Brussels, 21.11.2018
SWD(2018) 520 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(2018) 8020 final}

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**COMMISSION OPINION**

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## 1. INTRODUCTION

Lithuania submitted its Draft Budgetary Plan for 2019 on 15 October 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 (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2018 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 2018 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 2018-2019 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018, 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

Following a statistical data revision, real GDP growth in 2017 was adjusted upwards from 3.8% to 4.1%. According to the macroeconomic scenario, which was prepared before the data revision and which serves as a basis for the Draft Budgetary Plan, real GDP growth is expected to moderate to 3.4% in 2018 and to 2.8% in 2019. The scenario assumes that consumption and investment should be the main economic drivers in 2018 and 2019 while net exports are set to have a negative contribution to GDP growth. As the labour market is expected to continue tightening, wage dynamics and tax cuts are forecast to give a positive impetus to consumption growth (4.3% in 2018 and 2019). It should also be supported by a

decrease in inflation (from 3.7% in 2017 to 2.5% in 2019). Labour shortages, high capacity utilisation and a greater use of EU funds are expected to spur private investment growth to 9.0% in 2018 and 5.5% in 2019.

Compared to the scenario underlying the Stability Programme, the growth forecast for 2018 increased by 0.2 percentage points, linked to stronger than expected consumption and investment growth in the first half of 2018. Compared to the previous scenario, growth of both exports and imports are forecast to be lower, resulting in a somewhat smaller negative contribution of net exports. For 2019, GDP growth projections remained the same as in spring 2018, although the composition changed with an upward revision of consumption and gross fixed capital formation growth.

For 2018 and 2019, the output gap as recalculated by the Commission following the commonly agreed methodology is 2.9% and 2.2%. The Commission 2018 autumn forecast envisages a marginally lower positive output gaps for both years.

Overall, the Draft Budgetary Plan's macroeconomic scenario and the Commission 2018 autumn forecast are in line, with similar GDP growth figures for 2018 and 2019 and with buoyant consumption and investment growth as the main drivers. 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. In addition, according to the DBP, business and consumer expectations might decline due to higher unpredictability of the economic environment. This could translate into a negative effect on consumption and investment.

**Box 1: The macroeconomic forecast underpinning the budget in Lithuania**

The macroeconomic forecast underlying the Draft Budgetary Plan for 2019 was prepared by the Ministry of Finance and published on its website on 12 September 2018. 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 works under a legal framework that ensures its independence and has a long standing reputation as a body independent from the government. The National Audit Office was granted the function of an independent fiscal institution on 1 January 2015, following the adoption of the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania in November 2014. This law provides that the fiscal institution should not accept instructions from any other institution or person. 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 2019 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.

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

| | 2017 | 2018 | | | 2019 | | |
|---|---|---|---|---|---|---|---|
| | COM | SP | DBP | COM | SP | DBP | COM |
| Real GDP (% change) | 4.1 | 3.2 | 3.4 | 3.4 | 2.8 | 2.8 | 2.8 |
| Private consumption (% change) | 3.3 | 4.0 | 4.3 | 4.2 | 3.8 | 4.3 | 3.9 |
| Gross fixed capital formation (% change) | 6.8 | 7.6 | 9.0 | 7.3 | 5.3 | 5.5 | 5.3 |
| Exports of goods and services (% change) | 13.6 | 7.0 | 5.7 | 5.2 | 5.7 | 5.1 | 4.1 |
| Imports of goods and services (% change) | 12.0 | 7.6 | 6.0 | 6.5 | 6.5 | 5.8 | 5.2 |
| *Contributions to real GDP growth:* | | | | | | | |
| - Final domestic demand | 3.4 | 4.3 | 4.8 | 4.2 | 3.8 | 4.2 | 3.6 |
| - Change in inventories | -0.6 | | | 0.0 | | | 0.0 |
| - Net exports | 1.3 | -0.4 | -0.1 | -0.8 | -0.6 | -0.6 | -0.8 |
| Output gap[1] | 2.7 | 2.3 | 2.9 | 2.8 | 1.3 | 2.2 | 2.0 |
| Employment (% change) | -0.5 | -0.4 | 0.3 | -0.4 | -0.5 | -0.3 | -0.5 |
| Unemployment rate (%) | 7.1 | 6.5 | 6.3 | 6.5 | 6.1 | 5.9 | 6.3 |
| Labour productivity (% change) | 4.7 | 3.7 | 3.1 | 3.8 | 3.4 | 3.1 | 3.3 |
| HICP inflation (%) | 3.7 | 2.9 | 2.7 | 2.6 | 2.4 | 2.5 | 2.2 |
| GDP deflator (% change) | 4.3 | 2.6 | 3.0 | 2.6 | 2.0 | 2.6 | 3.7 |
| Comp. of employees (per head, % change) | 8.7 | 6.6 | 8.9 | 8.2 | 6.2 | 7.5 | 7.7 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | 2.1 | 1.8 | 1.4 | 0.6 | 1.6 | 1.3 | 0.6 |

