Eurogroup

Brussels, 22 November 2019
(OR. en)

EG 41/19
ADD 1

EUROGROUP 42
ECOFIN 1040
UEM 368

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	20 November 2019
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2019) 921 final
Subject:	COMMISSION STAFF WORKING DOCUMENT Analysis of the Draft Budgetary Plan of Lithuania Accompanying the document COMMISSION OPINION on the Draft Budgetary Plan of Lithuania
Enclosed:	SWD(2019) 921 final

Delegations will find attached document SWD(2019) 921 final.

EUROPEAN
COMMISSION

Brussels, 20.11.2019
SWD(2019) 921 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of Lithuania

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Lithuania

{C(2019) 9111 final}

COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of Lithuania

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Lithuania

1. INTRODUCTION

Lithuania submitted its Draft Budgetary Plan for 2020 on 15 October 2019 in compliance with Regulation (EU) No 473/2013. 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. Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn 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 2019 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. A box on the application of constrained judgement is contained in this section for Lithuania as it is flagged by the plausibility tool. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2019, 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

In 2018, real GDP growth reached 3.6%. According to the macroeconomic scenario, which serves as a basis for the Draft Budgetary Plan, real GDP growth is expected to stand at 3.7% in 2019 and then moderate to 2.4% in 2020. Compared to the Stability Programme, GDP growth forecast for 2019 was revised up by 1.1 percentage points as economic momentum remained unexpectedly strong in the first half of 2019.

The macroeconomic scenario assumes domestic demand as the main growth driver in 2019 and 2020. Solid wage growth and lower labour taxation as well as increases in social benefits are set to support consumption, while an accelerated use of the EU funds is projected to boost investment. Compared with the Stability programme, the macro scenario projects stronger growth of gross fixed capital formation (2 percentage points higher) in 2019 and a higher contribution from net trade, as less dynamic exports (-0.5 percentage points) are to be outpaced by a stronger reduction in imports (-0.8 percentage points) in 2020. Harmonised Index of Consumer Prices inflation is forecast to be slightly higher due to notable increases in gas and electricity prices as well as price hikes of some food products.

The Commission forecasts similar real GDP growth rates in 2019 and 2020. As in the scenario underlying the Draft Budgetary Plan, the Commission projects domestic demand as the main growth driver for 2019, but with private consumption growth 0.6 percentage points weaker and investment performance 0.5 percentage points stronger. For 2020, the Commission autumn forecast points to somewhat slower growth of the GDP components.

For 2019 and 2020, according to the Draft Budgetary Plan, the output gap as recalculated by the Commission following the commonly agreed methodology is 3.9% and 2.4%, respectively. The Commission 2019 autumn forecast envisages an identical estimate of the output gap for 2019 and a marginally lower positive output gap for 2020.

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.6	2.6	3.7	3.8	2.4	2.4	2.4
Private consumption (% change)	3.7	3.9	3.9	3.3	3.8	3.9	3.2
Gross fixed capital formation (% change)	8.4	5.5	7.5	8.0	4.9	4.9	4.4
Exports of goods and services (% change)	6.3	4.1	4.7	6.8	4.4	3.9	3.6
Imports of goods and services (% change)	6.0	5.0	5.1	7.1	4.8	4.0	4.6
Contributions to real GDP growth:							
- Final domestic demand	4.1	3.8	4.2	3.9	3.6	3.6	3.0
- Change in inventories	-0.8			0.0			0.0
- Net exports	0.4	-0.6	-0.2	0.0	-0.2	0.0	-0.6
Output gap[1]	3.6	2.7	3.9	3.9	1.4	2.4	2.3
Employment (% change)	1.4	0.5	0.7	0.2	0.2	0.1	0.1
Unemployment rate (%)	6.2	5.9	6.0	6.2	5.9	5.9	6.2
Labour productivity (% change)	2.2	2.1	2.9	3.6	2.3	2.3	2.3
HICP inflation (%)	2.5	2.2	2.4	2.4	2.2	2.3	2.2
GDP deflator (% change)	3.3	2.3	3.3	3.6	2.2	2.7	3.3
Comp. of employees (per head, % change)	7.7	8.0	8.3	7.0	6.4	7.4	4.4
Net lending/borrowing vis-à-vis the rest of	1.8	1.8	3.4	2.8	1.1	3.3	3.2

Note:

[1]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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

Table 1. Comparison of macroeconomic developments and forecasts

Overall, the Draft Budgetary Plan's macroeconomic scenario and the Commission 2019 autumn forecast are in line, with similar GDP growth figures for 2019 and 2020. Thus, in the Commission's view, the Draft Budgetary Plan is based on plausible macroeconomic assumptions.

