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Brussels, 16.11.2016  
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**COMMISSION STAFF WORKING DOCUMENT**

**Analysis of the draft budgetary plans of Lithuania**

*Accompanying the document*

**COMMISSION OPINION**

**on the draft budgetary plan of Lithuania**

{C(2016) 8010 final}

# **COMMISSION STAFF WORKING DOCUMENT**

## **Analysis of the draft budgetary plans of Lithuania**

### *Accompanying the document*

## **COMMISSION OPINION**

### **on the draft budgetary plan of Lithuania**

#### **1. INTRODUCTION**

Lithuania has submitted its no-policy-change Draft Budgetary Plan for 2017 on 17 October 2016 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Given the caretaker nature of the government in place on 17 October 2016, the budgetary projections for 2017 in the DBP reflect projections on unchanged policies and the measures that have been adopted and which are set to come into force from 2017. Lithuania is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission Forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2016 autumn forecast. In particular, it also includes an assessment of the measures underpinning the no-policy-change Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in the spring of 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

#### **2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN**

Lithuania's real GDP grew by 1.8% y-o-y in 2015. The macroeconomic scenario underlying the DBP foresees an uptick to 2.3% real GDP growth in 2016 followed by a further increase to 2.7% in 2017. The scenario assumes that domestic demand will continue to drive growth on the back of robust increase of nominal wages (8.1% in 2016, 7.0% in 2017) combined with continued employment growth (2.1% in 2016, 0.8% in 2017). The inflation is forecast at -

0.7% in 2016, and 2.2% in 2017, reflecting the impact of strong wage growth and waning base effects.

Compared to the scenario underlying the Stability Programme, the growth forecast for 2016 has been revised downwards by 0.2 pps. This revision mainly reflects the slower GDP growth during the first half of 2016 resulting from the weaker than expected investment, which suffered from a slowdown due to the end of the 2007-2013 EU programming period and the slow start of the 2014-2020 funding period. For 2017 the forecast has been revised downwards by 0.5 pps, as the uncertainty related to the outcome of the vote on the United Kingdom's membership of the European Union is expected to weaken external as well as domestic demand.

The output gaps as recalculated by the Commission following the commonly agreed methodology, are positive for 2016-2017 (1.1%, 1.5% respectively). The Commission forecasts a slightly lower positive output gap for 2016, but an identical one for 2017.

Overall, the DBP's macroeconomic projections, in particular real GDP growth and its composition are somewhat more positive for 2016 compared to those of the Commission, which projects real GDP growth of 2.0% and 2.7% for 2016 and 2017 respectively. The somewhat weaker outlook for 2016 is related to the poor performance of the third quarter, where y-o-y GDP growth only reached 1.6%. When looking at the growth composition though, growth rates of private consumption as well as wages and salaries, the tax bases for personal income tax and social contributions respectively, are broadly in line with the ones contained in the Commission 2016 autumn forecast. Thus, in the Commission's view, the DBP is based on plausible macroeconomic assumptions.

Risks to the macroeconomic scenario underpinning draft budgetary plan are tilted to the downside due to increased uncertainty in economic environment caused by the outcome of the vote on the United Kingdom's membership of the European Union and continued geopolitical tensions in the region. According to the Commission, these risks could be mitigated by the possibility that the supply of idle labour could be sufficient to provide room for further employment growth.

#### **Box 1: The macro economic forecast underpinning the budget in Lithuania**

Lithuania's budget and fiscal projections are based on the macroeconomic forecast of the Ministry of Finance. Such a macroeconomic scenario is prepared twice a year (by March 18<sup>th</sup> and September 12<sup>th</sup> in 2016). The Ministry of Finance receives comments on the draft scenario from the Ministry of Economy, Ministry of Social Security and Labour, the national central bank, Statistics Lithuania and the National Audit Office. The final scenario is published on the website of the Ministry of Finance.

