Vitas Vasiliauskas: Income inequality in Lithuania

Speech by Mr Vitas Vasiliauskas, Governor of the Bank of Lithuania, at the first Lithuanian Economy Conference, organised by the Bank of Lithuania, Vilnius, 5 October 2017.

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Good morning, dear colleagues and guests,

Welcome to Vilnius, everyone. And – special thanks to our distinguished speakers for joining us at this very special (for us) event – the first Lithuanian Economy Conference organised by the Bank of Lithuania.

Colleagues, I am saying "the first", as we intend to organise such conferences annually. The reason for organising such conferences and their direct purpose is not only to share insights, hold interesting discussions, but also formulate or at least contribute to the formulation of constructive proposals on economic policy.

This is what I also expect from today's meeting on income inequality.

Yes, I admit – the expectation is ambitious. Merely because the issue of inequality is one of those perennial issues, which have been widely discussed during all times, in all parts of the world and in numerous various formats. It seems that not much may be added in the wake of Plato, Marx, Smith and the eminent contemporary classics.

And yet life shows that this topic is not yet exhausted, the case remains open. Particularly in Lithuania, and at this point in time.

During the period of independence, we have made huge progress towards Western standards of living. We have overcome the 2009 crisis and the post-crisis recession, and we are now once again among the fastest-growing European economies.

This is good news.

At the same time, however, there is different news too.

Eurostat data shows that income inequality in Lithuania is among the highest in the whole European Union.

More than a fifth of our population still lives in poverty.

A large share of those in need are simple, working class people, trying to make ends meet and maintain their families with low (minimum or even lower) wage, also our compatriots who cannot find a job or those in retirement after having worked honestly all their lives.

This is bad news.

However, the worst thing of all is that, while the economy has been expanding, income inequality continues to worsen, and has been worsening at a very fast pace. Let us compare: in 2012, the level of income of the 20 per cent of the most-earning residents was five times higher than that of the 20 per cent of the poorest residents. In 2016, this indicator already exceeded seven times.

In terms of income inequality, external observers often tend to equate Lithuania not with Northern or even Eastern European countries – we are sometimes compared to economically less developed countries. We do not like such "radical" comparisons and try explaining them by referring to the large scale of shadow economy (and thus quite a significant share of income not represented in official statistics) in Lithuania. However, this is neither an attenuating nor aggravating factor behind the situation. Rather vice versa.

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There had long prevailed a belief that economic expansion will, in the long run, mitigate income inequality and that the task of the authorities is to enable rapid economic development, without ensuring a more equal distribution of the gains within the society.

A convenient doctrine. It had long allowed neglecting the issue without taking into account what is obvious: insufficient income limits the possibilities for people in poverty to purchase even the basic goods and services. This not only undermines their well-being but also hampers domestic consumption. In other words – high levels of income inequality prevent stronger and more sustainable economic growth.

On the other hand, income is not merely about economics. Left unaddressed, income inequality takes deep root. Over time, this threatens transforming into inequality of opportunities. I am convinced that this is the most unfair of all the existing forms of inequality. And the most cunning one too, as it gives rise to tensions, disappointment in one's country and, finally, leads to decisions such as emigration. We try to interpret the scope of emigration as well, aiming to explain it by statistical effects, errors, impact of compulsory health insurance (CCI) and other factors. But the facts are undeniable.

Dear guests,

We are aware that Lithuania is not the only country facing growing income inequality. Similar trends are observed (although to different extents) in many developed and developing economies. Nevertheless, this awareness does not comfort.

All the more so that there are states which have managed to successfully cope with the challenge of inequality. For example, at the time when Lithuania witnessed a drastic surge in inequality rates during the post-crisis years, in Sweden it rose only marginally, while in Finland its level even decreased.

So what should and what can we do to become more similar to our near-neighbours rather than the above-mentioned less developed economies?

I am certain that today we will hear various interesting answers – this is what we have gathered here for.

Seizing the opportunity, I will, however, mention a few, in my opinion, critical directions.

The first one is undoubtedly taxes. If we want to reach a real breakthrough in the fight against income inequality, we will have to, or, to be more exact – we must immediately start implementing real changes in the taxation system. The second pillar is reforming the old-age pension system. And the third one – education.

