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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(2017) 8020 final}

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1. INTRODUCTION

Lithuania submitted its Draft Budgetary Plan for 2017 on 16 of October 2017 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) of -1.0% of GDP, taking into account the allowances linked to the implementation of the systemic pension reform and the structural reforms for which a temporary deviation is granted.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 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 2017 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 2017-2018 (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 the composition of public finances and implementation of fiscal-structural reforms, 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 2.3% y-o-y in 2016. The macroeconomic scenario underlying the DBP envisages a surge in real GDP growth to 3.6% in 2017 moderating to 2.9% in 2018. The scenario assumes that domestic demand will continue to support growth on the back of a robust increase of nominal wages (8.7% in 2017, 6.2% in 2018). Nevertheless, increased inflation and contracting employment due to a lack of qualified workers are expected to weigh on domestic demand growth in 2018. Acceleration in export growth in 2017 is set to transform to robust export growth in 2018, while the 2017 rebound in investment will continue at a similar pace in 2018. The inflation is forecast to reach 3.5% in 2017. This increase is partially explained by one-off factors such as a sizable increase in excise duties in the spring of 2017 and an increase in oil prices. Consequently inflation is expected to decline to 2.7% in 2018 as one-off factors wane and fiscal consolidation curbs excessive domestic demand.

Compared to the scenario underlying the Stability Programme, the growth forecast for 2017 has been revised upwards by 0.9 percentage point. That revision reflects the much stronger GDP growth during the first half of 2017 resulting from the surge in exports and robust private sector investment, which were supported by solid growth in private consumption.

For 2018, the forecast has been revised upwards by 0.3 percentage point, as the 2017 growth momentum is expected to spill over into 2018.

The output gaps as recalculated by the Commission following the commonly agreed methodology are positive for 2017 and 2018 (2.5% and 2.7% respectively). The Commission 2017 autumn forecast envisages a marginally lower positive output gaps for 2017 and 2018.

Overall, the DBP's macroeconomic projections are somewhat less positive for both 2017 and 2018 compared to those of the Commission 2017 autumn forecast, which projects real GDP growth of 3.8% and 2.9% for 2017 and 2018, respectively. The somewhat stronger Commission's outlook for 2017 is related to the solid performance of the latest economic indicators, which were not yet included in the macroeconomic scenario underlying the DBP. While the main difference is located in exports, the DBP's growth rates of private consumption as well as wages, the tax bases for personal income tax and social contributions, are broadly in line with the assumptions of the Commission 2017 autumn forecast. Thus, in the Commission's view, the DBP is based on plausible macroeconomic assumptions.

Risks to the macroeconomic scenario underpinning the DBP are tilted to the downside, but lower compared to the scenario underlying the Stability Programme. There is a perceived uncertainty in the economic environment due to regional geopolitical tensions and challenges confronting a recovery in Lithuania's main export markets. As for domestic developments, the rapid increase in wages is being transmitted to higher service prices posing a risk of causing a wage-price spiral.

According to the Commission 2017 autumn forecast, those risks could be partially countered by cautious optimism about a strengthening recovery in Lithuania's main export markets. Moreover, Lithuania's debt-to-GDP ratio is expected to decline over the medium term.

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

The macroeconomic forecast underlying the Draft Budgetary Plan for 2018 was prepared by the Ministry of Finance and published on its website on 11 September 2017. 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 20 September, the Budget Policy Monitoring Department issued a positive opinion of the economic scenario and submitted it to the Parliament.

The National Audit Office was granted the function of independent fiscal institution on 1 January 2015. The procedure guiding the endorsement process was agreed in a Memorandum of Understanding between the Ministry of Finance and the National Audit Office signed on 29 April 2015.

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 published on the website of the National Audit Office and the website of the Ministry of Finance.