The National Audit Office of Lithuania carries the function of independent fiscal institution via its Budget Policy Monitoring Department. It has issued a positive opinion of the economic scenario which was submitted to the Lithuanian Parliament and forms the basis of the Draft Budget Plan. In its latest opinion the National Audit Office shared the views of the Ministry of Finance on the main downside risks to the macroeconomic scenario. The opinion was also posted on the website of the National Audit Office and the website of Ministry of Finance.

The National Audit Office has been granted the function of independent fiscal institution on January 1st 2015, following the adoption of the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania in November 2014. Relevant amendments were made to the Law on the National Audit Office. The procedure guiding the endorsement process has been agreed in a Memorandum of Understanding between the Ministry of Finance and the National Audit Office signed on 29 April 2015.

The National Audit Office works under a legal framework which ensures its independence and has a long standing reputation as a body independent from the government. The function of a budget policy monitoring institution has been set up in a dedicated department of the National Audit Office, the Budget Policy Monitoring Department. The Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania provides that the monitoring institution should not accept instructions from any other institution or person.

**Table 1. Comparison of macroeconomic developments and forecasts**

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.8	2.5	2.3	2.0	3.2	2.7	2.7
Private consumption (% change)	4.1	4.3	5.5	4.4	4.1	4.2	3.7
Gross fixed capital formation (% change)	4.7	2.1	-2.6	-0.9	5.2	6.3	6.0
Exports of goods and services (% change)	-0.4	3.6	4.9	4.1	4.4	2.8	2.8
Imports of goods and services (% change)	6.2	4.7	4.0	0.9	5.3	4.4	4.5
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	3.6	3.4	1.6	2.9	3.9	3.9	3.9
- Change in inventories	3.4			-3.2			0.0
- Net exports	-5.2	-0.9	0.7	2.4	-0.7	-1.2	-1.2
Output gap <sup>1</sup>	0.8	0.0	1.1	0.9	0.1	1.5	1.5
Employment (% change)	1.3	0.6	2.1	2.3	0.3	0.8	0.3
Unemployment rate (%)	9.1	8.0	8.0	7.6	7.1	7.2	7.4
Labour productivity (% change)	0.5	1.9	0.2	-0.3	2.9	1.9	2.4
HICP inflation (%)	-0.7	0.7	0.7	0.7	2.2	2.2	1.7
GDP deflator (% change)	0.2	1.1	0.7	1.4	2.0	2.2	1.6
Comp. of employees (per head, % change)	5.3	5.6	5.9	5.4	6.2	6.2	6.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.8	0.5	2.0	1.2	-0.4	1.6	0.5
<p><b>Note:</b></p> <p><sup>1</sup>In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.</p> <p><b>Source:</b></p> <p><i>Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations</i></p>							

### 3. RECENT AND PLANNED FISCAL DEVELOPMENTS

#### 3.1. Deficit developments

The no-policy-change DBP expects a slightly lower general government deficit of 0.7% of GDP compared to the 0.8% in the Stability Programme, despite the marginal slowdown in real GDP growth in 2016. This improvement is due to better-than-expected budgetary execution with revenue collection helped by a solid increase in tax rich components of GDP growth such as employment and wages. The Commission autumn forecast expects a slightly lower general government deficit of 0.6% of GDP for 2016 as the trend of tax revenue collection point to a better outcome, while spending discipline is expected to be maintained.

For 2017, the no-policy-change Draft Budgetary Plan indicates a general government deficit of 0.3% of GDP, which is 0.3% of GDP higher than in the Stability Programme. This increase

results from the inclusion of the costs of a structural reform<sup>1</sup> which was adopted after the submission of the Stability Programme. A number of new discretionary fiscal measures envisaged by the outgoing government, in particular an increase in the non-taxable income threshold and in public wages, are not included in the no-policy-change scenario.

The Commission 2016 autumn forecast predicts a general government deficit of 0.8% of GDP for 2017. It takes into account most of the measures<sup>2</sup> included in the no-policy-change DBP, although the Commission estimates of extra revenues from increased tax compliance more conservatively. In addition, increases in the non-taxable income threshold and in public wages envisaged by outgoing government, but yet to be confirmed in the final budget plan, are taken into account by the Commission autumn forecast.

