Monetary Fund, Working Paper*, 10/177.

[4] It is also required by the Stability & Growth Pact and the Fiscal Compact that Lithuania achieves an annual improvement of 0.5 percent of GDP in the structural fiscal balance.

Fair, balanced, and high-quality (permanent) fiscal measures should help ensure the sustainability of the adjustment and enhance the inclusiveness of growth. International experience suggests successful adjustments are characterized by broad-based, high quality, and inclusive measures. Countries such as Canada, Finland, Ireland, and New Zealand eliminated exemptions and expanded tax base towards previously non-taxed sources, to create fiscal space and achieve a relatively equitable tax system. Revenue adjustment programs are most likely needed and can play an important role when a large fiscal adjustment is needed and/or in countries with low initial revenue-to-GDP ratios (Indonesia and Mexico, see IMF (2010d)). Successful and sustainable adjustments have included the introduction of broad-based permanent tax measures and improvements in tax administration, while unsuccessful consolidations where characterized by temporary measures and reliance on narrow tax bases (Tsibouris et al. (2006)). Moreover, for the adjustment to be sustainable and inclusive, all members of society need to share the fair burden of the adjustment. Research at the IMF supports the idea that societies with lower income inequality typically experience more inclusive and sustainable growth.[5]

Figure 1. Composition of Cumulative Fiscal Adjustment after Crisis: Revenue vs. Expenditure - Based
(Excl. temporary measures on transfers to Pillar II pension funds)

Source: IMF staff estimates.
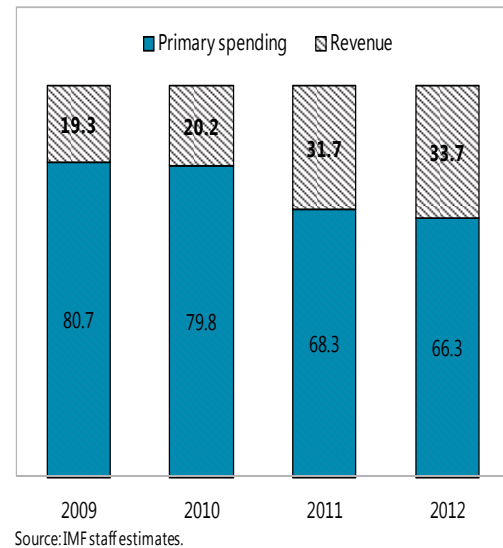
The rest of the paper is organized as follows: Section II reviews and assesses the fiscal consolidation in Lithuania during 2009–12, focusing on the balance and quality of measures. Section III compares key aspects of Lithuania's public sector (such as its size, tax structure, and tax bases) with other EU countries and with regional peers. Section IV assesses the role of Lithuania's taxes and benefits in redistributing income, both over time and compared with other EU countries and regional peers. Based on the findings in Section II, III and IV, Section V suggests directions for further fiscal consolidation in Lithuania. Section VI concludes.

II. THE COMPOSITION OF LITHUANIA'S FISCAL CONSOLIDATION (2009–12)

Lithuania's fiscal adjustment[6] since 2009 has relied mainly on expenditure measures. At the onset of the crisis, a focus on expenditure cuts may indeed have been unavoidable, as there was a need to rapidly respond to the crisis, and expenditure measures could be implemented more rapidly.[7] Moreover, given the high degree of uncertainty around GDP developments, and therefore the development in the tax base, the revenue yield of any additional taxes would

[5] See Berg & Ostry (2011).

have been very difficult to access. However, in the subsequent period (2010–12), the role of revenue measures rose only modestly. Overall, expenditure cuts accounted for around 70 percent of the total adjustment (Figure 1).

While expenditure measures have been broad-based, this was not so for revenue measures.

- Spending cuts were roughly proportional to the size of each spending category in total spending (Figure 2). However, capital spending on projects supported by EU funds was untouched during the consolidation, in order not to forgo external grants.

- On the revenue side, measures focused mainly on indirect taxes and one-off measures, while direct taxes, especially wealth taxes, were virtually untouched (Figure 3). The exceptions were a base broadening of social security contribution (by including self-employed professions that previously did not pay social contributions) and a reduction of the personal income tax (PIT).[8]

Figure 2. Structure of Expenditure-Based Measures in Lithuania (2009-2012)
(Percent of GDP in parentheses)

Subsidies 4 pct. (0.5)
Capital expenditure 13 pct. (1.63)
Across the board cut 9 pct. (1.1)
Social benefits 26 pct. (3.34)
Current expenditure: non-wages 24 pct. (3.04)
Current expenditure: wages 24 pct. (3.02)

Source: Staff estimates.