In addition to the macroeconomic forecast, the Draft Budgetary Plan for 2018 was also submitted to the National Audit Office. According to the Law on National Audit Office, the independent fiscal institution should publish its opinion by 15 November 2017.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.3	2.7	3.6	3.8	2.6	2.9	2.9
Private consumption (% change)	4.9	3.9	4.2	3.9	3.6	3.7	3.4
Gross fixed capital formation (% change)	-0.5	5.9	6.3	6.4	5.4	6.0	5.1
Exports of goods and services (% change)	3.5	3.8	9.3	10.4	3.9	6.6	5.3
Imports of goods and services (% change)	3.5	4.6	10.3	10.8	4.8	7.4	6.0
Contributions to real GDP growth:							
- Final domestic demand	3.2	4.0	4.2	4.0	3.7	3.6	3.5
- Change in inventories	-0.8			0.0			0.0
- Net exports	-0.1	-0.5	-0.6	-0.2	-0.7	-0.7	-0.5
Output gap[1]	1.0	1.1	2.5	2.4	0.8	2.7	2.5
Employment (% change)	2.0	0.8	-0.2	-0.3	0.3	-0.3	-0.3
Unemployment rate (%)	7.9	7.1	7.0	7.3	6.4	6.4	6.8
Labour productivity (% change)	0.4	1.9	3.8	4.1	2.3	3.2	3.2
HICP inflation (%)	0.7	3.4	3.5	3.8	2.7	2.7	2.9
GDP deflator (% change)	1.0	2.3	3.2	3.5	1.8	2.4	3.9
Comp. of employees (per head, % change)	6.2	6.7	8.7	8.4	6.1	6.2	6.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.9	1.6	0.5	0.3	1.1	1.2	0.9

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

For 2017, the DBP expects a general government surplus of 0.1% of GDP compared to a deficit of 0.4% in the Stability Programme. That improvement is due to lower-than-expected insurance pay-outs by the State Deposit and Investment Insurance Company and better-than-expected revenues of the social insurance funds and local governments. The Commission 2017 autumn forecast expects the same general government surplus of 0.1% of GDP for 2017 supported by the trend of robust tax revenue collection helped by a higher than expected increase in wages and consumption, while spending discipline is expected to have been maintained.

For 2018, the DBP plans a general government surplus of 0.6% of GDP, which is 0.2 percentage point of GDP higher than in the Stability Programme. The surplus increase compared to the Stability Programme was planned in order to respect the fiscal discipline rules defined in the national Constitutional Law on the Implementation of the Fiscal Treaty. The government introduced some tax adjustments and a decrease in administrative expenditure to meet tighter fiscal target. The Commission 2017 autumn forecast predicts a general government surplus of 0.2% of GDP for 2018. It takes into account the measures included in the DBP, although the Commission estimates the expected extra revenues from increased tax compliance more conservatively.

According to the Commission 2017 autumn forecast, risks to the public finance forecast are tilted to the upside due to prospects of more robust growth in the tax base that may materialise only if the government maintains discipline in expenditure growth.

In structural terms, the DBP projects a (recalculated) structural balance[1] of -0.9% of GDP in 2017 and -0.5% of GDP in 2018, compared to -0.7% and -0.1% respectively in the Stability Programme. This deterioration is due to a different assessment of Lithuania's potential output and comes in spite of an improvement in the general government balance in 2017 and 2018. The Commission forecasts a structural balance of -0.9% of GDP in 2017 and -0.9% in 2018[2].

The National Audit Office of Lithuania, in its capacity of independent fiscal institution, has not yet assessed whether the 2018 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 0.31[3]. 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 1.3% of GDP in 2016 to 1.2% in 2017 and is projected to decrease further next year, to 0.9% of GDP, well below the 2.0% recorded back 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, including a 0.3% of GDP drop in interest payments in 2018, which are mostly due to the repayment of high interest loans taken during the last crisis. Part of these interest payment savings are a result of shrinking market spreads as a consequence of Lithuania's prudent fiscal policies.

