



**Brussels, 18 November 2015  
(OR. en)**

**EG 31/15  
ADD 1**

**ECOFIN 878  
UEM 417  
EUROGROUP 30**

**COVER NOTE**

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From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	17 November 2015
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2015) 607 final
Subject:	COMMISSION STAFF WORKING DOCUMENT Analysis of the 2016 Draft Budgetary Plan of LITHUANIA Accompanying the document COMMISSION OPINION on the Draft BudgetaryPlan of LITHUANIA
Enclosed:	SWD(2015) 607 final

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Delegations will find attached document SWD(2015) 607 final.

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Brussels, 16.11.2015  
SWD(2015) 607 final

**COMMISSION STAFF WORKING DOCUMENT**

**Analysis of the 2016 Draft Budgetary Plan of LITHUANIA**

*Accompanying the document*

**COMMISSION OPINION**

**on the Draft Budgetary Plan of LITHUANIA**

{C(2015) 8107 final}

## **Analysis of the 2016 Draft Budgetary Plan of LITHUANIA**

### **1. INTRODUCTION**

Lithuania submitted its Draft Budgetary Plan (DBP) for 2016 on 15 October 2015 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. 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 DBP and provides an assessment based on the Commission Forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 (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 reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

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

Lithuania's real GDP grew by 3.0% y-o-y in 2014. The macroeconomic scenario underlying the DBP foresees a slowdown to 1.9% real GDP growth in 2015 followed by a recovery to 3.2% in 2016. The scenario assumes that domestic demand will be the main growth engine on the back of robust employment growth (1.3% in 2015, 0.8% in 2016) and higher nominal wages. The inflation forecast is at -0.4% in 2015, and 1.4% in 2016, reflecting the impact of accelerating wage growth.

Compared to the scenario underlying the Stability Programme, the growth forecast for 2015 has been revised downwards from 2.5% to 1.9%. This revision mainly reflects the disappointing GDP growth during the first half of 2015 resulting from a worse than expected decline in exports to Russia. For 2016, the forecast does not change compared to the Stability Programme since an upward revision of private consumption compensates for somewhat slower export growth.

The output gaps as recalculated by Commission based on the information in the DBP, following the commonly agreed methodology, are positive for 2015-2016 (0.7%, 1.4% respectively). The Commission forecasts slightly lower positive output gaps for both 2015 and 2016.

Overall, the DBP's macroeconomic projections, in particular real GDP growth and its composition are similar to those of the Commission. Its real GDP growth is set at 1.9% in 2015 and 3.2% in 2016 compared with the Commission's 1.7% and 2.9%. 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 2015 autumn forecast. Thus, in the Commission's view, the DBP is based on plausible macroeconomic assumptions.

Risks to the macroeconomic scenario are tilted to the downside as a worse than expected downturn in Russia might force further decline in Lithuania's exports to Russia. Moreover, a prolongation of the ban on food imports by Russia would hamper the expected recovery of exports in 2016.

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

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.0	2.5	1.9	1.7	3.2	3.2	2.9
Private consumption (% change)	4.1	3.7	4.5	4.9	4.3	4.5	4.0
Gross fixed capital formation (% change)	5.4	5.2	6.9	9.8	2.5	4.2	2.4
Exports of goods and services (% change)	3.0	-2.8	0.8	2.4	3.8	3.2	2.8
Imports of goods and services (% change)	2.9	-1.2	3.9	6.8	4.6	4.2	3.4
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	3.8	3.8	4.4	5.1	3.7	4.0	3.3
- Change in inventories	-0.9	n.a.	n.a.	0.0	n.a.	n.a.	0.0
- Net exports	0.2	-1.4	-2.5	-3.5	-0.5	-0.8	-0.4
Output gap <sup>1</sup>	1.2	-0.2	0.7	0.4	-0.8	1.4	0.8
Employment (% change)	2.0	0.6	1.3	1.5	0.6	0.8	0.2
Unemployment rate (%)	10.7	9.9	9.4	9.4	9.1	8.8	8.6
Labour productivity (% change)	1.0	1.9	0.6	0.2	2.5	2.3	2.7
HICP inflation (%)	0.2	-0.4	-0.4	-0.8	1.7	1.4	0.6
GDP deflator (% change)	1.2	0.5	0.0	-0.5	2.2	1.5	0.5
Comp. of employees (per head, % change)	3.9	4.9	4.8	4.5	5.3	5.2	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	6.6	3.6	0.6	0.9	1.0	-1.8	1.6