According to Commission forecast, risks to the public finance forecast are tilted to the upside linked to expectations of robust growth in the tax base, but only if expenditure growth is contained after the 2016 electoral cycle.

In structural terms, the no-policy-change DBP projects a (recalculated) structural balance<sup>3</sup> of -1.2% of GDP in 2016 and -0.9% of GDP compared to -0.7% and 0% respectively in the Stability Programme due to a different assessment of Lithuania's potential output and higher general government deficit in 2017. The Commission forecasts a structural balance of -0.9% of GDP in 2016, deteriorating to -1.4% of GDP in 2017<sup>4</sup>.

The National Audit Office of Lithuania, in its capacity of independent fiscal institution, has not yet assessed whether the 2017 Draft Budgetary Plan complies with the requirements of Lithuania's numerical fiscal rules.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Lithuania currently standing at 0.8<sup>5</sup>. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Lithuania is expected to fall from 1.5% of GDP in 2015 to 1.4% in 2016 and is projected to decrease further next year, to 1.3% of GDP, well below the 2.0% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The development of the interest expenditure as included in the DBP is broadly confirmed by the Commission forecast.

A modest change in interest expenditure would not lead to pronounced deviation in changes of structural primary balance from changes in the structural balance in 2016-17.

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<sup>1</sup> The reform encompasses labour market and pension system reforms.

<sup>2</sup> Except for the foreseen reversal of preferential VAT rate for house heating, since the incoming government has a possibility to extend the preferential VAT rate for 2017.

<sup>3</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

<sup>4</sup> The main differences between the (recalculated) structural balance of the Stability Programme and the (recalculated) no policy-change DBP as well as the Commission forecast stem from a different assessment of Lithuania's potential output, since the autumn assessment points to higher positive output gaps for both 2016 and 2017.

<sup>5</sup> Period average of secondary market yields of government bonds with maturities of close to 10 years as of 16 September 2016. Source: ECB

**Table 2. Composition of the budgetary adjustment**

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	SP	DBP	COM	SP	DBP	COM	DBP
<b>Revenue</b>	<b>34.9</b>	<b>34.6</b>	<b>35.3</b>	<b>34.5</b>	<b>35.2</b>	<b>36.1</b>	<b>35.0</b>	<b>1.2</b>
<i>of which:</i>								
- Taxes on production and imports	11.8	11.9	11.9	11.9	12.2	12.3	12.0	0.5
- Current taxes on income, wealth, etc.	5.5	5.6	5.8	5.7	5.7	6.0	5.5	0.5
- Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Social contributions	11.9	12.2	12.4	12.3	12.3	12.5	12.4	0.6
- Other (residual)	5.7	4.9	5.2	4.7	5.0	5.3	5.2	-0.4
<b>Expenditure</b>	<b>35.1</b>	<b>35.4</b>	<b>35.9</b>	<b>35.1</b>	<b>35.2</b>	<b>36.4</b>	<b>35.8</b>	<b>1.3</b>
<i>of which:</i>								
- Primary expenditure	33.5	34.0	34.5	33.6	33.9	35.1	34.4	1.6
<i>of which:</i>								
Compensation of employees	9.6	9.7	9.9	9.9	9.6	9.6	10.0	0.0
Intermediate consumption	5.2	5.3	5.4	5.3	5.2	5.5	5.5	0.3
Social payments	12.5	12.8	13.0	12.8	12.5	13.2	13.3	0.7
Subsidies	0.4	0.3	0.3	0.4	0.3	0.3	0.4	-0.1
Gross fixed capital formation	3.6	3.5	3.5	3.6	4.0	3.8	3.7	0.2
Other (residual)	2.2	2.5	2.4	1.6	2.3	2.7	1.5	0.5
- Interest expenditure	1.5	1.4	1.4	1.5	1.3	1.3	1.4	-0.2
<b>General government balance (GGB)</b>	<b>-0.2</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-0.6</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.8</b>	<b>-0.1</b>
<b>Primary balance</b>	<b>1.3</b>	<b>0.6</b>	<b>0.7</b>	<b>0.9</b>	<b>1.3</b>	<b>0.9</b>	<b>0.7</b>	<b>-0.4</b>
One-off and other temporary measures	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1
<b>GGB excl. one-offs</b>	<b>-0.3</b>	<b>-0.7</b>	<b>-0.7</b>	<b>-0.5</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.8</b>	<b>0.0</b>
Output gap <sup>1</sup>	0.8	0.0	1.1	0.9	0.1	1.5	1.5	0.7
Cyclically-adjusted balance <sup>1</sup>	-0.5	-0.8	-1.2	-1.0	0.0	-0.9	-1.4	-0.4
<b>Structural balance (SB)<sup>2</sup></b>	<b>-0.7</b>	<b>-0.7</b>	<b>-1.2</b>	<b>-0.9</b>	<b>0.0</b>	<b>-0.9</b>	<b>-1.4</b>	<b>-0.2</b>
Structural primary balance <sup>2</sup>	0.9	0.7	0.2	0.6	1.3	0.4	0.1	-0.5
<b>Notes:</b>								
<sup>1</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.								
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<b>Source:</b>								
Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations								