Figure 3. Structure of Revenue-Based Measures in Lithuania (2009-2012)
(Percent of GDP in parentheses)

SOE dividends: 12 pct. Asset sales: 3 pct. User fees: 1 pct. Other : mainly sales revenue of carbon emission rights : 17 pct.

Tax administration: mainly from indirect taxes 12 pct. (0.5)
Other Revenue 34 pct. (1.44)
Labor tax 12 pct. (0.53)
Indirect tax: excises 20 pct. (0.87)
Indirect tax: VAT 22 pct. (0.92)
Other direct tax: property tax 0 pct. (0.02)

Source: Staff estimates.

The quality of measures deteriorated somewhat over time. Based on the best available information on the duration of effectiveness and the fiscal impact, measures were classified

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[6] The size of fiscal adjustment/consolidation in this paper is measured as the estimated fiscal impact of announced and implemented fiscal consolidation measures.

[7] Also in Lithuania, any change in tax policy needs to be announced six months before implementation by law.

[8] Around 0.8 percent of GDP in the revenue increase from labor tax measures came from temporary reduction in the rate of social contribution transfers to Pillar II private pension funds from 5.5 percent to 3 percent in 2009, further to 2 percent and 1.5 percent in 2010 and 2012, respectively.

into permanent, semi-permanent, temporary, and deficit-postponing measures.[9] Such an analysis suggests that less than one third of the measures undertaken since 2009 were permanent and about one fifth merely postponed deficits into the future (Figure 4).

In sum, Lithuania's fiscal adjustment so far has mainly relied on expenditure measures, with the quality of measures deteriorating over time. International experience suggests successful and sustainable adjustments are characterized by broad-based, high quality, and inclusive measures, especially when a large fiscal adjustment is needed. Expenditure cuts have been broad-based across the spending spectrum, but this has not been the case for revenue measures. Moreover, the quality of measures has deteriorated over time. This suggests that there is scope to make the adjustment more sustainable and inclusive.

Figure 4. Composition of Fiscal Adjustment since 2009: Permanent vs Temporary 1/
(newly introduced measures in each year, in percent of GDP)
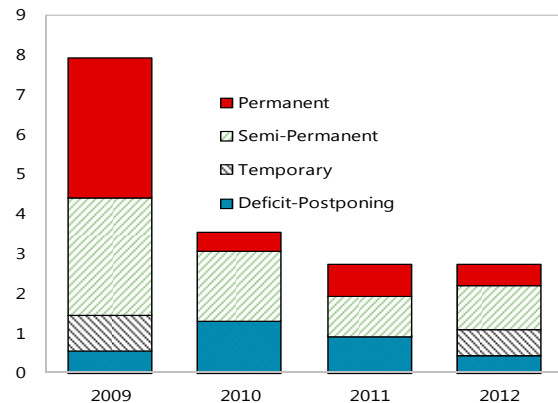
Sources: Authorites data and Staff analysis and estimates.
1/ Temporary measures are reversed in next year's budget. Semi-permanent measures have an explicit expiry date or are temporary measures that are repeatedly extended. Deficit postponing measures imply a future cost to the budget beyond their temporary nature.

III. Lithuania's Fiscal Experience: A Cross-Country Perspective

Lithuania's reliance on expenditure measures is similar to that of other countries that have undertaken large fiscal adjustments, despite its much smaller public sector.

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[9] Specifically, a measure is deemed to be permanent if there is no announced ending date for its effectiveness. A measure is considered to be temporary if it is only designated to one year's budget and does not affect future deficits. Measures are classified as semi-permanent if they were announced for more than one year but with an end date, or if they were announced as temporary measures but were extended or re-introduced thereafter. Semi-permanent measures do not shift the current deficit into the future. Deficit-postponing measures are those measures which shift the current deficit into future years, such as measures that use revenue earmarked for future spending to reduce the current deficit.

- The share of expenditure measures in Lithuania's total fiscal adjustment is broadly comparable to the average of eight other European countries which also experienced large fiscal adjustment since 2008 (Figure 5).

- However, most other countries in the sample have much larger public sectors than Lithuania, as measured by their expenditure-to-GDP ratios (Figure 5). Thus, these countries likely had greater scope for expenditure cuts.

