

# Reforming benefits in Lithuania to generate a double dividend: Making work pay while better protecting the jobless

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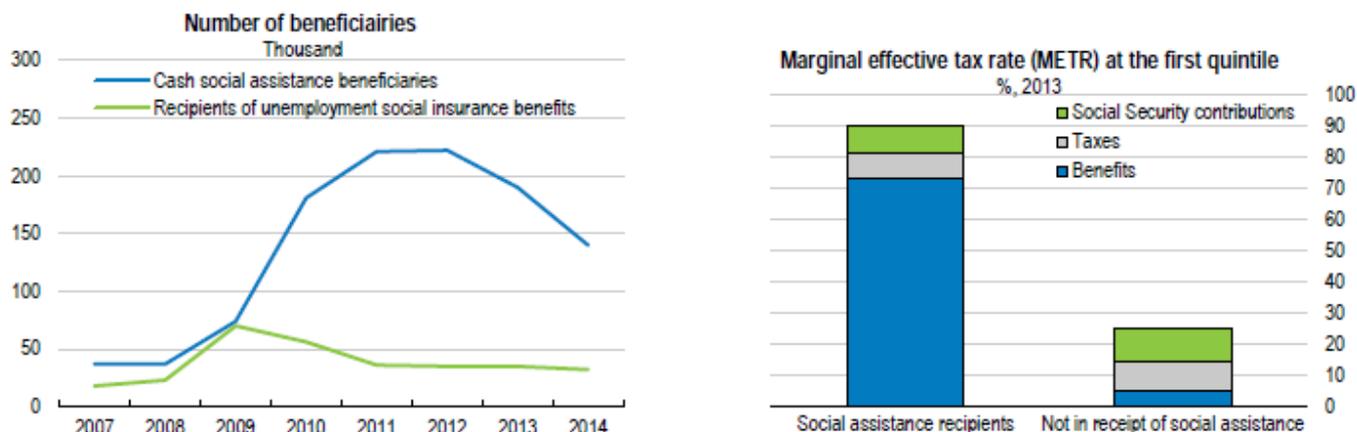
Inequality measures in Lithuania (like in Estonia and Latvia) are high. To an important extent this is related to the high risk of poverty for non-working individuals and to the low rewards to work. Therefore, increasing the quality of jobs, ensuring that the most vulnerable have access to employment and providing adequate income support for those that have lost their job are key for making labour markets and the economy more inclusive. Lithuania provides an interesting example on how to reform out-of-work benefits to reconcile three major objectives i) providing adequate support for living, ii) improving labour market matching by allowing job seekers to devote enough resources to job search iii) maintaining financial incentives to search for a job and accept a vacancy.

In Lithuania less than 20% of unemployed are covered by the unemployment benefit system and the replacement rate is comparatively low. Social assistance benefits have been in practice the main income buffer in the case of job loss: the number of recipients increased from 1% of the total population before the crisis to around 7% at its peak (Panel A).

However, the social assistance system provides also only a very low level of income replacement (at maximum half the poverty line for single individuals) and insufficient

incentives to work due to complete and immediate benefit withdrawal in case of accepting a formal job for the large majority of social assistance recipients. As a result of restrictive and low out-of-work benefits, losing a job goes often hand-in-hand with high risks of poverty, generating an inactivity trap and skills mismatch.

A. Recipients of social assistance benefits and potential impact of an earning disregards equivalent to 30% of net earning