The Draft Budgetary Plan is accompanied by a formal request to avail of the flexibility under the preventive arm for 2017 pursuant to the "Commonly agreed position on Flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council in February 2016 in view of the planned implementation of major structural reforms with a positive impact on the long-term sustainability of public finances. It appears that on the basis of the Commission forecast Lithuania has sufficient fiscal space to benefit from a temporary deviation. However, an assessment of the fulfilment of the eligibility criteria will be made once the full Draft



Budgetary Plan is transmitted by the incoming government. A complete assessment of the application would take place in spring 2017.

### **3.2. Debt developments**

General government debt projections for 2016 and 2017 are similar in the non-policy-change DBP and the Commission forecast when adjusted for the impact of some discretionary fiscal measures included in Commission forecast (see Table 3). The debt decrease by 0.2 pps of GDP in 2016 compared to Stability Programme can be explained by the lower general government deficit. Debt stock is 3 pps of GDP higher in 2017 than planned in the Stability Programme because of a planned shift in the timing of pre-financing of forthcoming bond redemptions and a slightly higher 2017 general government deficit assumed under the no-policy-change DBP.

Risks related to the debt projections are balanced as public guarantees are just at 1.1% of GDP in 2016 and 1.4% of GDP in 2017. The non-policy-change DBP does not foresee contingent liabilities linked to the financial sector.

**Table 3. Debt developments**

(% of GDP)	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio<sup>1</sup></b>	<b>42.7</b>	<b>41.1</b>	<b>40.9</b>	<b>40.8</b>	<b>39.9</b>	<b>42.9</b>	<b>43.3</b>
Change in the ratio	2.2	-1.6	-1.8	-1.9	-1.2	2.0	2.5
<i>Contributions<sup>2</sup>:</i>							
<b>1. Primary balance</b>	<b>-1.3</b>	<b>-0.6</b>	<b>-0.7</b>	<b>-0.9</b>	<b>-1.3</b>	<b>-0.9</b>	<b>-0.7</b>
<b>2. “Snow-ball” effect</b>	<b>0.7</b>	<b>-0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>-0.7</b>	<b>-0.7</b>	<b>-0.3</b>
<i>Of which:</i>							
Interest expenditure	1.5	1.4	1.4	1.5	1.3	1.2	1.4
Growth effect	-0.7	-1.0	-1.0	-0.8	-1.2	-1.1	-1.1
Inflation effect	-0.1	-0.5	-0.3	-0.6	-0.8	-0.9	-0.6
<b>3. Stock-flow adjustment</b>	<b>2.8</b>	<b>-0.9</b>	<b>-1.2</b>	<b>-1.1</b>	<b>0.8</b>	<b>3.6</b>	<b>3.4</b>
<i>Of which:</i>							
Cash/accruals difference							
Net accumulation of financial		0.0			0.0		
<i>of which privatisation</i>							
<i>proceeds</i>							
Valuation effect & residual							
<b>Notes:</b> <sup>1</sup> End of period. <sup>2</sup> The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual <b>Source:</b> <i>Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations</i>							