Note:

<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.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

### **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 20th

and September 10th) based on a draft methodology yet to be formally adopted. 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 a budget policy monitoring institution (independent fiscal institution). It has issued a positive opinion on the approval of the economic development scenario to the Lithuanian Parliament on 18 August 2015. In its opinion the National Audit Office stressed that the forecast is subject to downside risks and recommended a prudent planning of budget revenues in 2016. The opinion was also posted on the website of the National Audit Office.

The National Audit Office has been granted a function of budget policy monitoring 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 long standing reputation as a body independent from the government. The new function of a budget policy monitoring institution has been set up in a separate department of the National Audit Office, which is building its expertise and gathers experience.

### **3. RECENT AND PLANNED FISCAL DEVELOPMENTS**

#### **3.1. Deficit developments**

Despite the slowdown in real GDP in 2015 the DBP expects a slightly lower general government deficit of 0.9% of GDP compared to the 1.2% in the Stability Programme. This improvement is due to better budgetary outcomes of local governments and additional one-off revenues to the state Deposit and Investment Insurance Fund. In addition, the DBP assumes a solid increase in tax rich components of GDP growth such as private consumption, employment and wages supporting revenue collection. On the expenditure side, the DBP foresees higher spending on investments compared with the Stability Programme. The Commission autumn forecast expects a slightly higher general government deficit of 1.1% of GDP for 2015 as the forecast is more cautious on the positive impact of tax enforcement measures and the budgetary outcome of local governments.

In 2016 the DBP's general government deficit is projected to be 1.3% of GDP, 0.2% above the one of the Stability Programme. This slight increase results from a number of new discretionary fiscal measures contained in the DBP, in particular an increase in the non-taxable income, in pensions and some public wages, which are only partially offset by a number of smaller tax increases.

The Commission 2015 autumn forecast predicts a general government deficit of 1.3% of GDP in line with the one of the DBP. Risks to the budget implementation are tilted to the downside, in particular in 2016, due to the forthcoming general election in autumn 2016.

In structural terms, the DBP projects a (recalculated) structural balance<sup>1</sup> of -1.3% of GDP in 2015 and -1.8% of GDP compared to -1.2% and -0.9% respectively in the Stability Programme due to a different assessment of Lithuania's economic cycle. The Commission forecasts a structural balance of -1.2% of GDP in 2015 set to deteriorate to -1.4% of GDP in 2016. The main differences between the structural balance of the Stability Programme and the (recalculated) DBP as well as the Commission forecast stem from a different assessment of Lithuania's economic cycle, since the Commission forecasts slightly lower positive output gaps for both 2015 and 2016.