Figure 5. Intensity of Expenditure-based Adjustment vs. Size of Public Sector, average 2009-12 1/
(Percent)

$y = 0.4974x + 43.095$
$R^2 = 0.1298$

Expenditure adjustment as ratio of total adjustment

Lithuania

Expenditure-to-GDP ratio
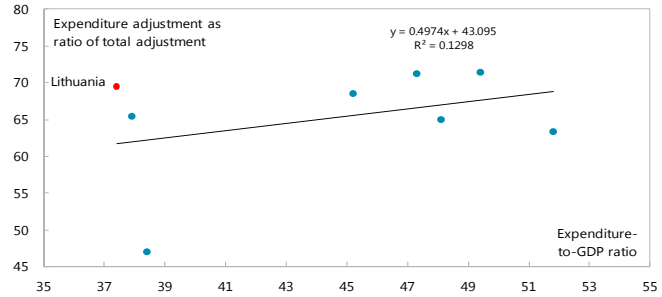
Sources: April 2012 Fiscal Monitor; and IMF staff calculations.
1/ Eight European Countries (Iceland, Ireland, Greece, Latvia, Lithuania, Portugal, Romania and Spain) which went through large fiscal adjustments after the 2008/09 crisis are included in the chart.

Lithuania's public sector has become one of the smallest in the EU. Partly as a result of the large expenditure cuts during the fiscal adjustment, Lithuania had the lowest revenue-to-GDP and one of the lowest expenditure-to-GDP ratios in the EU in 2011(Figures 6 & 7). Even though Lithuania's general government sector has traditionally been relatively small, it was not the smallest in the EU in 2008.

Figure 6. Size of Public Sector, 2011
(General government revenue as percent of GDP)
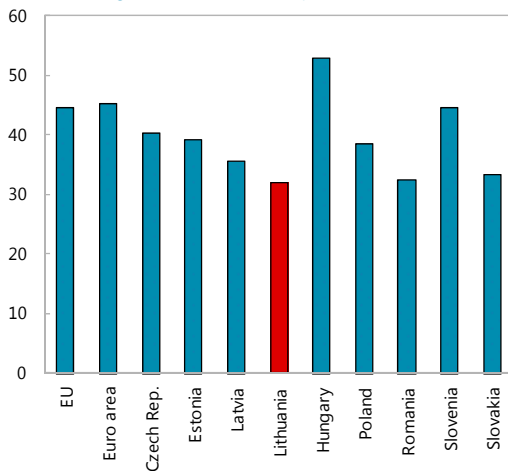
Sources: Eurostat, and IMF staff estimates.

Figure 7. Size of Public Sector, 2011
(General government expenditure as percent of GDP)
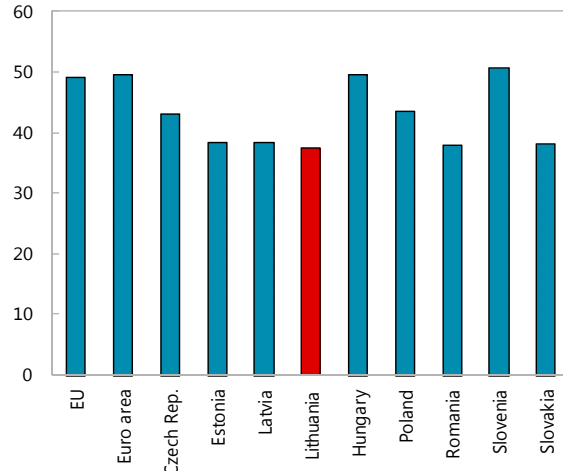
Sources: Eurostat, and IMF staff estimates.

Lithuania's overall tax burden (in percent of GDP) is lower than both the EU average and regional peers (Table 1). At around 27 percent of GDP, Lithuania's overall tax burden is 11 percentage points of GDP lower than the EU average, and 5 percentage points of GDP lower than in the CEE peers.

- Half of the difference in the overall tax burden can be explained by lower capital and wealth taxation, which average 7.8 and 2.5 percent of GDP, respectively, in the EU and 4.7 and 1.2 percent of GDP, respectively, in the CEE peers, but only 2.3 and 0.7 percent of GDP, respectively, in Lithuania.

Table 1. Level of Taxation in Europe (2010)
(Percent of GDP)

	Euro area	European Union	CEE 1/	Lithuania
Taxes on capital	7.6	7.8	4.7	2.3
Corporations	2.3	2.4	2.0	1
Households	0.7	0.8	0.3	0.2
Self-employed	2.2	2	1.3	0.5
Stock of capital (wealth)	2.3	2.5	1.2	0.7
Taxes on consumption	10.7	11	12.1	11.5
Taxes on labor	20.8	19.6	15.4	13.4
Employed paid by employers	8.9	8	8.0	7.7
Employed paid by employees	10.2	10.1	6.8	5.5
Non-employed	1.7	1.5	0.6	0.3
Total taxes	39.1	38.4	32.2	27.2

Source: Eurostat.
1/ CEE includes Czech Republic, Estonia, Hungary, Latvia, Poland and Slovakia.

- o Lithuania's low revenue from wealth taxes reflects limited taxation of residential property and non-taxation of motor vehicles. The former is only taxed at values exceeding LTL one million (about euro 300,000), while motor vehicles and net wealth are not taxed at all.[10] Capital transfers, capital gains, and corporate profits benefit from various exemptions, which lower the effective taxation of capital.