### 3.3. Measures underpinning the draft budgetary plan

The no-policy-change DBP only includes discretionary measures for 2017 that have been adopted before the submission of the no-policy-change DBP, notably fifteen discretionary revenue and eleven expenditure measures, whose net effect taken at face value adds around 0.2% of GDP to the general government deficit (see Table 4). The costs of the legislated structural reform are only partially compensated by the adopted multiannual small tax increases and by the expected revenues from a set of tax compliance measures.

Most measures as included in the no-policy-change Draft Budgetary Plan have been incorporated in the Commission autumn forecast, although estimates of revenues from improved tax compliance are more conservative and the preferential VAT rate for heating is assumed to be maintained. In addition, increases in the non-taxable income threshold and in public wages as envisaged by the outgoing government, but not yet confirmed in no-policy-change DBP, are taken into account by the Commission autumn forecast.

**Table 4. Main discretionary measures reported in the no-policy-change DBP****A. Discretionary measures taken by General Government - revenue side**

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	2017	2018
Taxes on production and	0.3	0.5	n.a.
Current taxes on income,	0.2	0.2	n.a.
Capital taxes	n.a.	n.a.	n.a.
Social contributions	n.a.	0.0	n.a.
Property Income	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
<b>Total</b>	<b>0.5</b>	<b>0.6</b>	<b>n.a.</b>
<u>Note:</u> The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure. <i>Source: Draft Budgetary Plan for 2017</i>			

**B. Discretionary measures taken by general Government- expenditure side**

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	2017	2018
Compensation of employees	0.2	0.1	n.a.
Intermediate consumption	n.a.	n.a.	n.a.
Social payments	0.4	0.7	n.a.
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	n.a.	n.a.
Gross fixed capital formation	-0.1	n.a.	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
<b>Total</b>	<b>0.5</b>	<b>0.8</b>	<b>n.a.</b>
<u>Note:</u> The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure. <i>Source: Draft Budgetary Plan for 2017</i>			

#### 4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Lithuania is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country specific recommendations in the area of public finances.

##### **Box 2: Council recommendations addressed to Lithuania**

On 12 July 2016, the Council addressed recommendations to Lithuania in the context of the European Semester. In particular, in the area of public finances the Council recommended to Lithuania to ensure that the deviation from the medium-term budgetary objective is limited to the allowance linked to the systemic pension reform in 2016 and in 2017.

In 2016, Lithuania benefits from a temporary deviation of 0.1% of GDP from the required adjustment path towards the MTO linked to the pension reform clause. According to the no-policy-change DBP the (recalculated) structural balance is expected to deteriorate in 2016 by 0.5% of GDP, which is slightly better than the allowed deterioration of 0.7% of GDP. The growth rate of government expenditure, net of discretionary revenue measures, in 2016 is expected not to exceed the applicable expenditure benchmark rate (4.1%). Therefore, the overall assessment of the (recalculated) no-policy-change DBP points to compliance with the provisions of the Pact in 2016.

This is also confirmed by the Commission's autumn forecast which projects that both pillars will be compliant in 2016. Lithuania is thus considered to be compliant with the provisions of the Pact in 2016.

For 2017, Lithuania's no-policy-change DBP was accompanied by a formal request to avail itself of 0.6% of GDP flexibility under the structural reform clause (see section 3.1). The following assessment of compliance with the required adjustment towards the MTO in 2017 is however carried out on the basis of the preventive arm requirement enshrined in the fiscal CSR (see Box 2).

For 2017, the (recalculated) projections of the no-policy-change DBP indicate that both the structural deficit and the expenditure benchmark pillars are set to be compliant with the requirements of the Pact.