Against the background of falling interest expenditure, the projected maintenance of the structural balance in 2017 and 2018 (-0.9% for both years) is accompanied by a slight deterioration in the structural primary balance (from 0.2% to 0.0%, respectively).

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

[2] The main differences between the (recalculated) structural balance of the Stability Programme and the (recalculated) DBP (as well as the Commission 2017 autumn forecast) stem from lower estimates in the DBP compared to the SP of Lithuania's potential output against the backdrop of accelerating real growth, leading to an increase in the output gap.

[3] 10-year bond yields, average of September 2017. Source: Eurostat

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**34.5**	**36.0**	***35.8***	**34.5**	**36.4**	***37.0***	**34.3**	**2.5**
of which:								
- Taxes on production and imports	11.7	12.4	*12.0*	11.7	12.5	*12.1*	11.6	0.4
- Current taxes on income, wealth, etc.	5.7	5.6	*5.6*	5.5	5.5	*5.8*	5.3	0.1
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	12.5	12.8	*12.9*	12.9	12.9	*13.4*	12.9	0.9
- Other (residual)	4.5	5.2	*5.3*	4.4	5.5	*5.7*	4.4	1.2
Expenditure	**34.2**	**36.3**	**35.7**	**34.4**	**36.0**	**36.4**	**34.0**	**2.2**
of which:								
- Primary expenditure	32.9	35.1	34.5	33.2	34.9	35.5	33.2	2.6
of which:								
Compensation of employees	9.8	9.7	9.6	9.7	9.5	9.4	9.7	-0.4
Intermediate consumption	4.8	5.5	5.5	4.7	5.5	5.6	4.6	0.8
Social payments	12.7	13.3	13.3	13.0	13.7	14.7	13.2	2.0
Subsidies	0.4	0.3	0.3	0.4	0.3	0.3	0.4	-0.1
Gross fixed capital formation	3.0	3.6	3.6	3.1	3.8	3.4	3.1	0.4
Other (residual)	2.2	2.7	2.2	2.4	2.1	2.1	2.2	-0.1
- Interest expenditure	1.3	1.3	1.2	1.2	1.0	0.9	0.9	-0.4
General government balance (GGB)	**0.3**	**-0.4**	**0.1**	**0.1**	**0.4**	**0.6**	**0.2**	**0.3**
Primary balance	**1.6**	**0.9**	**1.2**	**1.3**	**1.4**	**1.5**	**1.1**	**-0.1**
One-off and other temporary measures	0.1	-0.1	0.0	0.1	0.2	0.0	0.1	-0.1
GGB excl. one-offs	**0.2**	**-0.2**	**0.1**	**0.0**	**0.2**	**0.6**	**0.2**	**0.4**
Output gap[1]	1.0	1.1	2.5	2.4	0.8	2.7	2.5	1.4
Cyclically-adjusted balance[1]	-0.1	-0.8	-0.9	-0.8	0.1	-0.5	-0.8	-0.3
Structural balance (SB)[2]	**-0.2**	**-0.7**	**-0.9**	**-0.9**	**-0.1**	**-0.5**	**-0.9**	**-0.2**
Structural primary balance[2]	1.1	0.6	0.3	0.2	0.9	0.4	0.0	-0.6

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 = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.2. Debt developments

The general government debt projections for 2017 are similar in the DBP and the Commission 2017 autumn forecast. The government debt level is expected to fall below 40% of GDP in

2018, which is well below the 60% of GDP threshold. For 2018, the debt projections are also close when adjusted for the forecast differences in the general government surpluses. The debt decrease of 0.9% of GDP in 2017 compared to the Stability Programme can be explained by the 0.5 percentage point improvement in the general government balance, as well as by the impact of higher real GDP growth and higher inflation on the debt ratio (through the denominator). The debt stock is projected to be 0.8 percentage point lower in 2018 than planned in the Stability Programme mostly because of a lower starting level in 2017.