We have already submitted proposals on the restructuring of the first two systems – tax and pension – to the Government, and have presented them to the public. I believe that some of you are already familiar with them.

For others, let me briefly tell you that, in the view of the Bank of Lithuania, the changes to the tax system proposed by the Government this summer, such as easing the tax burden for those with the lowest income, are the right actions in the right direction. However, alone, they will not be sufficient to fundamentally alter the present situation.

That requires a more thorough and far-reaching tax reform. When designing it, we should focus on several elements. Firstly – on reviewing workforce taxation, secondly – on reducing the variety of income tax regimes, and thirdly – on searching for additional sources of revenue. In this regard, expansion of the property tax base could, and should, be considered. The data confirms such needs: budget revenue from income and property taxes in Lithuania accounts for less than a fifth of total tax revenues. In the European Union, this share stands at one-third on average.

The general government revenue-to-GDP ratio in Lithuania also lags significantly behind the EU average. This has an inevitable and, unfortunately, negative impact on the quality of public services. In other words, compared to Western Europe, not enough money is collected into the budget. This results in insufficient funds necessary for adequately funding public services and ensuring their high quality for all citizens of the country – in line with the needs of a developed society.

Now let me refer to the pension system. In our view, in its current form, it not only fails to address the issue of income inequality, but even makes it more acute. Retirement pensions in our country over the last few years have increased at much slower pace than average wages, which has significantly deteriorated the financial situation of many pensioners.

As of next year, indexation of pensions is to come into effect, meaning that pension payments will be linked to the average annual change in the economy-wide wage level. From today's perspective, this is undoubtedly the right solution, which is to be viewed as a precondition for a more consistent and sustainable pension system, dissociated from political cycles.

Or rather – as one of the necessary preconditions. And clearly not sufficient.

After carrying out comprehensive research, we came to the conclusion that changes which (should we commit to implementing them) would increase transparency of the pension system, boost motivation to participate in the social security net and reduce incentives for acting in the shadow, are both necessary and possible. People need clarity. If, on our virtual personal account, we could see how much we would accumulate for our future pension given our official wage "on paper", everyone would think twice before agreeing to take payments "under the table".

This would not cost much and would not require particular expenses or long-term investments. Yet, it would bring us closer to a few of our basic goals. It would improve the situation of SoDra. More importantly – it would enhance the financial situation of each future pensioner. And, most importantly, it would change our understanding of what social security is and whom – the authorities or the insurance policy holder as well – it is necessary for.

One more thing that we need to keep in mind when discussing this reform – we must see the pension system as an integral whole. This implies not making artificial divisions between its elements (pillars).

I mentioned education. I am not going to argue for what is obvious. Income possibilities are directly linked to the possibilities for achieving quality education. Meanwhile, insufficient utilisation of the human capital potential increases the risk of getting stuck in the "average income trap" without having caught up with the wealthier Western economies.

This is why I hope that in our today's discussions on the causes of income inequality and the possible solutions, we will also focus on this, I dare say, essential pillar. We have been hearing about the necessity of reforming the education system nearly as long as we can remember. However, today we really are at the "either–or" point, when we must undertake essential reforms. With these reforms, we must make sure that the bulk of money allocated to the sector is used to ensure high quality education in the whole country rather than just maintaining the existing infrastructure. This is the piece of advice that we constantly receive from various international organisations.

Dear colleagues,

A few days ago, while discussing the latest economic projections, a colleague of ours presented the following facts: labour resources are depleting; the reserves have dried up. Hence, the number of the employed has decreased as well. Projections suggest that it will continue on the downward path. The conclusion was laconic: we have reached the end of the road – Lithuania is shrinking.

I must say that until now the insights of our economists have been rather precise. I hope the latter insight will not come true. To be more exact, I hope that we will finally undertake solutions and, most importantly, actions for it not to be fulfilled. Let me assure you that the Bank of Lithuania is ready to contribute with its expertise.

I am sure that members of the academia, policymakers and representatives of the private sector participating in today's conference will add to this by sharing their knowledge as well. A multi-layer discussion and insights from different perspectives should help us better comprehend the underlying causes of the issue at hand and, hopefully, provide us with effective solutions.

Thank you for your attention. I wish you a meaningful discussion.