- o International experience suggests that revenue from property taxes were on the rise over the last several decades in OECD countries as well as in transition economies (Table 2). By contrast, Lithuania collected only 0.37 percent of GDP in property and land taxes in 2010, whereas countries at Lithuania's income level generally collect about ¾ percent of GDP in property taxes.[11]

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[10] Motor vehicle taxation is a common tax in other EU countries.

[11] Lithuania introduced property taxation on residential properties starting in 2012, but only residential properties with a value of over one million litas are taxed at a rate of one percent. The revenue from residential property tax in 2012 is estimated to have been about 0.02 percent of GDP.

Table 2. International Comparisons: Importance of Property Taxes' Revenue

(Percent of GDP)

	1970s	1980s	1990s	2000s
OECD countries	1.24	1.31	1.44	2.12
(number of countries)	16	18	16	18
Developing countries	0.42	0.36	0.42	0.60
(number of countries)	20	27	23	29
Transition countries	0.34	0.59	0.54	0.68
(number of countries)	1	4	20	18
All countries	0.77	0.73	0.75	1.04
(number of countries)	37	49	59	65
Lithuania (Property and Land Taxes' Revenue in 2010)				0.37

Source: Bahl, R. and Martinez-Vazquez, J. (2008). "The Property Tax in Developing Countries: Current Practice and Prospects" in Making the Property Tax Work: Experiences in Developing and Transitional Countries, ed. by Roy Bahl, Jorge Martinez-Vazquez and Joan Youngman. (Cambridge: Lincoln Institute of Land Policy).

- The other half of the difference in the overall tax burden comes from divergences in the burden of direct taxes on labor. In the EU and CEE countries, this amounts to 19.6 and 15.4 percent of GDP on average, respectively, while this only accounts for 13.4 percent of GDP in Lithuania. This largely reflects Lithuania's low and flat PIT tax rate (15 percent). It may also be a result of Lithuania's lower labor share of income compared to the EU average, which could be due to high outward migration post-EU accession or a large shadow economy.

- Consumption taxes, while comparable to the EU average, are somewhat below regional peers with similar per capita income levels. This likely reflects the impact of preferential rates and exemptions, and more importantly, low VAT productivity in Lithuania. The latter is a result of which is driven by tax administration weaknesses and a high compliance costs (estimated at 2 percent of GDP).[12] Closing half of the VAT compliance gap would yield up to ¾ percent of GDP over the medium term. Meanwhile smuggling and cross-border shopping have contributed to lower-than-expected excise revenue.

Lithuania also has relatively low implicit and statutory tax rates, when compared with those of its EU comparators and regional peers (Table 3). The implicit tax rate captures the proportion of the total potential taxable base that is successfully taxed. In 2010, the implicit tax rate on corporate income in Lithuania was 4.9, far below the statutory rate of 15 percent. The same applies to labor and consumption taxes: the implicit rates of 31.7 and 18.2 are well below the

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[12] See Box 4 in the (IMF Country Report 10/201) 2010 Article IV Consultation Staff Report for the Republic of Lithuania.

statutory rates of 55 percent and 21 percent, respectively. Moreover, in terms of the productivity of taxes (proxied by the ratio of implicit tax rates to statutory rates), Lithuania is below the averages of both the EU and regional peers for all three tax subcategories (corporate income tax, consumption and labor tax). Some of the gap between the statutory and implicit tax rates in Lithuania could be explained by generous allowances, exemptions, and preferential rates as well as loopholes and compliance gaps.

Table 3. Implicit vs. Statutory Tax Rates in Europe (2010) 1/

	Euro area	European Union	CEE 2/	Lithuania
Implicit tax rates				
Capital	27.5	...	14.5	6.8
Capital and business income	21.6	...	12.0	3.7
Corporations	18.8	...	10.6	4.9
Households and self-employed	14.9	...	7.5	3.7
Consumption	19.2	19.7	21.5	18.2
Labor	38.1	36.0	35.0	31.7
Statutory tax rates 3/				
Capital	...	...	...	...
Capital and business income	...	...	...	...
Corporations	25.3	23.1	18.7	15.0
Households and self-employed	...	...	...	...
Consumption	19.5	20.4	21.6	21.0
Labor	56.9	57.1	57.1	55.0
Implicit tax rates as ratio of statutory tax rates				
Capital	...	...	...	...
Capital and business income	...	...	...	...
Corporations	0.74	...	0.56	0.33
Households and self-employed	...	...	...	...
Consumption 4/	0.98	0.97	1.00	0.87
Labor	0.67	0.63	0.61	0.58

Sources: Eurostat, IMF Fiscal Affairs Department dataset.