Risks related to the debt projections are balanced as public guarantees are at just 1.3% of GDP in 2017 and 1.2% of GDP in 2018. The DBP does not envisage any contingent liabilities linked to the financial sector.

The National Audit Office of Lithuania, in its capacity of independent fiscal institution, in its July 2017 Financial Sustainability Report assessed that over a 30 year horizon Lithuania's public debt is not expected to breach the 60% of GDP limit set in the national Constitutional Law on the Implementation of the Fiscal Treaty.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**40.1**	**42.4**	**41.5**	**41.5**	**38.4**	**37.6**	**37.9**
Change in the ratio	-2.5	2.3	1.4	1.4	-4.0	-3.9	-3.6
Contributions [2] *:*							
1. Primary balance	**-1.6**	**-0.9**	**-1.2**	**-1.3**	**-1.4**	**-1.5**	**-1.1**
2. "Snow-ball" effect	**0.0**	**-0.6**	**-1.4**	**-1.6**	**-0.7**	**-1.2**	**-1.8**
Of which:							
Interest expenditure	1.3	1.3	1.1	1.2	1.0	0.9	0.9
Growth effect	-1.0	-1.0	-1.4	-1.4	-1.0	-1.1	-1.1
Inflation effect	-0.4	-0.9	-1.2	-1.3	-0.7	-0.9	-1.5
3. Stock-flow adjustment	**-0.8**	**3.9**	**4.1**	**4.3**	**-1.8**	**-1.2**	**-0.7**
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

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The DBP includes thirty two discretionary revenue measures with a cumulative positive budgetary impact of around 0.7% of GDP in 2018 and eight discretionary expenditure measures with a similar cumulative negative budgetary impact resulting in a total net positive impact of around 0.1% of GDP in 2018 (see Table 4).

The costs of additional social spending and public salary increases are assumed to be covered by the expected revenues from a set of tax compliance measures and from increase in excise duties. The high number of discretionary revenue measures is explained by numerous albeit small-scale adjustments of various taxes. A good part of these adjustment are in line with country-specific recommendations to lower the tax burden on low income earners, provide incentives for investment in research and innovation, and improve tax compliance and broaden the tax base to sources of revenue that are less detrimental to growth.

The measures included in the DBP have been incorporated in the Commission 2017 autumn forecast, although the Commission has more conservative estimates of revenues from improved tax compliance. This explains the somewhat lower budget surplus as forecast by the Commission.

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)		
	2017	**2018**	**2019**
Taxes on production and	0.5	0.3	n.a
Current taxes on income, wealth, etc.	-0.3	0.0	n.a
Capital taxes	n.a	n.a	n.a
Social contributions	0.1	0.4	n.a
Property Income	n.a	n.a	n.a
Other	n.a	n.a	n.a
Total	0.3	0.7	n.a.

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 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	-0.3	-0.1	n.a
Intermediate consumption	0.0	0.0	n.a
Social payments	-0.5	-0.5	n.a
Interest Expenditure	n.a	n.a	n.a
Subsidies	n.a	n.a	n.a
Gross fixed capital formation	0.0	0.0	n.a.
Capital transfers	-0.1	0.0	n.a.
Other	n.a	n.a	n.a.
Total	-0.9	-0.7	n.a.

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 2018

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

Lithuania is subject to the preventive arm of the SGP and should ensure maintaining its fiscal position at the MTO defined as a structural deficit of 1% of GDP taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms for which a temporary deviation is granted. Box 2 reports on the latest country-specific recommendations in the area of public finances.

Box 2: Council Recommendations[4] addressed to Lithuania

On 11 July 2017, 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 pursue fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which implies to remain at Lithuania's medium term budgetary objective in 2018, taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms for which a temporary deviation is granted.