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:*

*Convergence Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations*

## 3. RECENT AND PLANNED FISCAL DEVELOPMENTS

### 3.1. Deficit developments

As in the 2018 Stability Programme, the Draft Budgetary Plan projects a general government surplus of 0.6% of GDP for 2018. For 2019, the planned general government surplus of 0.4% of GDP is 0.2 percentage points lower compared to the one indicated in the 2018 Stability Programme. This deterioration stems mainly from projected revenue losses related to labour taxation and social system adjustments (legislated in the middle of 2018) as well as newly planned wage increases in the public sector.

The Commission 2018 autumn forecast predicts a general government surplus of 0.6% and 0.4% of GDP in 2018 and 2019, respectively. Therefore, the Draft Budgetary Plan projections are in line with the Commission estimations. In general, for 2018 and 2019 revenues and

expenditures are projected to be somewhat lower in the Commission 2018 autumn forecast compared to the D raft Budgetary Plan.

In structural terms, the Draft Budgetary Plan projects a (recalculated) structural balance[1] of -0.6% of GDP in 2018, which is set to remain at that level in 2019, compared to -0.2% and -0.1% of GDP respectively in the 2018 Stability Programme. For 2018, a lower structural balance is linked to a higher output gap. The structural balance for 2019 is set to be driven down by a smaller nominal surplus and a larger positive output gap. The Commission forecast of the structural balance is broadly in line with the Draft Budgetary Plan at -0.6% of GDP in 2018 and -0.5% in 2019.

According to the Commission autumn forecast, for 2018 and 2019, the primary (recalculated) structural balance of the DBP is expected to slightly deteriorate compared to 2017. The Draft Budgetary Plan envisages that the (recalculated) structural primary balance should be 0.2 percentage point lower compared to 2017 for both 2018 and 2019. This difference is even bigger compared to the indicators in the 2018 Stability programme. Therefore, taking into account planned revenue cuts and expenditure increases, the DBP points to a slight expansion in the fiscal stance.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Lithuania currently standing at 0.31[2]. 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 1.1% of GDP in 2017 to 0.9% in 2018 and is projected to remain at 0.9% of GDP in 2019, well below the 2.0% 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.

The National Audit Office of Lithuania, in its capacity of independent fiscal institution, assessed the 2019 Draft Budgetary Plan and published their opinion on 8 November 2018. According to the National Audit Office of Lithuania, there is a risk that the 2019 Draft Budgetary Plan would not comply with the rule to improve general government structural balance.

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

[2] 10-year bond yields, average of September 2018. Source: Eurostat.