1/ Defined as the ratio of total tax revenues to a proxy of the potential tax base (Eurostat calculations).

2/ CEE includes Czech Republic, Estonia, Hungary, Latvia, Poland, and Slovakia.

3/ Unweighted average of standard rates.

4/ The ratio of implicit tax rate to statutory tax rate for consumption tax may be overstated. This is because the implicit tax rates (from Eurostat) are for all kinds of consumption taxes, including VAT, excises tax and others, while the statutory tax rates we used here are only the VAT rates, and exclude the much higher excise tax rates, and therefore may be understated.

Lithuania's tax effort is also low compared with its CEE regional peers (Figures 8). Tax effort is the ratio between actual revenue and the tax capacity, the latter of which represents the maximum tax revenue that a country can collect given its economic, social, institutional and demographic characteristics (see Pessino & Fenochietto (2010)). The difference between tax capacity and actual tax revenue can be interpreted as unused tax, which may be caused by two

factors: country's preferences of low provision of public goods and serv ices, so the low tax revenue is chosen intentionally, and inefficiency of governments in tax collection. At 60.8 in 2011, Lithuania's tax effort is well below the average of 77.1 for its CEE peers, and hence there is relatively large potential for Lithuania to increase tax revenue to its full capacity.

Figure 8. Tax Effort in CEE Countries, 2011 1/
(Percent)
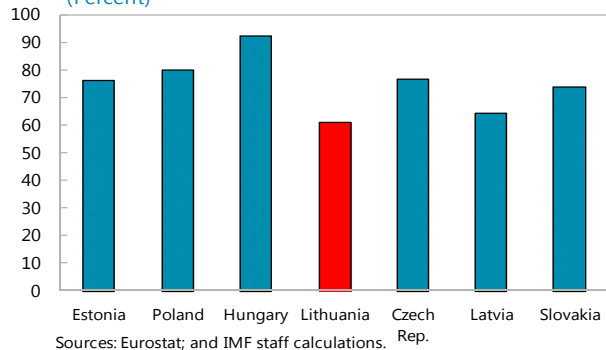
Sources: Eurostat; and IMF staff calculations.
1/ Tax effort is defined as the ratio between actual revenue and tax capacity. Tax capacity is from Pessino & Fenochietto (2010), estimated as a function of variables determining tax-to-GDP potential using panel data of 96 countries .

Lithuania's tax structure remains heavily concentrated on labor and consumption taxes, with very little taxation on capital and near-zero wealth taxes (Figures 9 & 10)**.** Compared to the EU average, Lithuania's share of consumption taxes in total tax revenue is very high (42 percent in Lithuania, vs. 29 percent in the EU), and that of capital and wealth low (9 percent in Lithuania, vs. 20 percent in the EU). Its share of taxes on labor income is close to the EU average (49 percent in Lithuania vs. 51 percent in the EU), but this is relative to a much lower overall tax base in Lithuania.

Figure 9. Average Tax Structure in EU Countries
(Percent, 2010)

Source: Eurostat.
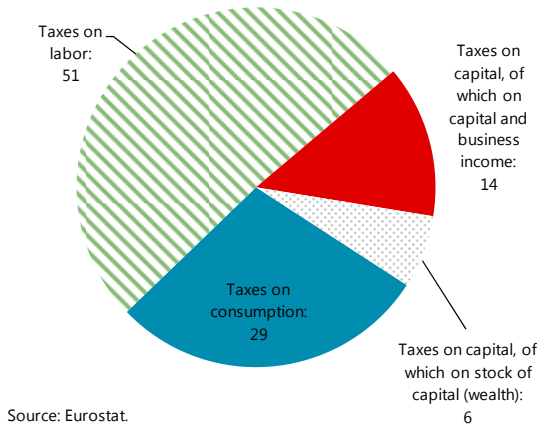
Figure 10. Tax Structure in Lithuania
(Percent, 2010)

Source: Eurostat.
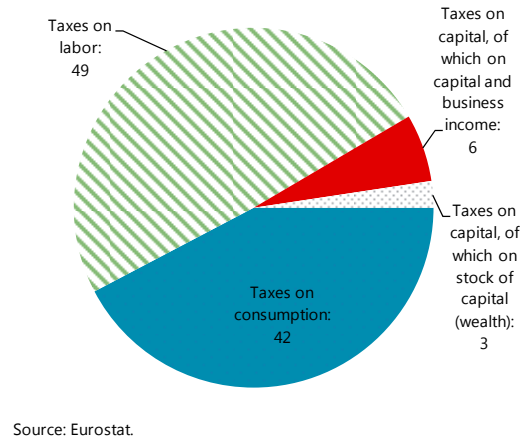
IV. THE ROLE OF TAXES AND EXPENDITURES IN INCOME REDISTRIBUTION:
A COMPARISON ACROSS COUNTRIES AND OVER TIME