Risks to the macroeconomic scenario underpinning the Draft Budgetary Plan are tilted to the downside, linked to uncertainty related to international trade and regional geopolitical tensions.

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

The macroeconomic forecast underlying the Draft Budgetary Plan for 2020 was prepared by the Ministry of Finance and published on its website on 11 September 2019. The macroeconomic scenario was reviewed by the National Audit Office of Lithuania which carries out the function of an independent fiscal institution via its Budget Policy Monitoring Department.

On 19 September, the Budget Policy Monitoring Department issued a positive opinion of the economic scenario and submitted it to the Parliament. In its opinion the National Audit Office also shared the views of the Ministry of Finance on the main downside risks to the macroeconomic scenario. The opinion was also published on the website of the National Audit Office[1] and the website of the Ministry of Finance.

In addition to the macroeconomic forecast, the Draft Budgetary Plan for 2020 was submitted to the National Audit Office. In line with the Law on the National Audit Office, the independent fiscal institution is expected to publish its opinion by mid-November.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

According to the Draft Budgetary Plan, general government balance in 2019 is projected to be 0.3 percentage points lower compared with the target in the Stability Programme. This is explained by a smaller than previously expected surplus of the State Social Insurance Fund and higher than planned expenditure of the state budget. For 2019, the Commission forecast of revenue and expenditure as well as the nominal balance is slightly more cautious.

For 2020, the projected general government surplus in the Draft Budgetary Plan and the Stability Programme are in line, i.e. 0.2% of GDP. However, the Draft Budgetary Plan anticipates notably higher revenue and expenditure levels.

The Commission forecasts a balanced general government budget in 2020. The projected level of revenues is lower compared to the Draft Budgetary Plan due to a slightly lower growth forecast of relevant tax bases, i.e. consumption and wages, and a more conservative assessment of additional revenues linked to improvements in the tax administration. On the expenditure side, the Commission assumes a more gradual increase in government spending.

In structural terms, the Draft Budgetary Plan envisages a (recalculated) structural balance[2] of -1.5% of GDP in 2019, which is set to improve to -0.8% of GDP in 2020. For both years, the expected (recalculated) structural balance is worse compared with the Stability programme as a result of lower surplus forecasts and larger positive output gaps. The Commission autumn forecast of structural balance is only slightly worse than the (recalculated) structural balance of the Draft Budgetary Plan. This mainly stems from different projections of the nominal balance. Both the Draft Budgetary Plan and the Commission autumn forecast point to an expansionary fiscal stance in 2019, followed by a fiscal consolidation in 2020.

As indicated in the Draft Budgetary Plan, there are a few important risks to the medium term fiscal outlook. These include implementation risks in view of upcoming elections and risks linked to the recording of military expenses following the principles of accrual-based accounting, i.e. certain expenses will be recorded once goods and services are delivered, but there is some uncertainty linked to the time of their delivery.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Lithuania currently standing at 0.31[3]. As a consequence, total interest payments by the general

[1] http://www.vkontrole.lt/bp/isvada.aspx?id=10317

[2] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[3] 10-year bond yields, average of September 2019. Source: Eurostat.