According to the Commission autumn forecast, the structural balance is set to deteriorate by 0.4% of GDP to -1.4% in 2017, thus deviating by 0.3% from the required adjustment and pointing to a risk of some deviation. Net expenditure growth in 2017 is expected to exceed the applicable benchmark rate (2.2%) leading to deviation of 0.8% of GDP and pointing to the risk of a significant deviation. This calls for overall assessment. The structural balance in 2017 is positively impacted by temporary revenue windfalls (0.3% of GDP) mostly reflecting strong wage growth. Moreover, the evolution of the public investment is increasing the effort as computed by the structural balance. The expenditure benchmark is thus a better indicator of the underlying budgetary position. Therefore, the overall assessment points to a risk of significant deviation from the adjustment path towards the MTO in 2017, based on Commission autumn forecast.

The divergence between the no-policy-change (recalculated) DBP and the Commission 2016 autumn forecast structural balance and expenditure benchmark indicators for 2017 can mostly be explained by the higher general government deficit forecast by the Commission that results from the impact of discretionary fiscal measures envisaged by the outgoing government, but not included in the no-policy-change Draft Budgetary Plan.

In conclusion, according to the Commission 2016 autumn forecast the required adjustment towards the MTO is not projected to be delivered pointing to a risk of significant deviation from the adjustment path towards the MTO in 2017.

Notwithstanding these findings, the fulfilment of the eligibility criteria for flexibility under the structural reform clause is a factor that could be taken into account in future assessments. In its 2016 Stability Programme and no-policy change Draft Budgetary Plan, Lithuania has requested a temporary deviation from the required adjustment path towards the MTO in 2017 in view of a legislated structural reform with expected direct long-term positive budgetary effects. Lithuania estimates the budgetary costs of the structural reform at around 0.6% of GDP in 2017. Lithuania appears to have sufficient fiscal space to benefit from a temporary deviation of 0.5% of GDP in 2017. However, the complete assessment of the request for flexibility will take place once the full Draft Budgetary Plan is transmitted by the incoming government, and within the normal European Semester cycle in the context of the assessment of the 2017 Stability Programme.

**Table 5: Compliance with the requirements of the preventive arm**

(% of GDP)	2015	2016		2017	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance <sup>2</sup> (COM)	-0.7	-0.9		-1.4	
Structural balance based on freezing (COM)	-0.4	-0.9		-	
<b>Position vis-a-vis the MTO<sup>3</sup></b>	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	2015	2016		2017	
	COM	DBP	COM	DBP	COM
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	0.0	0.0		0.0	
Required adjustment corrected <sup>5</sup>	0.2	-0.7		-0.2	
Change in structural balance <sup>6</sup>	1.1	-0.5	-0.3	0.3	-0.4
One-year deviation from the required adjustment <sup>7</sup>	0.9	0.2	0.4	0.4	-0.3
Two-year average deviation from the required adjustment <sup>7</sup>	0.8	0.6	0.7	0.3	0.1
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	1.4	4.1		2.2	
One-year deviation <sup>9</sup>	-0.5	0.1	0.4	0.0	-0.8
Two-year average deviation <sup>9</sup>	0.3	-0.2	0.0	0.0	-0.2
<b>Conclusion</b>					
Conclusion over one year	Overall assessment	Compliance	Compliance	Compliance	Overall assessment
Conclusion over two years	Compliance	Overall assessment	Compliance	Compliance	Overall assessment
<b>Notes</b>					
<sup>1</sup> The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.					
<sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.					
<sup>3</sup> Based on the relevant structural balance at year t-1.					
<sup>4</sup> Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).					
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
<sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.					
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.					
<sup>8</sup> Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.					
<sup>9</sup> Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<b>Source :</b>					
Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.					

## 5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The Council in the context of the 2016 European Semester has recommended to Lithuania a number of fiscal structural reform measures, such as reducing the tax burden on low-income earners by shifting the tax burden to other sources less detrimental to growth and improving tax compliance, in particular in the area of VAT.