The Council recalled that in 2018, based on the Commission 2017 spring forecast, Lithuania should ensure that the nominal growth rate of net primary government expenditure does not exceed 6.4%, corresponding to a deterioration in the structural balance of -0.6% of GDP.

In 2017, 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 and from a temporary deviation of 0.4% linked to structural reform clause. Lithuania started 2017 from an initial position above its MTO. According to the information provided in the Draft Budgetary Plan, with the (recalculated) structural deficits of -0.9% and -0.5% of GDP in 2017 and 2018, respectively, Lithuania is expected to remain above its medium-term objective also in 2017 and 2018, which is in line with the Commission 2017 autumn forecast. The (recalculated) structural balance is expected to deteriorate in 2017 by 0.7% of GDP, which is less than the allowed deterioration of 1.3% of GDP. Therefore, the assessment of the (recalculated) DBP points to compliance with the provisions of the SGP in 2017. This is also confirmed by the Commission 2017 autumn forecast. Given that both signals are consistent, Lithuania is considered to be compliant with the provisions of the SGP in 2017.

For 2018, Lithuania continues to benefit from a total temporary deviation of 0.5% from the required adjustment path towards the MTO linked to the pension reform clause and to the structural reform clause. In 2018, based on the agreed freezing principles, Lithuania starts from an initial position 0.1% of GDP above its MTO. The (recalculated) structural balance is expected to improve in 2018 by 0.4 percentage point of GDP compared with the allowed deterioration of 0.6% of GDP. The (recalculated) projections of the DBP indicate that structural deficit pillar will be complied with in 2018. The Commission 2017 autumn forecast also projects that Lithuania will maintain a structural position above the MTO, i.e. the structural deficit is expected to remain at -0.9% of GDP. Lithuania is thus considered to be compliant with the provisions of the SGP in 2018.

Following an assessment based on the Draft Budgetary Plan and the Commission 2017 autumn forecast, Lithuania plans to ensure maintaining its fiscal position at the MTO defined as a structural deficit of 1% of GDP taking into account the allowances linked to the implementation of the systemic pension reform and of the structural reforms for which a temporary deviation is granted.

[4] OJ C 261, 9.8.2017.

Table 5. Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-0.2	-0.9		-0.9	
Structural balance based on freezing (COM)	-0.2	-0.9		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]					
Required adjustment corrected[5]					
Change in structural balance[6]					
One-year deviation from the required adjustment [7]					
Two-year average deviation from the required adjustment [7]					
Expenditure benchmark pillar	Compliance				
Applicable reference rate[8]					
One-year deviation adjusted for one-offs [9]					
Two-year average deviation adjusted for one-offs [9]					
PER MEMORIAM: One-year deviation [10]					
PER MEMORIAM: Two-year average deviation [10]					
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Compliance	Compliance
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance

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 (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = 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, 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 2016) was carried out on the basis of Commission 2017 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.

[10] 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.

Source :

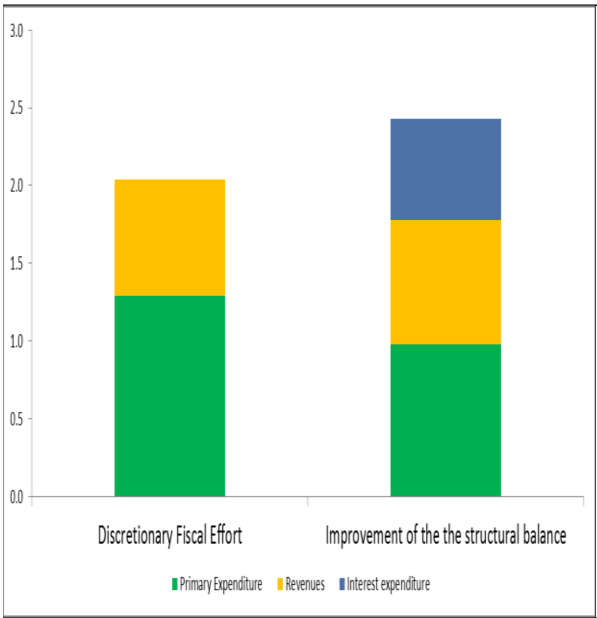
Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