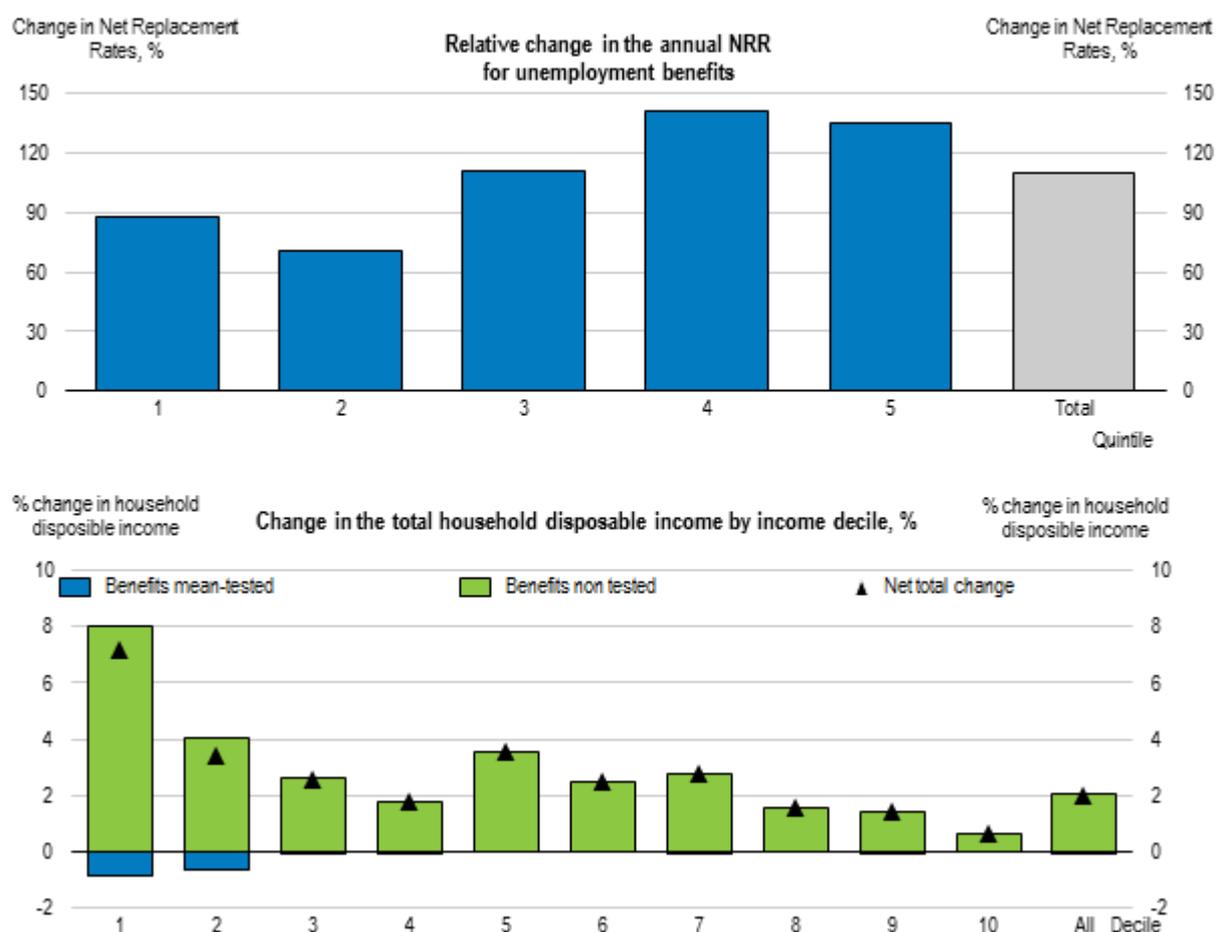


In line with OECD countries experience (Immervoll and Pearson, 2009), providing in-work benefits could strike a balance between labour market inclusiveness and maintaining incentives to work. Recent studies on Lithuania show that effective marginal taxation related to benefits withdrawal reaches almost 75% of additional income for low paid jobs (Panel A). The current in-work benefit scheme reduces effective taxes and increases work incentives by adding up to 25% of total income for those eligible with the lowest earnings. However, the macro effect on poverty remains limited due to the narrow population covered by the current system (2% of social assistance recipients) because high informality requires strict eligibility.

Against that background, reforming unemployment benefits might generate a double dividend: it would improve the functioning of the labour market by providing adequate support for job search and would reduce incentives for informal wage payments. Our simulations show that modifying the unemployment benefit

system in line with the government's proposed reforms under the "New Social Model" would roughly double the level of the average annual replacement rate and would increase the number of benefit recipients by 13%. The reform would be associated with a large increase in the disposable income of those at the bottom of the income distribution and a large increase in the replacement rate at the upper part of the income distribution, as the level of the benefit ceiling is increased (Panel B).

**B. Changes in disposable income and replacement rate following the reform of unemployment benefits in line with the "New Social Model"**



**Source: Navicke J., Avram S. and Demmou L., (2016)**

This stronger link established with previous earnings would allow in a second step strengthening in-work benefits system by reducing incentives for underreporting wages.

**Find out more:**

Immervoll, H. and M. Pearson (2009), A good time for making

work pay? Tacking stock of in-work benefits and related measures across the OECD, *OECD DELSA working paper n.81*

OECD (2016), Economic Survey: Economic Assessment of Lithuania 2016, OECD Publishing

OECD (2015), Investing in Youth :Lithuania, OECD Publishing

Navicke J., Avram S. and Demmou L., (2016), The effects of Reform Scenarios for Benefits Systems on Work Incentives and Poverty in Lithuania, *OECD Economics Department working paper forthcoming*