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

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<sup>1</sup> Cyclically adjusted balance net of one-off and temporary measures, as recalculated by the Commission services on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
<b>Revenue</b>	<b>34.1</b>	<b>34.4</b>	<b>35.4</b>	<b>34.6</b>	<b>33.2</b>	<b>34.0</b>	<b>34.5</b>	<b>-0.1</b>
<i>of which:</i>								
- Taxes on production and imports	11.3	12.0	11.8	11.9	11.7	11.6	12.1	0.3
- Current taxes on income, wealth, etc.	5.1	5.2	5.7	5.5	5.4	5.5	5.3	0.4
- Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Social contributions	11.3	11.8	12.1	12.1	11.6	12.0	12.4	0.7
- Other (residual)	6.4	5.4	5.8	5.1	4.5	4.9	4.7	-1.5
<b>Expenditure</b>	<b>34.8</b>	<b>35.6</b>	<b>36.3</b>	<b>35.7</b>	<b>34.3</b>	<b>35.3</b>	<b>35.8</b>	<b>0.5</b>
<i>of which:</i>								
- Primary expenditure	33.2	33.9	34.6	34.1	32.8	33.7	34.2	0.5
<i>of which:</i>								
Compensation of employees	9.5	9.8	9.5	9.8	9.1	9.3	10.0	-0.2
Intermediate consumption	4.8	5.2	5.2	4.8	5.2	5.0	4.8	0.2
Social payments	12.5	12.9	13.0	12.7	12.5	12.9	13.0	0.4
Subsidies	0.3	0.4	0.3	0.3	0.4	0.3	0.3	0.0
Gross fixed capital formation	3.5	3.6	3.9	3.9	3.6	3.5	3.6	0.0
Other (residual)	2.7	2.0	2.7	2.5	2.0	2.7	2.7	0.0
- Interest expenditure	1.6	1.7	1.7	1.6	1.5	1.6	1.6	0.0
<b>General government balance (GGB)</b>	<b>-0.7</b>	<b>-1.2</b>	<b>-0.9</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-1.3</b>	<b>-1.3</b>	<b>-0.6</b>
<b>Primary balance</b>	<b>0.9</b>	<b>0.5</b>	<b>0.8</b>	<b>0.6</b>	<b>0.5</b>	<b>0.3</b>	<b>0.3</b>	<b>-0.6</b>
One-off and other temporary measures	0.3	0.1	0.1	0.0	0.1	-0.1	-0.1	-0.4
<b>GGB excl. one-offs</b>	<b>-0.9</b>	<b>-1.3</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-0.3</b>
Output gap <sup>1</sup>	1.2	-0.2	0.7	0.4	-0.8	1.4	0.8	0.3
Cyclically-adjusted balance <sup>1</sup>	-1.1	-1.1	-1.2	-1.2	-0.8	-1.9	-1.6	-0.8
<b>Structural balance (SB)<sup>2</sup></b>	<b>-1.4</b>	<b>-1.2</b>	<b>-1.3</b>	<b>-1.2</b>	<b>-0.9</b>	<b>-1.8</b>	<b>-1.4</b>	<b>-0.4</b>
Structural primary balance <sup>2</sup>	0.2	0.5	0.4	0.4	0.6	-0.2	0.1	-0.4
<b>Notes:</b>								
<sup>1</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the 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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations								

## **Box 2: Impact of the current low interest rate environment on compliance with the SGP**

### **Identifying an interest rate windfall/shortfall for 2016**

Sovereign bond yields have fallen sharply since end-2013 and reached historical lows in the first half of 2015, before increasing somewhat during the summer months. However, yields in Lithuania still remain well below their long-term averages (of roughly 6.2%), with 10-year rates currently standing at 1.34% (Bloomberg, 27 Oct. 2015). As a result of lower interest rates, total interest payments by the general government have also decreased over the last few years. Interest expenditure in Lithuania is expected to fall from 2% of GDP in 2012 to 1.7% in 2015, and is projected to decrease further to 1.6% of GDP in 2016, based on the information provided in the DBP.

The DBP's projections for the interest expenditure in 2015 and 2016, slightly exceed the Commission's estimations based on its 2015 autumn forecast, which sets broadly stable interest expenditure at 1.6% over 2015 and 2016.