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 0.9% of GDP in 2018 to 0.8% in 2020 and is projected to decrease further next year, to 0.5% of GDP, well below the 2% recorded in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Member States' plans is broadly confirmed by the Commission forecast.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2018		2019			2020			Change: 2018-2020
	COM	DBP	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**34.6**	**34.6**	**36.0**	***35.5***	**34.9**	**36.0**	***36.7***	**35.4**	**2.1**
of which:									
- Taxes on production and imports	11.5	11.5	11.8	*11.5*	11.3	12.0	*12.1*	11.6	0.6
- Current taxes on income, wealth,	5.7	5.7	8.5	*8.7*	8.6	8.6	*9.0*	8.7	3.3
- Capital taxes	0.0	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	13.0	13.0	10.4	*10.1*	10.0	10.6	*10.6*	10.3	-2.4
- Other (residual)	4.4	4.4	5.3	*5.2*	5.0	4.8	*5.0*	4.8	0.6
Expenditure	**34.0**	**34.0**	**35.5**	**35.4**	**34.9**	**35.9**	**36.5**	**35.4**	**2.5**
of which:									
- Primary expenditure	33.2	33.2	34.6	34.6	34.2	35.2	36.0	34.9	2.8
of which:									
Compensation of employees	9.8	9.8	9.6	9.7	9.7	9.6	10.0	9.9	0.2
Intermediate consumption	4.4	4.4	5.0	5.0	4.8	4.8	5.0	4.7	0.6
Social payments	13.5	13.5	14.1	13.9	13.8	14.7	14.6	14.4	1.1
Subsidies	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	-0.1
Gross fixed capital formation	3.2	3.2	3.7	3.6	3.5	3.7	3.8	3.7	0.6
Other (residual)	1.8	1.8	1.9	2.1	2.1	2.1	2.3	2.0	0.5
- Interest expenditure	0.9	0.9	0.9	0.8	0.8	0.7	0.5	0.5	-0.4
General government balance (GGB)	**0.6**	**0.6**	**0.4**	**0.1**	**0.0**	**0.2**	**0.2**	**0.0**	**-0.4**
Primary balance	**1.5**	**1.5**	**1.3**	**0.8**	**0.8**	**0.8**	**0.7**	**0.5**	**-0.8**
One-off and other temporary measures	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
GGB excl. one-offs	**0.6**	**0.6**	**0.3**	**0.0**	**0.0**	**0.2**	**0.2**	**0.0**	**-0.4**
Output gap[1]	3.6	3.8	2.7	3.9	3.9	1.4	2.4	2.3	-1.4
Cyclically-adjusted balance[1]	-0.9	-0.9	-0.7	-1.5	-1.5	-0.4	-0.8	-0.9	0.2
Structural balance (SB)[2]	**-0.8**	**-0.9**	**-0.8**	**-1.5**	**-1.6**	**-0.4**	**-0.8**	**-0.9**	**0.2**
Structural primary balance[2]	0.0	0.0	0.1	-0.7	-0.8	0.3	-0.3	-0.4	-0.2

Notes:

[1] 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.

[2] Structural (primary) balance corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.2. Debt developments

In 2018, the debt-to-GDP ratio stood at 34.1% of GDP, which is the lowest since 2010. Due to accumulated pre-financing for upcoming bond redemptions, scheduled at the beginning of 2020, the Draft Budgetary Plan projects the gross government debt to reach 36.4% of GDP in 2019. This is 0.6 percentage points lower compared with the Stability Programme and is mainly linked to higher debt-reducing effects stemming from nominal GDP growth.

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**34.1**	**37.0**	**36.4**	**36.3**	**36.2**	**35.1**	**35.1**
Change in the ratio	-5.3	2.9	2.3	2.2	-0.8	-1.3	-1.2
Contributions[2]:							
1. Primary balance	**-1.5**	**-1.3**	**-0.8**	**-0.8**	**-0.8**	**-0.7**	**-0.5**
2. "Snow-ball" effect	**-1.7**	**-0.7**	**-1.4**	**-1.6**	**-1.0**	**-1.3**	**-1.5**
Of which:							
Interest expenditure	0.9	0.9	0.8	0.8	0.7	0.5	0.5
Real growth effect	-1.3	-0.8	-1.2	-1.2	-0.8	-0.8	-0.8
Inflation effect	-1.2	-0.8	-1.0	-1.1	-0.8	-0.9	-1.1
3. Stock-flow adjustment	**-2.1**	**4.9**	**4.6**	**4.6**	**1.1**	**0.7**	**0.8**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

[2] 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 effects.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

For 2020, the Draft Budgetary Plan, compared with the Stability Programme, envisages a more evident decline in the debt ratio. A notably lower forecast of the debt stock at the end of 2019 and lower than previously planned interest expenditure as well as a stronger effect of a larger denominator are set to drive the debt-to-GDP ratio down to 35.1%. Stock flow adjustments are set to amount to 0.7% of GDP, as the government plans to prepare for the bond redemptions scheduled in 2021.

Despite marginal differences in the forecast of general government primary balances and deflators, overall, the debt projections in the Draft Budgetary Plan and the Commission 2019 autumn forecast are in line for 2019 and 2020.