The no-policy-change DBP explicitly refers to these structural CSRs. A special section provides details on measures envisaged in the 2017 budget, targeted at the recommendations.

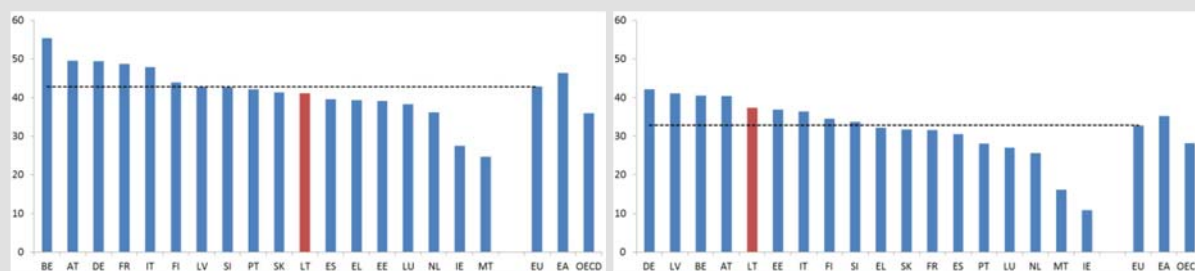
On the fiscal side, a number of measures have been envisaged to strengthen the tax administration. In particular a systematic cross-check of VAT invoices has been expanded, as well as a smart tax administration information system is set to launch in full. The outgoing government envisaged an increase of the non-taxable income threshold (to be legislated by the incoming government) to alleviate the tax burden of low-income individuals. However, only part of this planned reduction appears to be covered by the tax shift.

### Box 3: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Lithuania for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

#### The tax burden on labour in Lithuania at the average wage and a low wage (2015)



*Notes:* Data for Latvia, Lithuania and Malta is for 2014. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

*Source:* European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2016 European Semester, Lithuania was issued the recommendation to "(...) Reduce the tax burden on low-income earners by shifting the tax burden to other sources less detrimental to growth and improve tax compliance, in particular in the area of VAT".

Lithuania's no-policy-change Draft Budgetary Plan refers to the following measures that affect the tax wedge on labour:

Lithuania has envisaged measures (to be confirmed by the incoming government) to increase the non-taxable personal income threshold from currently EUR 200 to EUR 310 per month, as of 1 January 2017. In addition, the outgoing government has envisaged increasing the amount of parents' non-taxable income for each child, from currently EUR 120 to EUR 200 per month. Lithuania also plans measures to raise the tax exempt amount for disabled people. These measures, and in particular those affecting the thresholds for non-taxable personal labour income, mostly target low income earners. As a result of these measures, the outgoing government expects an increase in real disposable income for low wage earners.

Lithuania set to reduce social insurance tariff by 1 pp from 2017 (tax savings of 0.3% of GDP). Most of these savings for employees and employers will be offset by the higher unemployment insurance tariff and payments to the new unemployment insurance fund. These, in turn, will strengthen unemployment protection, while losses of social insurance revenue will not be fully offset by revenue-enhancing or expenditure-reducing measures.

Bonuses of the boards of observers set to become subject to social insurance taxes, thus marginally increasing social insurance revenue at the expense of high income earners, while such earners set to benefit from newly set ceiling on social insurance contributions.

## **6. OVERALL CONCLUSION**

Following an overall assessment of the (recalculated) no-policy-change DBP, the indicated structural adjustment points to compliance with the MTO in 2016 and 2017. Based on the Commission 2016 autumn forecast, the structural adjustment points to compliance with the MTO in 2016.

Regarding 2017, the Commission 2016 autumn forecast indicates a risk of significant deviation from the adjustment path towards the MTO following an overall assessment, before considering the request for flexibility. In its no-policy-change Draft Budgetary Plan Lithuania requests a temporary deviation from the required adjustment path towards the MTO in 2017 to take account of major structural reforms with a positive impact on the long-term sustainability of public finances.