### **Prospects and vulnerability**

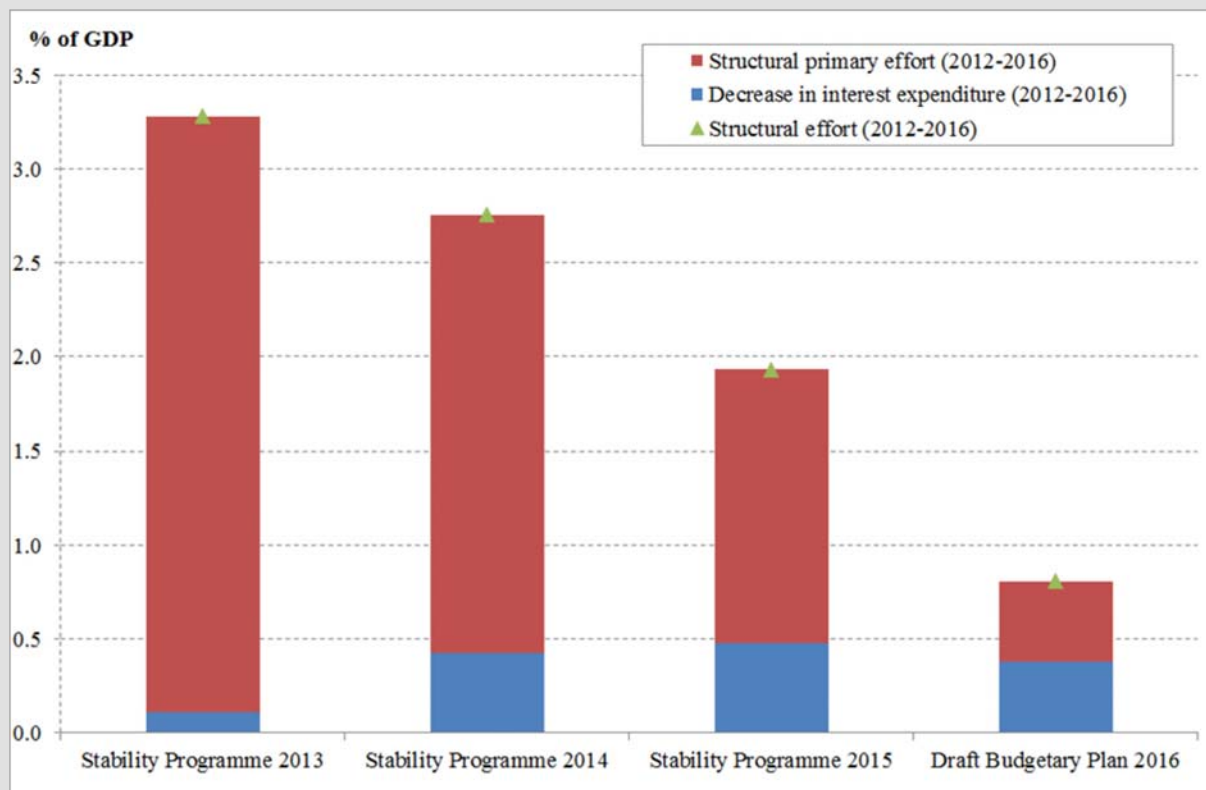
On the basis of the outstanding debt to be renewed over the time horizon 2016 to 2018, Lithuania could further benefit from the historically low interest rates going forward, given the need to refinance roughly 41% of central government debt (including all tradable central government equities (t-bills, notes and bonds) but no loans). At the same time public finances could also take a hit in case of a significant increase in interest rates.

### **Consequences for public finances**

Comparing the interest expenditure projections across different vintages of Stability and Convergence Programmes and the DBP sheds more light on the (unexpected) interest expenditure savings since the fall in interest rates (see Chart). Analysing the evolution of the planned structural effort between 2012 and 2016 shows that the interest expenditure savings consistently increased, and peaked in 2015 with an estimated contribution to the structural effort of almost 0.5% of GDP, while the latter amounts to 0.4% of GDP in 2016. Part of these gains are a result of shrinking market spreads as a consequence of past prudent fiscal policies. The planned structural primary effort decreased considerably over the considered time horizon (see Chart).