Lithuania's tax system exhibits relatively limited progressivity, especially toward the high end
of the income distribution. Lithuania
relies largely on taxes on labor and
consumption, which exhibit limited or
no progressivity for higher incomes,
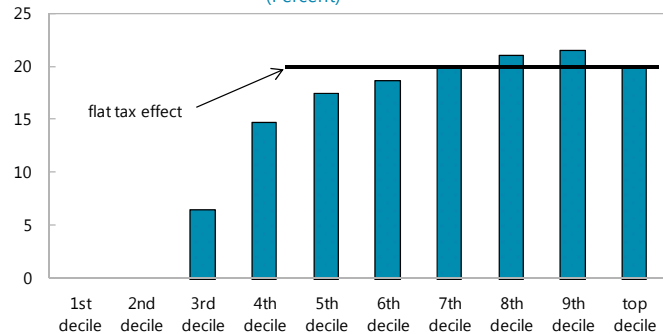and the limited taxation of wealth
reinforces this trend (Figure 11).
While the PIT is generally considered
key to the pursuit of equity in the tax
system (IMF (2010d)), PIT in
Lithuania does not feature any strong
progressivity beyond the lowest
income deciles. This reflects tax
exempt thresholds for low income

Figure 11. Average Effective Rate of Income Tax and SSC by Income Decile of All Lithuanian Households
(Percent)

Sources: Income and Living Conditions Survey (2010); and IMF staff estimates.

earners and the uniform flat tax for all others, together with its multiple allowances and
exemptions that favor high income taxpayers, such as non-taxation of interest income and
certain capital gains. Similarly, social security contributions are calculated as a uniform
uncapped proportion of the wage.[13] In addition, consumption taxes by design also exhibit
limited progressivity, as lower income households typically have a higher propensity to
consume.[14] The limited role of wealth and capital taxation further reinforces the trend of an
overall tax system with limited progressivity.

Lithuania's social benefits system (the expenditure side) has done a fairly good job in
protecting the most vulnerable groups from the effects of the crisis. As a result of the crisis,
the at-risk-of-poverty rate before social transfers increased, but the at-risk-of-poverty rate after
social transfers remained broadly at pre-crisis levels (Figure 12). This suggests that the social
transfer system has managed to protect those households that are the most vulnerable to
income losses. Yet, Lithuania's at-risk-of-poverty rate after social transfers remains above that
of most other regional peers (Figure 13).

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[13] It is important to note that Lithuania's social security contributions are not capped while benefits are capped,
thus imparting progressivity to the overall security system. At the same time, this also reportedly created
compliance problems of under-reporting wages to avoid social security contribution, especially for high-income
earners.

[14] While different brackets are common in the EU countries, this is not desirable, as the main purpose of indirect
taxes is to efficiently raise revenues (which can be greatly helped by having a uniform rate and simple structure).

Figure 12. Lithuania: At-Risk-of-Poverty Rate 1/
(Percent)
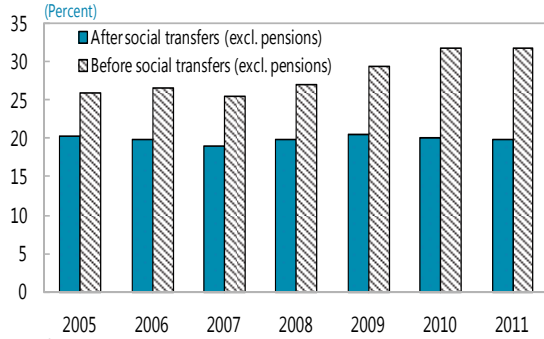
Source: Eurostat.
1/ The at-risk-of-poverty rate is the share of people with an equivalised disposable income (after social transfer) below the at-risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income after social transfers.

Figure 13. Role of Public Transfers in Reducing At-risk-of-poverty Rate, 2011
(Percent)
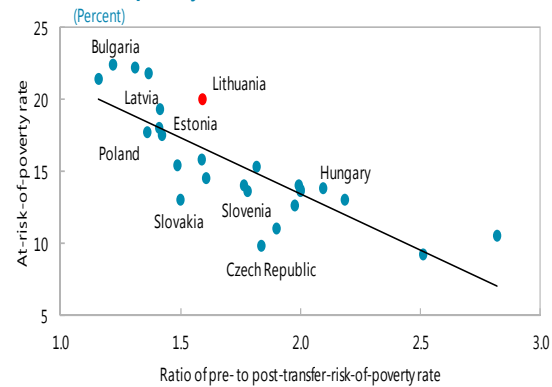
Sources: Eurostat and IMF staff calculations.