Risks related to the debt projections are balanced as public guarantees are set to stand at just 0.8% of GDP in 2019 and 1.1% of GDP in 2019.

3.3. Measures underpinning the draft budgetary plan

For 2020, the Draft Budgetary Plan includes 33 discretionary revenue measures with a cumulative positive budgetary impact of around 1.2% of GDP and 18 discretionary expenditure measures having a negative budgetary impact of 0.9% of GDP (see Table 4).

Approximately two thirds of the discretionary revenue measures are small-scale tax adjustments, totalling 0.2% of GDP in additional tax receipts. The biggest positive effects are expected to come from improvements in tax administration (0.4% of GDP) and termination of transfers from the State Social Insurance Fund to private pension funds (0.4% of GDP).

The revenue projections also comprise a few newly announced taxes, namely taxes on participants of the financial markets and on turnover of large retailers as well as tax on vehicle-emitted pollution. Overall, these new measures are expected to bring additional revenues amounting to 0.2% of GDP.

The introduction of vehicle taxation and increasing the base of real estate tax are in line with the country-specific recommendation[4], namely to broaden the tax base to sources less detrimental to growth and address income inequality, poverty and social exclusion, including by improving the design of the tax and benefit system. At the same time, it was decided to slow increases in the tax-free allowance which leads to a smaller than previously planned negative effect on public finances and lesser support to low wage earners.

On the expenditure side, planned wage increases in the public sector are set to result in approximately 0.4% of GDP higher government spending. Increases in social benefits and other types of social support should amount to 0.6% of GDP in 2020.

The measures included in the Draft Budgetary Plan have been incorporated in the Commission 2019 autumn forecast, although the Commission has more conservative estimates of revenues from improved tax compliance. This somewhat explains differences in general government balances forecast by the Commission and in the Draft Budgetary Plan.

[4] Council Recommendation of 9 July 2019 on the 2019 National Reform Programme of Lithuania and delivering a Council opinion on the 2019 Stability Programme of Lithuania, OJ C 301, 5.9.2019, p. 91.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan

A. Discretionary measures taken by General Government - revenue side

Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Taxes on production and imports	0.3	0.6
Current taxes on income, wealth, etc.	2.9	0.1
Capital taxes		
Social contributions	-3.1	0.5
Property Income		
Other	0.0	-0.1
Total	**0.1**	**1.2**

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source:

Draft Budgetary Plan for 2020

B. Discretionary measures taken by general Government- expenditure side

Discretionary measures taken by General Government - expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Compensation of employees	0.5	0.4
Intermediate consumption	0.0	0.0
Social payments	0.5	0.6
Interest Expenditure		
Subsidies		
Gross fixed capital formation		
Capital transfers		
Other	0.1	0.0
Total	**1.0**	**0.9**

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source:

Draft Budgetary Plan for 2020

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

Lithuania is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position, which ensures compliance with its medium-term budgetary objective of -1.0% of GDP, taking into account the allowance linked to the implementation of the structural reforms for which a temporary deviation is granted. This allowance, amounting to 0.5% of GDP, was granted in 2017 and is carried forward for three years until 2019. The Draft Budgetary Plan contains an annex on the outcomes of the implemented structural reforms.

In 2019, according to the Draft Budgetary Plan the (recalculated) structural budget balance is expected to stand at -1.5% of GDP, i.e. it deviates from the country's medium-term budgetary objective by the allowance linked to the structural reforms, therefore meeting its medium-term budgetary objective adjusted for temporary deviation allowance.

The Commission 2019 autumn forecast projects the structural balance to stand at -1.6% of GDP, close to the medium-term budgetary objective after taking into account the allowance linked to the structural reforms (gap of 0.1%). However, according to the plausibility tool indications, there is a large uncertainty around the output gap estimations (see Box 2). This implies that the actual structural deficit in 2019 might be lower.

At the same time, the applicable expenditure benchmark rate for Lithuania is 7.6% in 2019, corresponding to a maximum deterioration of the structural balance by 0.9% in 2019. The expenditure benchmark would currently point to a risk of a significant deviation in 2019 based on both the Draft Budgetary Plan and the Commission 2019 autumn forecast. If the structural balance is no longer projected to be close to the medium-term budgetary objective after taking into account the allowance linked to structural reforms, in the future an overall assessment of compliance with the requirements of the preventive arm would need to take into account a possible deviation in 2019.