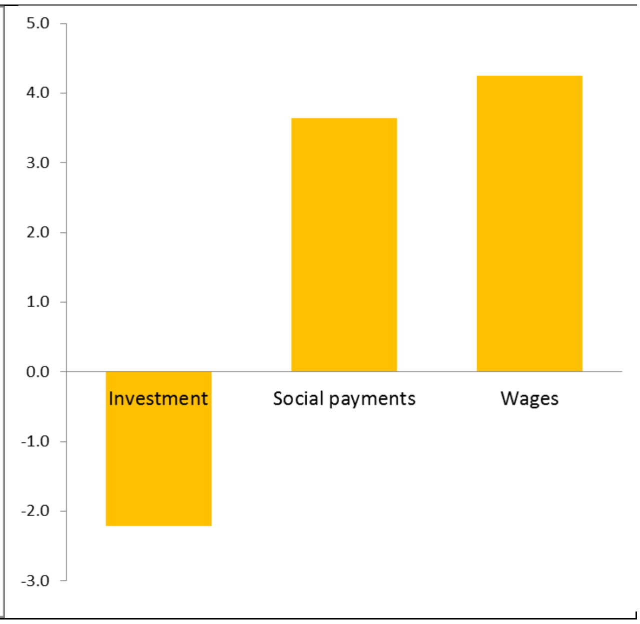
5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

In 2018, the size of planned adjustments in revenues and expenditure are expected to coincide, although in the past the fiscal effort has generally depended more on expenditure cuts rather than on lifting revenues. Legislative changes and an improvement in tax compliance in 2018 are expected to increase revenues by 0.3% of GDP from taxes on production and by 0.4% of GDP from social insurance contributions.

On the expenditure side, the amount of the social payments is set to increase by 0.5% of GDP, which is in line with the long term trend and strong emphasis of the government on addressing social issues in recent years. Contrary to the long-term trend, no cuts in public investment are scheduled, especially taking into account the need to accelerate the absorption of EU funds.

Graph 1: Composition of the fiscal effort (2011-2017), Lithuania (% GDP)	**Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Lithuania (% change)**





Source:

Draft Budgetary Plans 2018, European Commission 2017 autumn forecast. Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

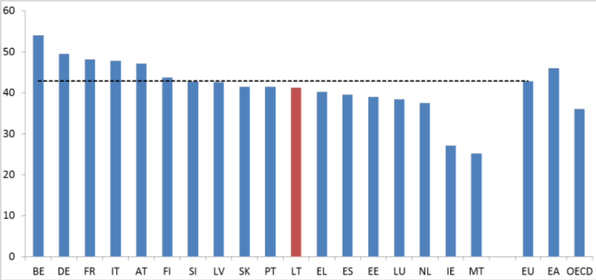
On 11 July 2017, the Council, in the context of the 2017 European Semester, has recommended to Lithuania a number of fiscal structural reform measures, such as improving tax compliance and broadening the tax base to sources that are less detrimental to growth and taking steps to address the medium term fiscal sustainability challenge related to pensions. The DBP explicitly refers to those structural country-specific recommendations. 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 Lithuania plans advancing the use of a new smart tax administration information system, simplifying tax accounting for small businesses, implementing the automatic exchange of tax information with foreign jurisdictions. The government has planned an increase in excise duties and in some environmental taxes. It also set a minimum threshold of pension social insurance contributions (see box 3).