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

| (% of GDP) | 2017 | 2018 | | | 2019 | | | Change: 2017-2019 |
|---|---|---|---|---|---|---|---|---|
| | COM | CP | DBP | COM | CP | DBP | COM | DBP |
| **Revenue** | **33.6** | **36.2** | ***36.0*** | **34.9** | **36.3** | ***36.6*** | **35.3** | **3.0** |
| *of which:* | | | | | | | | |
| - Taxes on production and imports | 11.6 | 11.7 | *11.7* | 11.3 | 11.7 | *11.9* | 11.6 | 0.3 |
| - Current taxes on income, wealth, etc. | 5.4 | 5.7 | *5.6* | 5.5 | 6.0 | *8.6* | 8.4 | 3.2 |
| - Capital taxes | 0.0 | 0.0 | *0.0* | 0.0 | 0.0 | *0.0* | 0.0 | 0.0 |
| - Social contributions | 12.6 | 13.1 | *13.4* | 13.2 | 13.3 | *10.4* | 10.4 | -2.2 |
| - Other (residual) | 4.0 | 5.7 | *5.3* | 4.9 | 5.3 | *5.7* | 4.9 | 1.7 |
| **Expenditure** | **33.1** | **35.7** | **35.4** | **34.3** | **35.7** | **36.2** | **34.9** | **3.1** |
| *of which:* | | | | | | | | |
| - Primary expenditure | 32.0 | 34.8 | 34.5 | 33.4 | 34.8 | 35.3 | 34.0 | 3.3 |
| *of which:* | | | | | | | | |
| Compensation of employees | 9.5 | 9.7 | 9.1 | 9.0 | 9.5 | 9.3 | 9.0 | -0.2 |
| Intermediate consumption | 4.6 | 5.1 | 4.8 | 4.9 | 5.2 | 5.2 | 5.4 | 0.6 |
| Social payments | 12.6 | 14.5 | 13.1 | 13.0 | 14.3 | 14.0 | 13.6 | 1.4 |
| Subsidies | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.0 |
| Gross fixed capital formation | 3.2 | 3.1 | 4.0 | 3.3 | 3.5 | 3.9 | 3.4 | 0.7 |
| Other (residual) | 1.8 | 2.1 | 3.2 | 2.8 | 2.0 | 2.6 | 2.2 | 0.8 |
| - Interest expenditure | 1.1 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | -0.2 |
| **General government balance (GGB)** | **0.5** | **0.6** | **0.6** | **0.6** | **0.6** | **0.4** | **0.4** | **-0.1** |
| **Primary balance** | **1.6** | **1.5** | **1.5** | **1.5** | **1.5** | **1.3** | **1.2** | **-0.3** |
| One-off and other temporary measures | 0.0 | -0.1 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| **GGB excl. one-offs** | **0.4** | **0.7** | **0.6** | **0.6** | **0.5** | **0.3** | **0.3** | **-0.1** |
| Output gap[1] | 2.7 | 2.3 | 2.9 | 2.8 | 1.3 | 2.2 | 2.0 | -0.6 |
| Cyclically-adjusted balance[1] | -0.6 | -0.3 | -0.6 | -0.6 | 0.0 | -0.5 | -0.5 | 0.1 |
| **Structural balance (SB)[2]** | **-0.7** | **-0.2** | **-0.6** | **-0.6** | **-0.1** | **-0.6** | **-0.5** | **0.1** |
| Structural primary balance[2] | 0.5 | 0.7 | 0.3 | 0.4 | 0.8 | 0.3 | 0.4 | -0.1 |

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:*

*Convergence Programme 2018 (CP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations*

## 3.2. Debt developments

Since 2015, the general government debt-to-GDP ratio has been declining, and for 2018 the Draft Budgetary Plan envisages it to drop further to 34.8% of GDP, which is a faster decline than expected in the 2018 Stability Programme. This is partially determined by the effect of a larger denominator through higher-than-expected nominal GDP growth. For 2019, the debt stock is projected at 37.8% of GDP, which is 0.3 percentage points lower than planned in the Stability Programme, mainly linked to the lower 2018 level. The increasing debt ratio in 2019

is determined by a planned pre-financing of government bond redemptions, which are scheduled in 2020. The general government debt projections in the Draft Budgetary Plan and the Commission 2018 autumn forecast are in line for 2018 and 2019.

Overall, according to the Draft Budgetary Plan and the 2018 Commission autumn forecast, the general government debt should remain well below the 60% of GDP threshold.

Risks related to the debt projections are balanced as public guarantees are at just 0.9% of GDP in 2017 and 1.1% of GDP in 2018. The DBP does not envisage any contingent liabilities linked to the financial sector.

**Table 3. Debt developments**

| (% of GDP) | 2017 | 2018 | | | 2019 | | |
|---|---|---|---|---|---|---|---|
| | | SP | DBP | COM | SP | DBP | COM |
| **Gross debt ratio[1]** | **39.4** | **35.8** | **34.8** | **34.8** | **38.1** | **37.8** | **37.9** |
| Change in the ratio | -0.6 | -3.6 | -4.6 | -4.6 | 2.3 | 3.0 | 3.1 |
| *Contributions[2] :* | | | | | | | |
| **1. Primary balance** | **-1.6** | **-1.5** | **-1.5** | **-1.5** | **-1.5** | **-1.3** | **-1.2** |
| **2. "Snow-ball" effect** | **-2.0** | **-1.3** | **-1.5** | **-1.3** | **-0.7** | **-0.9** | **-1.2** |
| *Of which:* | | | | | | | |
| Interest expenditure | 1.1 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 |
| Growth effect | -1.5 | -1.2 | -1.3 | -1.2 | -1.0 | -0.9 | -0.9 |
| Inflation effect | -1.6 | -1.0 | -1.1 | -1.0 | -0.7 | -0.9 | -1.2 |
| **3. Stock-flow adjustment** | **3.1** | **-0.8** | **-1.6** | **-1.7** | **4.6** | **5.2** | **5.7** |
| *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:*

*Convergence Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations*

### 3.3. Measures underpinning the Draft Budgetary Plan

The DBP includes twenty eight discretionary revenue measures with a cumulative positive budgetary impact of around 0.1% of GDP and twenty two discretionary expenditure measures having a negative budgetary impact of 0.9% of GDP in 2019 (see Table 4).