Overall, taking into account the distance to the medium-term budgetary objective, the current assessment based on the Commission's 2019 autumn forecast points to a risk of some deviation in 2019.

Box 2. Implementation of the "constrained judgement" approach and its impact on fiscal surveillance

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the commonly agreed methodology. To this end, the Commission developed, in consultation with the Member States, an objective screening tool based on a set of cyclically relevant indicators as well as thresholds/ranges - to signal cases when the outcomes of the common method could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. In such cases, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

Regarding Lithuania, the plausibility tool provided indications that the output gap for 2019, estimated on the basis of the commonly agreed methodology, may be counterintuitive. The output gap, as calculated on the basis of the common methodology, is estimated to have increased to 3.9% of potential GDP in 2019 (from 3.6% in 2018) and then decrease to 2.3% of potential GDP in 2020. The plausibility tool estimates the 2019 output gap at 1.8% of potential GDP, lower than the one based on the commonly agreed methodology. This result depends mainly on the lower wage inflation growth in the last years, and is confirmed by a slight decrease in GDP growth in 2018 as well as by a slight increase in short term unemployment. The estimates based on the common methodology for the output gap are above the ones derived from the HP filter (1.8% in 2019) and of IMF (0.7% in 2019)[5].

The structural balance estimates are affected by a large uncertainty over output gap estimates. In particular, the plausibility tool, based on the Commission's autumn forecast, indicates that the output gap for Lithuania could be lower than the common methodology estimate. However, in line with the applicable "freezing" rules, the requirement for 2019 is kept "frozen" for the compliance assessments during 2019, until the ex post assessment in spring 2020. If in spring 2020 the plausibility tool also indicates a high degree of uncertainty surrounding the output gap estimate for 2019, an in-depth analysis will be carried out in the Commission's assessment for 2019.

[5] https://www.imf.org/en/News/Articles/2019/07/30/pr19308-republic-of-lithuania-imf-executive-board-concludes-article-iv-consultation

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2018	2019		2020	
Initial position[1]					
Medium-term budgetary objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-0.8	-1.6		-0.9	
Structural balance based on freezing (COM)	-0.6	-1.0		-	
Position vis-a -vis the MTO[3]	At or above	At or above the MTO		At or above the MTO	
	2018	**2019**		**2020**	
(% of GDP)	**COM**	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-0.7	-0.9		0.0	
Change in structural balance[6]	0.0	-0.6	-0.7	0.8	0.7
One-year deviation from the required adjustment [7]	0.7	0.3	0.2	0.8	0.7
Two-year average deviation from the required	0.9	0.5	0.5	0.6	0.5
Expenditure benchmark pillar					
Applicable reference rate[8]	6.9	7.6		5.2	
One-year deviation adjusted for one-offs [9]	-0.5	-0.5	-0.7	0.1	0.2
Two-year average deviation adjusted for one-offs [9]	0.2	-0.5	-0.6	-0.2	-0.3

Notes

[1] 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 is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance corresponds to cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] 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 ed. 2018, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2018) was carried out on the basis of Commission 2019 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] 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.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs 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.

Source :

Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.

For 2020, the (recalculated) structural budget balance is projected at -0.8% of GDP, above the medium-term budgetary objective. The Commission forecast projects the structural balance to stand at -0.9% of GDP, i.e. above the country's medium-term budgetary objective. Therefore, according to the Draft Budgetary Plan and the Commission 2019 autumn forecast, Lithuania is expected to comply with the requirements of the preventive arm of the Stability and Growth Pact in 2020.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

For 2020, the Draft Budgetary Plan envisages an increase in the revenue-to-GDP ratio by 1.2 percentage points compared to the 2019 plan and 2.1 percentage points compared to the actual outturn in 2018. As indicated in section 3.3, 0.6 percentage point increase in the revenue level comes from additional tax receipts linked to improvements in the tax administration and newly planned taxes. There is also a notable shift from social insurance contributions (-2.4

percentage points of GDP) to personal income tax (increase of 3.3 percentage points). This reflects the outcomes of the labour taxation reform that was implemented as of 1 January 2019.