### Structural effort and decrease in interest expenditures between 2012 and 2016 based on government plans



Source: Stability programmes, Draft Budgetary Plan 2016 and AMECO

### 3.2. Debt developments

General government debt projections for 2015 and 2016 are similar in the DBP and the Commission forecast (see Table 3). The debt increase by 0.7% of GDP in 2015 compared to the Stability Programme can be mostly explained by a higher-than-usual pre-financing of EU funded expenditures. Debt stock is 3.1pps of GDP higher in 2016 than planned in the Stability Programme because of a shift in timing of pre-financing of forthcoming bond redemptions and a slightly higher 2016 general government deficit assumed under the DBP and forecast by the Commission.

Risks related to the debt projections are balanced as public guarantees are just at 1.1% of GDP in 2015 and 2016. The DBP does not foresee contingent liabilities linked to the financial sector.

**Table 3. Debt developments**

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio<sup>1</sup></b>	<b>40.7</b>	<b>42.2</b>	<b>42.9</b>	<b>42.9</b>	<b>37.7</b>	<b>40.8</b>	<b>40.8</b>
Change in the ratio	1.9	1.5	2.2	2.2	-4.5	-2.1	-2.1
<i>Contributions<sup>2</sup> :</i>							
<b>1. Primary balance</b>	<b>-0.9</b>	<b>-0.5</b>	<b>-0.8</b>	<b>-0.6</b>	<b>-0.5</b>	<b>-0.3</b>	<b>-0.3</b>
<b>2. “Snow-ball” effect</b>	<b>0.0</b>	<b>0.5</b>	<b>1.0</b>	<b>1.1</b>	<b>-0.5</b>	<b>-0.3</b>	<b>0.2</b>
<i>Of which:</i>							
Interest expenditure	1.6	1.7	1.7	1.6	1.6	1.6	1.6
Growth effect	-1.1	-1.0	-0.8	-0.7	-1.3	-1.3	-1.2
Inflation effect	-0.4	-0.2	0.0	0.2	-0.9	-0.6	-0.2
<b>3. Stock-flow adjustment</b>	<b>2.8</b>	<b>1.5</b>	<b>2.1</b>	<b>1.6</b>	<b>-3.4</b>	<b>-1.5</b>	<b>-1.9</b>
<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							
<i>Source:</i>							
<i>Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations</i>							

### 3.3. Measures underpinning the Draft Budgetary Plan

The DBP indicates a number of discretionary measures for 2016 which the government has included in the draft budget (see Table 4). The net effect of these measures taken at face value is to increase the general government deficit by around 0.5% of GDP. For 2016 the DBP puts forward nine measures on the revenue side and nine measures on the expenditure side. An increase in the minimum wage is set to have a neutral effect on the general government balance since higher spending on public wages should be compensated by an overall increase in personal income tax and social contributions. However, the increase of the non-taxable income thresholds (lost revenues of around EUR 65 million in 2016), higher pensions and social benefits (over EUR 121 million additional expenditures) as well as some public wages (over EUR 40 million), is only partially compensated by several small tax increases (around EUR 36 million in extra revenues) envisaged in the DBP. Some of these tax increases have to be approved by the Parliament in the 2016 budget adoption process.

All measures have been included in the Commission autumn forecast, except for 2015 expected revenues from value added tax enforcement measures introduced in mid-2015, since the precise impact of these measures can hardly be disentangled from other factors at the current stage.