Reforms of labour taxation and pension system are set to have the main impact on both revenues and expenditures. Overall, adjustments to the personal income tax and social insurance contributions are set to result in revenue loss amounting to 1% of GDP in 2019.

The revenue gap is partially mitigated by terminating transfers of the social insurance contributions from the State Social Insurance Fund (SODRA) to private pension funds, amounting to 0.4% of GDP in 2019. The Draft Budgetary Plan also envisages additional tax revenues stemming from improved tax administration (approximately 0.5% of GDP) while other smaller adjustments, e.g. to the excises on tobacco products, should result in additional government income of 0.2% of GDP. Planned wage increases in the public sector are set to result in approximately 0.5% of GDP higher government spending. Increase in social benefits and other types of social support should amount to 0.4% of GDP in 2019.

In general, adjustments to the tax and social security systems to some extent are in line with the Country Specific Recommendations[3], namely improvements to the design of the tax and benefit system to reduce poverty and income inequality and also to broaden the tax base to sources less detrimental to growth. However, the impact on poverty and income inequality still remains to be examined while efforts to broaden the tax base, which is less detrimental to growth, remain sluggish.

The measures included in the Draft Budgetary Plan have been incorporated in the Commission 2018 autumn forecast, although the Commission has more conservative estimates of revenues from improved tax compliance.

**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 | |
|---|---|---|
| | **2018** | **2019** |
| Taxes on production and imports | 0.3 | 0.3 |
| Current taxes on income, wealth, etc. | 0.1 | 3.0 |
| Capital taxes | | |
| Social contributions | 0.3 | -3.2 |
| Property Income | | |
| Other | | |
| Total | 0.7 | 0.1 |

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 2019*

[3] Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Lithuania and delivering a Council opinion on the 2018 Stability Programme of Lithuania, OJ C 320, 10.9.2018, p. 64-67.

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

| Components | Budgetary impact (% GDP) (as reported by the | |
|---|---|---|
| | **2018** | **2019** |
| Compensation of employees | 0.2 | 0.5 |
| Intermediate consumption | | |
| Social payments | 0.7 | 0.4 |
| Interest Expenditure | | |
| Subsidies | | |
| Gross fixed capital formation | | |
| Capital transfers | | |
| Other | | |
| Total | 0.9 | 0.9 |

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 2019*

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

Lithuania is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with its 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.

Lithuania benefits from the systemic pension reform in 2018 and the structural reform clause in 2018 and 2019. For both years, this leads to a total allowed temporary deviation of 0.5% of GDP.

For 2018 and 2019, the (recalculated) structural budget balance is expected to stand at -0.6% of GDP, i.e. above country's MTO. The Commission 2018 autumn forecast also points to the overachievement of the MTO in both years. However, at the same time, expenditure developments should be monitored carefully, especially in light of possible future risks to the robustness of revenues, to safeguard fiscal sustainability in line with the Stability and Growth Pact.

Overall, following an assessment based on the Draft Budgetary Plan and the Commission 2018 autumn forecast, Lithuania is expected to comply with the requirements of the preventive arm of the Stability and Growth Pact both in 2018 and 2019.

### Table 7: Compliance with the requirements of the preventive arm

| (% of GDP) | 2017 | 2018 | | 2019 | |
|---|---|---|---|---|---|
| **Initial position**[1] | | | | | |
| Medium-term objective (MTO) | -1.0 | -1.0 | | -1.0 | |
| Structural balance[2] (COM) | -0.7 | -0.6 | | -0.5 | |
| Structural balance based on freezing (COM) | -0.9 | -0.6 | | - | |
| **Position vis-a -vis the MTO**[3] | At or above the MTO | At or above the MTO | | At or above the MTO | |
| (% of GDP) | **2017** | **2018** | | **2019** | |
| | **COM** | **DBP** | **COM** | **DBP** | **COM** |
| **Structural balance pillar** | | | | | |
| Required adjustment[4] | 0.0 | 0.0 | | 0.0 | |
| Required adjustment corrected[5] | -1.3 | -0.6 | | -0.9 | |
| Change in structural balance[6] | -0.3 | 0.1 | 0.1 | 0.0 | 0.0 |
| *One-year deviation from the required adjustment* [7] | 1.1 | 0.7 | 0.7 | 0.9 | 1.0 |
| *Two-year average deviation from the required adjustment* [7] | 1.1 | 0.9 | 0.9 | 0.8 | 0.8 |
| **Expenditure benchmark pillar** | | | | | |
| Applicable reference rate[8] | 5.7 | 6.4 | | 7.6 | |
| *One-year deviation adjusted for one-offs* [9] | 0.9 | -0.7 | -0.7 | -0.3 | -0.3 |
| *Two-year average deviation adjusted for one-offs* [9] | 0.6 | 0.1 | 0.1 | -0.5 | -0.5 |