According to the Draft Budgetary plan, the expenditure-to-GDP ratio is projected to be 1.1 percentage points higher than the expected outcome of 2019 and 2.5 percentage points higher than in 2018. The most notable increases come from higher social benefits, intermediate consumption and gross fixed capital formation. The latter two categories are affected by an accelerated use of EU funds as the investment cycle matures. Consequently, the Draft Budgetary Plan does not envisage any cuts in public investment.

It should be noted that in Lithuania general government expenditure forecasts mainly rely on incremental planning. There are cases when certain expenditure items are proportionally reduced without proper expenditure reviews in order to meet desired budgetary targets. The ongoing reform of the medium term budgetary planning system is expected to address these deficiencies.

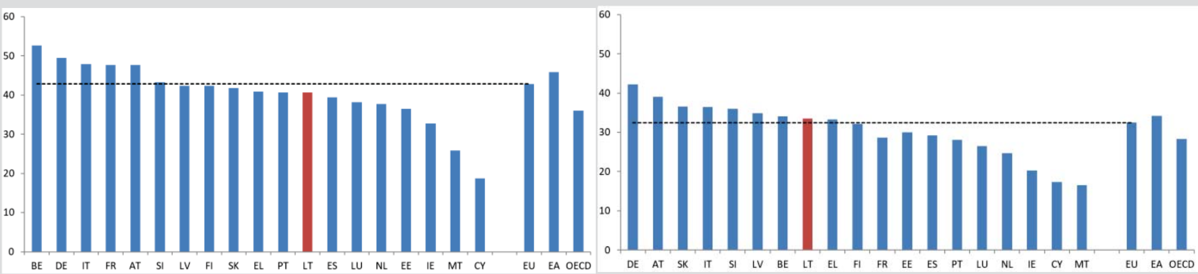
The Council, in the context of the 2019 European Semester, has recommended some fiscal structural reform measures to Lithuania, such as improving tax compliance and broadening the tax base to sources less detrimental to growth. The Draft Budgetary Plan comprises two measures – introduction of tax on vehicle-emitted pollution and broadening the real estate tax base – that are in line with the afore-mentioned recommendation. It also mentions other measures, such as strengthening of the tax administration and changes in labour taxation (see Box 3).

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 at low wage (2018)



Notes: 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 2019 European Semester, Lithuania was issued a recommendation to "(…) broaden the tax base to sources less detrimental to growth". In addition, it was also issued a recommendation to "(...) address income inequality, poverty and social exclusion, including by improving the design of the tax and benefit system".

Lithuania's Draft Budgetary Plan contains the following measures that affect the tax wedge on labour:

- Increase in tax-free allowance from EUR 300 to EUR 350 in 2020 and to EUR 400 in 2021. However, the planned increases are less ambitious compared to the initial schedule as the cost for the public finances was assessed to be too high.
- Increases in tax-free allowance up to EUR 645 for the disabled as of 1 January 2020.
- Increase of the top personal income tax rate from 27% to 32% in 2020.

The first two measures benefit low-income earners and more vulnerable groups of employees. A more in-depth analysis of the above-mentioned changes will be provided in the upcoming 2020 Country Report. The overall costs of increases in the tax-free allowances are set to be covered by revenue stemming from other adjustments to personal income tax and other tax measures.

6. Overall conclusion

Based on the Draft Budgetary Plan, in 2019, Lithuania is projected to respect its medium-term budgetary objective after taking into account the allowance linked to the structural reforms.

For 2019, according to the Commission autumn forecast, Lithuania's structural balance is expected to be only marginally below the medium-term budgetary objective after taking into account the allowance linked to the structural reforms. According to the plausibility tool indications, there is a large uncertainty around the output gap estimations (see Box 2). This implies that the actual structural deficit in 2019 might be lower. At the same time, Lithuania plans a growth rate of government expenditure, net of discretionary revenue measures, which is above the applicable expenditure benchmark rate in 2019. Following an overall assessment based on the Commission 2019 autumn forecast, taking into account the distance to the medium-term budgetary objective, there is a risk of some deviation. If the structural balance is no longer projected to be close to the medium-term budgetary objective, the future assessment of compliance with the requirements of the preventive arm would need to consider a possible deviation in 2019.

For 2020, according to both the Draft Budgetary Plan and the Commission autumn forecast, the structural balance is expected to be above the medium-term budgetary objective.