**Table 4. Main discretionary measures reported in the DBP****A. Discretionary measures taken by General Government - revenue side**

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	2016	2017
Taxes on production and	0.2	0.1	0.2
Current taxes on income,	0.0	-0.1	0.0
Capital taxes	n.a.	n.a.	n.a.
Social contributions	0.1	0.1	n.a.
Property Income	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
<b>Total</b>	<b>0.3</b>	<b>0.0</b>	<b>0.2</b>

Note:  
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.  
*Source: Draft Budgetary Plan for 2016*

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

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	2016	2017
Compensation of employees	0.0	0.2	n.a.
Intermediate consumption	n.a.	0.0	n.a.
Social payments	0.1	0.4	n.a.
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	n.a.	n.a.
Gross fixed capital formation	n.a.	-0.1	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
<b>Total</b>	<b>0.2</b>	<b>0.5</b>	<b>n.a.</b>

Note:  
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.  
*Source: Draft Budgetary Plan for 2016*

The discretionary measures indicated in the DBP do not include the impact of one-off revenues and expenditures, such as compensations of wage cuts ordered by the court and revenue/expenditure of the state Deposit and Investment Insurance Fund from bankruptcy proceedings, which are outside of the government's control. Such measures are set to have a positive impact on the general government balance in 2015 (0.1% of GDP) and a negative one in 2016 (-0.1% of GDP), in line with the Commission forecasts.

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

Lithuania is subject to the preventive arm of the Pact and should ensure adherence to the medium-term budgetary objective. Box 3 reports the latest CSRs in the area of public finances.

##### **Box 3. Council recommendations addressed to Lithuania**

On 14 July 2015, 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 avoid deviating from the medium-term budgetary objective in 2015 and ensure that the deviation in 2016 is limited to the allowance linked to the systemic pension reform. The Council also recommended to broaden the tax base and improve tax compliance and reduce the high tax wedge for low-income earners by shifting the tax burden to other sources less detrimental to growth.

According to the DBP, the (recalculated) structural balance is expected to improve in 2015 by 0.1% of GDP, slightly below the required improvement of 0.2% of GDP, implying a risk of some deviation. Over two years, the average improvement is above the requirement. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures, will not exceed the applicable expenditure benchmark rate (1.4%) in 2015, pointing to compliance. This warrants an overall assessment.

The structural balance in 2015 is negatively affected by a temporary increase in investments, which is smoothed when calculating the expenditure benchmark. Therefore, the latter is considered to be a more relevant indicator for Lithuania's fiscal effort in 2015. Following an overall assessment of the recalculated DBP, the adjustment path towards the MTO seems to be appropriate and compliant with the requirement of the preventive arm of the Pact in 2015.

This is also confirmed by the Commission's autumn forecast which projects the structural balance to improve by 0.2% of GDP, in line with the required adjustment, reaching a structural balance of -1.2% of GDP. As a result, Lithuania is assessed to be at its MTO (set at -1% of GDP) due to the 0.25% GDP margin of tolerance. Furthermore, the net growth rate of expenditure is expected to be in line with the expenditure benchmark. Lithuania is thus considered to be compliant with the requirements in 2015.

For 2016, Lithuania is eligible to a pension reform clause allowing for a deviation of 0.1% of GDP from the matrix-based adjustment (0.2% of GDP), leading to a required adjustment of 0.1% of GDP towards the MTO.

In 2016, the DBP (recalculated) structural deficit of 1.8% of GDP points to a risk of a significant deviation from the required adjustment of 0.1% of GDP (gap of 0.6% of GDP). The growth rate of government expenditure, net of discretionary revenue measures, in 2016 is planned to exceed the applicable expenditure benchmark rate by 0.4% pointing to a risk of some deviation. This calls for an overall assessment. As the structural balance in 2016 is negatively impacted by sizable revenue shortfalls, the expenditure benchmark is a better indicator of the underlying budgetary position, so that the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016 based on the DBP.