*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 20XX-1) was carried out on the basis of Commission 20XX 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 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations.*

## 5. Composition of public finances and Implementation of fiscal structural reforms

In 2019, the Draft Budgetary Plan envisages an increase in the revenue-to-GDP ratio by 0.6 percentage points compared to the 2018 plan. Due to changes in labour taxation, the share of revenues from taxes on income and wealth is set to increase by 3 percentage points next year. This is expected to offset losses stemming from cuts in the rates of social insurance contributions.

According to the Draft Budgetary Plan, the expenditure-to-GDP ratio is projected to be 0.8 percentage points higher in 2019, the highest increase being in social payments. As expenditure growth is projected to outpace revenue increases, the general government balance is set to decline accordingly. No cuts in public investment are scheduled, especially taking into account the need to accelerate the use of EU funds.

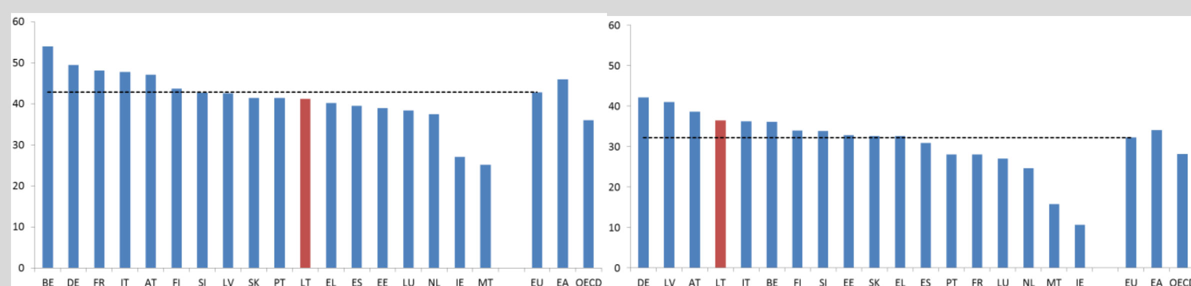
The Council, in the context of the 2018 European Semester, has recommended some fiscal structural reform measures to Lithuania, such as improving tax compliance and broadening the tax base to sources less detrimental to growth, as well as improving the design of the tax and benefit system to reduce poverty and income inequality. The Draft Budgetary Plan explicitly refers to those structural country-specific recommendations in a dedicated section. It also mentions corresponding measures, such as changes in labour taxation and strengthening of the tax administration (see box 4).

**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 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 2018 European Semester, Lithuania was issued the recommendation to "(…) broaden the tax base to sources that are less detrimental to growth". In addition, it was also issued the recommendation to "(...) improve the design of the tax and benefit system to reduce poverty and income inequality".

Lithuania's Draft Budgetary Plan contains the following measures that affect the tax wedge on labour: 1) consolidation of the social insurance contributions paid by the employers and employees and reduction of their overall rate by 0.55 percentage points; 2) adjustments to the personal income tax rate, i.e. increase in the tax rate from 15% to 20% as well as introduction of the 27% tax rate for income exceeding certain threshold; 3) increase in tax-free allowance; 4) introduction of ceilings for social insurance contributions.

Initial estimations show that reforms of personal income tax and social security contributions should result in lower tax wedge for the whole working population in 2019. A more in-depth analysis of these reforms will be provided in the upcoming 2019 Country Report.

The above-mentioned changes to the personal income tax and social insurance contributions are a part of the six reform package adopted in summer 2018. On 3 October, as requested by the Lithuanian authorities, an impact assessment of the reforms was published[4] by the contractors. According to this document, the tax wedge is set to decrease by up to 3.4 percentage points depending on the level of earnings.

## 6. OVERALL CONCLUSION

The assessment based on the (recalculated) Draft Budgetary Plan, as well as the assessment based on the Commission's 2018 autumn forecast, point to Lithuania remaining above its medium-term budgetary objective in 2018 and 2019 and thus to compliance with the rules of the preventive arm of the Pact.

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4 http://www.esinvesticijos.lt/lt/media/download?id=14753&h=833c3&t=Strukt%C5%ABrini%C5%B3%20reform%C5%B3%20poveikio%20Lietuvos%20ekonomikai%20vertinimas_suderinta.pdf