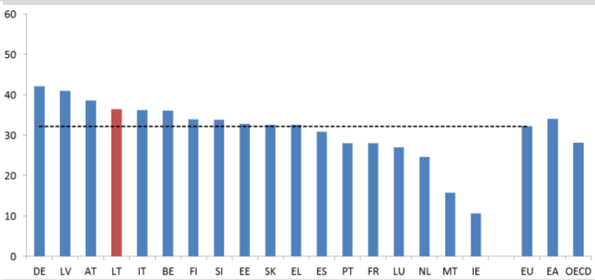
Box 3: Addressing the tax burden on labour in the euro area

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 (2016)





Notes: 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 2017 European Semester, Lithuania was issued the recommendation to "(…) broaden the tax base to sources that are less detrimental to growth".

Lithuania's Draft Budgetary Plan contains the following measures that affect the tax wedge on labour: 1) further adjustments to the tax-exempt amount of personal income tax; and 2) introduction of the minimum threshold for pension social insurance contributions paid by the employers.

From 1 January 2018 the tax-exempt amount of personal income for the minimum wage earners is set to increase from EUR 310 to EUR 380. The tax-exempt amount is decreasing proportionally as the level of income raises until it becomes inapplicable. In addition, the tax-exempt amount for the persons with reduced capacity to work is set to increase from EUR 390 to EUR 450. Moreover, the tax-exempt amount of income tax for working parents will be replaced by the direct payments for their children as under the current scheme a number of parents are unable to use this tax benefit due to low wages.

Another measure – setting a minimum threshold of pension social insurance contributions paid by the employers – is planned to be introduced to guarantee stronger social insurance coverage for employees receiving lower than a minimum monthly wage. A relatively large share of employees is working part time and they receive less than a minimum monthly wage. This leaves them more socially vulnerable once they reach their retirement age. Therefore, starting from 1 January 2018, the minimum monthly wage will serve as a basis to calculate employer's pension contributions when an employee is paid less than the minimum monthly wage.

The two above-mentioned measures are part of a larger set of amendments to the social and tax system in Lithuania that were proposed in the middle of 2017 and should help to reduce poverty, support families as well as increase fairness, according to the Ministry of Finance. Based on its calculations, increases in the tax-exempt amount of personal income should result in revenue losses of round 0.2% of GDP in 2018, but a change in pension payments should offset these losses.

In 2017, Lithuania was granted a temporary deviation of 0.4% of GDP from the required adjustment path towards the MTO linked to the structural reform clause. The main aims of the reform are to strengthen the sustainability and adequacy of the pension system and address labour market regulatory bottlenecks. Measures related to the pension reform have been implemented from the start of 2017, while the labour market and associated reform measures entered into force in July 2017. The pension part of the structural reform package strengthened a rules-based pension indexation system enacting increases based on labour market trends and available financing to ensure consistent adjustment of pensions, while securing financial soundness of the pension system. The reform also envisages a gradual increase of the required length of service before becoming pensionable to counteract a worsening dependency ratio. The labour market part of the reform updated the regulation of labour relations to fit the needs of a catching-up economy, especially through setting more flexible rules for employment contracts, while at the same time strengthening the coverage and adequacy of the unemployment and social insurance benefits. The Commission concluded that the structural reform was set to have a positive impact on the sustainability of public finances, including on the sustainability of public debt. This conclusion continues to hold.

A boost in tax-rich economic growth in 2017 improved the financial position of the pension system in a short-term, but the reform aim to address longer term sustainability issues remains valid. As for the labour market part, reform aims became even more pertinent. At the start of 2017, after six years of employment growth, the number of employed persons started to shrink as an increase in the participation rate was outweighed by negative demographic trends and emigration. More flexible employment conditions introduced from the middle of 2017 are expected to support an increase in the participation rate, counteracting the shrinking working age population.

6. OVERALL CONCLUSION

The assessment based on the (recalculated) Draft Budgetary Plan, as well as the assessment based on the Commission's 2017 autumn forecast, point to Lithuania remaining above the medium-term objective in 2017 and 2018 and thus to compliance with the rules of the preventive arm of the Pact.