According to the Commission autumn forecast, the structural balance is set to deteriorate by 0.2% of GDP to -1.4% in 2016, thus deviating by 0.3% from the required adjustment and pointing to a risk of some deviation. Net expenditure growth in 2016 will exceed the applicable benchmark rate by 1.2%, pointing to a risk of significant deviation. This calls for an overall assessment. The structural balance is positively affected by revenue windfalls (whereas shortfalls are expected in the DBP as the DBP forecasts a larger positive output gap for 2016). Correcting for these windfalls, the projected deviation based on the structural balance pillar would become significant. In the meantime, while the deviation from the expenditure benchmark is partly the result of deficit-increasing one-offs (related to lower capital transfers to the deposit insurance fund), and the smoothing of investment as a result of the assumed – largely permanent – reduction in public investment due to the end of the 2007-2013 programming period of EU funding, it would remain significant when corrected for these two factors. Therefore, the overall assessment points to a risk of significant deviation from the MTO in 2016.

The main differences between structural balance assessment of the DBP at face value and in the (recalculated) DBP as well as in the Commission forecast stem from a different assessment of Lithuania's economic cycle. While the DBP at face value estimates that 2016 actual growth is set to be below potential leading to a slightly negative output gap and compliance with MTO in 2016, the (recalculated) DBP and Commission forecast estimate significant positive output gaps in 2016 worsening the structural balance position (see Table 5). The difference in the structural balance between the (recalculated) DBP and the Commission forecast also mostly arises from a higher positive output gap in case of the (recalculated) DBP. Moreover, the Commission's assessment does not yet take into account the full effect of the tax administration reform given that the underlying impact was not yet specified at the time of the assessment.

The divergence of the (recalculated) DBP and the Commission 2015 autumn forecast expenditure benchmark indicators for 2016 can be explained by the DBP's higher estimate of the general government expenditures for 2015, which is the base for estimating expenditure growth in 2016. In addition, the DBP seems to have been adjusted for the impact of temporary swings in investments, which is not accounted for in the Commission's calculations.

In conclusion, according to the Commission 2015 autumn forecast the required adjustment towards the MTO is not projected to be delivered, leading to a risk of significant deviation from the MTO in 2016.

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

(% of GDP)	2014	2015		2016	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance <sup>2</sup> (COM)	-1.4	-1.2		-1.4	
Structural balance based on freezing (COM)	-1.2	-1.2		-	
<b>Position vis-a-vis the MTO<sup>3</sup></b>	Not at MTO	At or above the MTO		At or above the MTO	
(% of GDP)	<b>2014</b>	<b>2015</b>		<b>2016</b>	
	<b>COM</b>	<b>DBP</b>	<b>COM</b>	<b>DBP</b>	<b>COM</b>
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	0.5	0.0		0.0	
Required adjustment corrected <sup>5</sup>	0.5	0.2		0.1	
Change in structural balance <sup>6</sup>	1.1	0.1	0.2	-0.5	-0.2
<i>One-year deviation from the required adjustment<sup>7</sup></i>	0.6	-0.1	0.0	-0.6	-0.3
<i>Two-year average deviation from the required adjustment<sup>7</sup></i>	0.5	0.3	0.3	-0.3	-0.1
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	0.4	1.4		1.6	
<i>One-year deviation<sup>9</sup></i>	1.2	0.4	0.0	-0.4	-1.2
<i>Two-year average deviation<sup>9</sup></i>	0.8	0.8	0.6	0.0	-0.6
<b>Conclusion</b>					
Conclusion over one year	Compliance	Overall	Compliance	Overall	Overall
Conclusion over two years	Compliance	Compliance	Compliance	Overall assessment	Overall assessment
<i>Notes</i>					
<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.					
<i>Source:</i>					
Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.					

## 5. IMPLEMENTATION OF REFORMS IN THE AREA OF FISCAL GOVERNANCE

The Council, in the context of the 2015 European Semester, has recommended to Lithuania a number of fiscal governance measures, such as to broaden the tax base and improve tax compliance, reduce the high tax wedge for low-income earners by shifting the tax burden to other sources less detrimental to growth.

The DBP explicitly refers to these structural CSRs. A special section provides details on measures included in the 2016 budget targeted at the recommendations.