Compared with social benefits, Lithuania's tax system plays a relatively limited role in overall income redistribution, especially of late (Figures 14 & 15). To evaluate the relative role of taxes and benefits in reducing overall income inequality, the pre- and post-benefits and pre- and post-taxes Gini coefficients are calculated.[15] While social benefits helped reduce the Gini coefficient by about 50 percent in 2010, the tax system reduced the Gini coefficient by only 8 percent. Also of note is that the relative redistributive role of taxes has declined since 2006. This could be due to a deterioration in tax compliance after the crisis and/or an expansion of the informal economy.

Figure 14. Role of Taxes in Reducing Inequality, 2006
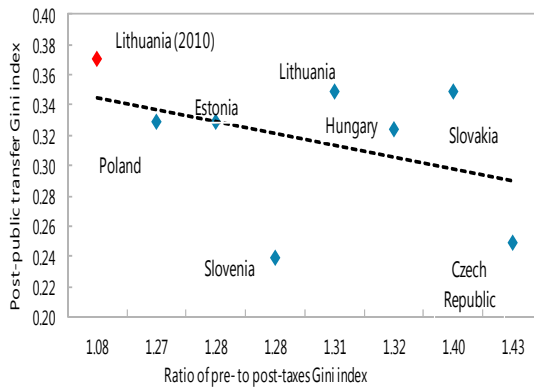
Sources: Staff calculations based on data from Lithuania 2010 Survey of Income and Living Conditions and Zaidi (2008), "Main Drivers of Income Inequality in EU8 Countries: Some Insights from Recent Household Survey Data".

Figure 15. Role of Social Benefits in Reducing Inequality, 2006
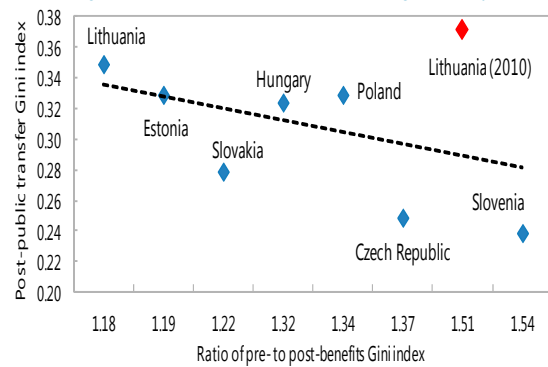
Sources: Staff calculations based on data from Lithuania 2010 Survey of Income and Living Conditions and Zaidi (2008), "Main Drivers of Income Inequality in EU8 Countries: Some Insights from Recent Household Survey Data".

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[15] Gini coefficients are calculated based on household equivalized income data. In calculating the equivalized household size, the first member of the household is given a weight of 1; each subsequent adult a weight of 0.5; and each child under 14 a weight of 0.3. After combining the weights of all household members, the equivalent household size is obtained.

Partly as a result of these factors, overall inequality in Lithuania was the highest in the EU in
2010 (Figure 16). The Gini coefficient after
social transfers (both taxes & benefits) in
Lithuania also remains among the highest
in the EU.

Figure 16. Gini Coefficient, 2010

Source: Eurostat.
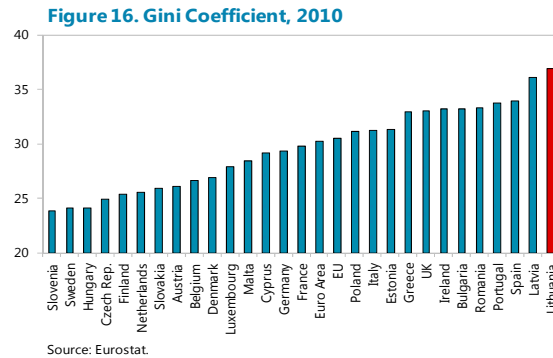
V. SUSTAINABLE AND INCLUSIVE FISCAL CONSOLIDATION GOING FORWARD—
SOME CONSIDERATIONS

Based on the analysis above, Lithuania should shift the focus of future consolidation to the
revenue side. This is because: (i) most of the consolidation so far has taken place on the
expenditure side; (ii) Lithuania's revenue-to-GDP ratio and level of taxation are low
compared to the EU average and regional peers; and (iii) Lithuania's tax system exhibits
relatively limited progressivity, especially toward the high end of the income distribution.
High quality revenue measures can be designed to help ensure a more balanced sharing of the
tax burden across all income groups. International experience suggests that such measures can
be an important part of the fiscal adjustment. Countries such as Canada, Finland, Ireland, and
New Zealand eliminated exemptions and expanded tax bases (particularly by taxing
previously non-taxed sources of revenue) to help create fiscal space and promote sustainable
and inclusive growth.[16]

Lithuania has ample scope to implement high quality revenue measures with a view to
achieving a sustainable and inclusive consolidation going forward:

- Expanding some wealth taxes can raise additional revenue. Certain wealth taxes such as
  recurrent property taxes have the benefit of bringing a source of stable and less
  distortionary revenue, while also helping to increase the progressivity of the tax system,
  especially toward the higher end of the income distribution. Research by both the OECD
  and the IMF finds that wealth taxes are the least distortionary and harmful to growth
  compared to other taxes.[17] As a percent of GDP, wealth taxes in Lithuania are only about

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[16] See Tsibouris et al. (2006).