On the fiscal side, a number of measures have been put forward to strengthen the tax administration. In particular a systematic cross-check of VAT invoices to identify risky transactions has been introduced in mid-2015 as well as an advanced tax administration information system. The DBP contains an increase of the non-taxable income threshold to alleviate the tax burden of low-income individuals. However, only part of this planned reduction should be covered by a tax shift towards sources less detrimental to growth.

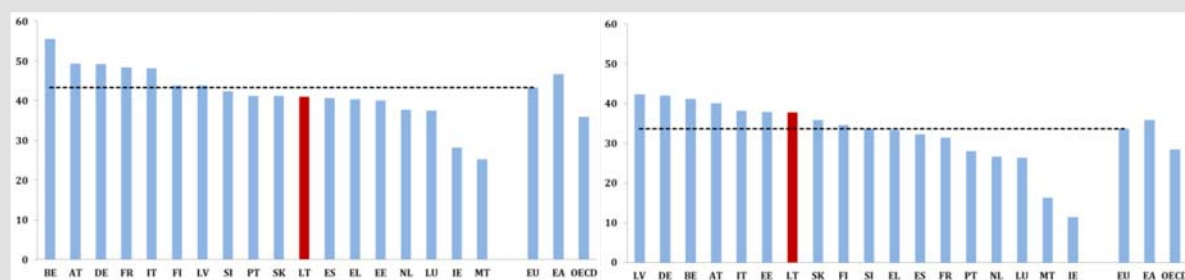
The DBP also presents a list of measures to address bottlenecks in the labour market and to improve the adequacy of pension, employment support and social assistance systems.

### Box 4: 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 screen 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. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

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 (2014)



*Notes:* Data for Latvia, Lithuania and Malta is for 2013. 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.

This screening 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 2015 European Semester, Lithuania was issued the recommendation to "(...) reduce the high tax wedge for low income earners by shifting the tax burden to other sources less detrimental to growth."

Lithuania's DBP contains the following measures that affect the tax wedge on labour:

Lithuania has approved measures to increase the non-taxable personal income threshold from currently EUR 166 to EUR 200 per month, as of 1 January 2016. In addition, the government plans to increase the amount of parents' non-taxable income for each child, from currently EUR 60 to EUR 120 per month. Lithuania also adopted measures to raise the tax exempt amount for disabled people from EUR 175 to EUR 210, and for severely disabled people from EUR 235 to EUR 270, as of 1. January 2016.

On the taxation of capital income, Lithuania plans to reduce the tax exempt amount from EUR 3000 to EUR 500 for the disposal of securities, interests on deposits and debt securities. The government also adopted measures to prolong the retention period from 5 to 10 years for real estate other than dwellings (i.e. the officially declared place of residence), so that if the property is retained during the said period, the income from its sale would be attributed to the tax exempt amount. The DBP estimates of the total cost of these new tax exemptions amounts to around -0.17% of GDP in 2016 (equivalent to EUR 64.6 million). These measures, and in particular those affecting the thresholds for non-taxable personal labour income, mostly target low income earners, and are envisaged to be financed by unspecified revenues. As a result of these measures, the government expects an increase in real disposable income for low wage earners, and an additional positive effect on household consumption and employment.

In July 2015 Eurostat has confirmed that the pension reform fulfils the necessary conditions for the country to benefit in 2016 from the requested temporary deviation from the required adjustment path towards the medium-term objective (pension reform clause). The DBP estimates the costs at EUR 33 million or 0.1% of GDP in 2016.

A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

## **6. OVERALL CONCLUSION**

Following an overall assessment of the DBP, the planned structural adjustment is in line with the required adjustment path towards the MTO in 2015 while some deviation is to be expected in 2016. Based on the Commission 2015 autumn forecast, the structural balance is expected to improve in line with the required adjustment in 2015. Regarding 2016, the Commission 2015



autumn forecast points to a risk of significant deviation from the MTO following an overall assessment.