[17] See OECD (2010), Tax Policy Reform and Economic Growth, Tax Policy Study No 20, IMF (2010d), and
IMF forthcoming working paper by Norregaard (2013), "Taxing Immovable Property: Revenue Potential and
Implementation Challenges".

one quarter of the EU average and one half of the CEE regional average. Raising wealth taxation to the CEE average could generate 0.8 percentage points of GDP in additional revenue. Concrete options include:

- o Expanding immovable property taxation to include all residential properties could generate about 0.4 percent of GDP in additional revenue. Given the distribution of housing valuations in Lithuania, generating such a yield would require a low-rate tax imposed on a broad base. IMF staff calculations suggest that broadening the residential property tax base by lowering the tax-free threshold could double revenue from property taxation.

- o Introducing annual motor vehicle taxes (license/registration fee) could be imposed in relation to engine capacity (or weight) in line with international practice. IMF staff estimates suggest that an annual motor vehicle tax at standard international rates could generate about 0.4 percent of GDP in revenue. This tax has the added benefit of being environmentally friendly.

- Broadening tax bases by removing exemptions and closing loopholes can help boost revenue without changing statutory rates.

- o Broadening the PIT base by eliminating tax exemptions on interest income could generate 0.1 percent of GDP in revenue. Restricting the exemption from the capital gains tax on housing to only the sale of primary residences and subjecting all short-term gains on financial assets to a withholding tax at a rate of 15 percent can also help generate additional revenue. With respect to pensions, Lithuania is one of the few countries in the world that has a so-called "EEE-based" pension and annuity regime, which means pensions are not taxed at the time of contribution, accumulation, or payout. Subjecting all pension payments to income tax could generate about 0.5 percent of GDP in revenue.

- o Broadening the CIT base could generate additional revenue of about 0.5 percent of GDP. Specific measures include: (i) consolidating reduced/preferential CIT rates on small companies[18]; (ii) expanding the CIT to include realized gains on security transactions; and (iii) removing CIT exemptions/preferential rates on investment incentives[19] and tax holiday schemes in free economic zones.

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[18] At present, a 5 percent rate (instead of 15 percent statutory rate), is applied to small companies, which are defined as companies with: (i) less than 10 employees, or (ii) generating less than LTL 1 million in taxable revenue during tax period. The reduced rate was much higher (13 percent) before 2010 and could be restored to generate additional revenues.

[19] Lithuania offers generous allowances, exemptions and preferential rates to various investment incentives, including R&D incentive, incentive for substantial investments and incentive for SEZ companies.

It is essential to continue strengthening tax administration. This will help ensure that any changes in taxation ultimately bear fruit in terms of revenue generation and boost tax compliance more broadly. There is anecdotal evidence of a large and pro-cyclical shadow economy in Lithuania. Strengthening tax compliance would help maximize the gains from revenue-raising tax reforms.

VI. CONCLUSIONS

Lithuania has undertaken significant fiscal adjustment to date, but further efforts are needed to complete the adjustment. Most of the consolidation so far has taken place on the expenditure side and as a result, Lithuania's revenue-to-GDP ratio is the lowest in the EU. Lithuania's tax system relies heavily on labor and consumption taxes, with very little taxation on capital and wealth. Staff estimates suggest that the tax system plays a limited role in income redistribution, especially toward the higher-end of the income distribution.

It is appropriate to shift the focus of future consolidation from expenditure to high quality revenue measures. These measures can generate considerable and relatively-stable revenue and at the same time enhance progressivity at the higher end of the income distribution. Comparisons of Lithuania's public sector both within the EU and with regional peers suggest that significant revenue can be raised through expanding recurrent property taxes and broadening PIT and CIT base by tightening of exemptions and closing of loopholes. Given the ample scope to enhance revenue performance for Lithuania to be in line with regional peers, the impact of revenue measures on growth and competitiveness would be minimized. At the same time, it is essential to continue strengthening tax administration, both to ensure that any changes in taxation ultimately bear fruit in terms of revenue generation and to help boost tax compliance more broadly.

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