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Assessment of the 2017 stability programme for

Lithuania

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

On 28 April 2017, the Lithuanian government approved and submitted the 2017 stability programme (hereafter called stability programme), covering the period 2017-2020. The programme was presented to the Parliamentary committee after the approval by the government.

Lithuania is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position which ensures compliance with the medium-term objective.

This document complements the Country Report published on 22 February 2017 and updates it with the information included in the stability programme.

Section 2 presents the macroeconomic outlook underlying the stability programme and provides an assessment based on the Commission 2017 spring forecast. The following section presents the recent and planned budgetary developments, according to the stability programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the stability programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Lithuania's 2017 stability programme's macroeconomic scenario covers the years 2017 – 2020. In 2016, private consumption carried growth, driven by strong wage and employment growth and subdued inflation. However, a temporary slowdown in EU-funded projects weighed on investment. GDP growth is forecast to rise from 2.3% in 2016 to 2.7% in 2017 as solid investment and export growth is set to complement strong private consumption, supported by strong wage growth and expanding employment despite rising inflation. A gradual roll-out of EU funded projects should ensure strong rise in investment in both 2017 and 2018. GDP growth is expected to moderate slightly to 2 ½ % for the years 2018 - 2020.

Compared to the macroeconomic projections included in 2016 stability program, GDP growth has been revised downwards by 0.5 pps. for both 2017 and 2018. This is due to a slightly lower private consumption and considerably lower export growth.

The positive output gap, as recalculated by the Commission following the commonly agreed methodology, is expected to peak in 2017 and then moderately decrease from 2018 to 2020. A negative labour contribution to the potential output drives the opening of the output gap.

Overall, the programme's macroeconomic projections of real GDP growth in 2017 and 2018 are somewhat lower than the 2.9% and 3.1% growth forecast by the Commission. This is notably reflected in stability programme's higher projection for inflation, which weighs on public consumption by lowering real disposable income growth. Also, lower employment growth from 2018 on suggests more cautious view about the room for the labour supply to grow. As a result, while the stability programme is more cautious about the real growth than the spring forecast, the forecasts of nominal GDP growth are broadly in line given the higher inflation projected in the programme.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.3	2.3	2.9	2.7	3.1	2.6	2.5	2.4
Private consumption (% change)	5.6	5.6	3.8	3.9	3.4	3.6	3.5	3.5
Gross fixed capital formation (% change)	-0.5	-0.5	6.0	5.9	4.5	5.4	4.4	4.3
Exports of goods and services (% change)	2.9	2.9	3.5	3.8	3.7	3.9	4.0	4.1
Imports of goods and services (% change)	2.6	2.6	4.9	4.6	4.0	4.8	4.2	4.1
Contributions to real GDP growth:								
- Final domestic demand	3.7	3.7	3.8	4.0	3.3	3.7	3.4	3.4
- Change in inventories	-1.6		0.0		0.0			
- Net exports	0.2	0.2	-1.0	-0.5	-0.2	-0.7	-0.1	-0.1
Output gap[1]	0.8	1.1	1.3	1.1	1.8	0.8	0.6	0.6
Employment (% change)	2.0	2.0	0.6	0.8	0.5	0.3	0.2	0.1
Unemployment rate (%)	7.9	7.9	7.6	7.1	7.2	6.4	5.9	5.4
Labour productivity (% change)	0.3	0.3	2.2	1.9	2.6	2.3	2.3	2.3
HICP inflation (%)	0.7	0.7	2.8	3.4	2.0	2.7	2.5	2.5
GDP deflator (% change)	1.2	1.2	2.9	2.3	2.5	1.8	1.7	1.6
Comp. of employees (per head, % change)	5.0	5.0	5.1	6.7	5.6	6.1	6.2	6.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0.1	1.2	-1.4	1.6	-1.0	1.1	0.7	0.4

Note:

[1] In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2017 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

Lithuania's general government surplus reached 0.3% of GDP in 2016, after a deficit of 0.2% of GDP a year before. The 2016 outcome was significantly better than 0.8% of GDP deficit target set in the 2016 stability programme.

The improvement was a result of tax rich economic growth and overall government underspending. The buoyant labour market led to a strong collection of payroll taxes leading to a 0.5% of GDP surplus of the local governments, which rely heavily on personal income tax revenue. Expenditure of the central and local governments was also lower than planned. In addition, the balance improved by around 0.2% of GDP due to one-off revenues of the State Deposit Insurance Fund from liquidation proceeds. These developments have more than offset the loss of revenues due to an increase in non-taxable income, as well as higher spending on pensions and public wages. The social insurance fund, SoDra, continued to benefit from the robust labour market, balancing its budget in 2016 for the first time since 2007.

In 2017, the general government surplus is set to revert to a deficit of 0.4% of GDP according to the 2017 stability programme. This deficit is mostly explained by the costs of structural reforms related to the labour market and pensions (0.5% of GDP). The programme's 2017 deficit target is more ambitious than the one set in the 2017 updated Draft Budgetary Plan (0.7% of GDP). The 2016 stability programme foresaw a balanced general government budget for 2017, but it had not taken into account the costs of the 2017 structural reforms. Accounting for these costs, the 2017 general government deficit target remains close to the one set in the 2016 stability programme.

Compared with the 2016 stability programme, the government has introduced some new discretionary fiscal measures in 2017. These relate to an increase in public wages and pensions which is set to raise expenditure, while a further increase in the non-taxable income threshold is set to add to tax revenue losses. On the positive side, a number of tax increases and efforts to improve tax compliance are expected to offset part of the revenues losses. In addition, a boost in revenues from tax-rich economic growth is expected to cover the higher spending on public wages and pensions.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The programme aims to achieve a headline surplus of 1.3% of GDP by 2020, which according to the authorities would result in a structural surplus of 0.7% of GDP. The programme also seeks to bring the general government debt level below 40% of GDP by the end of the programme period.

The programme foresees staying above the MTO (set at -1.0% of GDP) in 2017 and 2018, with a structural deficit improving from 0.7% in 2017 to 0.3% of GDP in 2018. Further consolidation should result in a structural surplus by 2020. The dynamics of the recalculated structural balance[1] indicate a similar consolidation path with a somewhat stronger consolidation starting from 2018.

According to the Commission 2017 spring forecast, the structural deficit is set to stay above the MTO in 2017 at 0.9% of GDP before increasing to 1.1% of GDP in 2018. For 2017, this is broadly in line with the (recalculated) structural deficit in the programme of 0.7% of GDP. In 2018, the divergence between the Commission's estimate and the (recalculated) structural deficit is 1% of GDP and mainly due to a different forecast of the general government headline balance. On a no-policy-change basis, the Commission forecasts Lithuania to have a headline deficit of 0.2% of GDP in 2018, while the programme targets a 0.4% of GDP surplus.

The stability programme includes the costs of a structural reform (0.5% of GDP) for which Lithuania requests a temporary deviation from the required adjustment path towards the MTO in 2017 under the structural reform clause.

The planned nominal consolidation path in the 2017 stability programme is faster than the one in the updated 2017 Draft Budgetary Plan. This is in line with the Commission opinion on the updated DBP indicating the necessity to take measures to ensure compliance with the SGP. The nominal consolidation is slower than the one targeted in the 2016 programme, but once adjusted for additional costs of the structural reform, the consolidation path is similar to the one planned a year ago.

[1] Recalculated by the Commission according to the commonly agreed methodology.

Improvement in the public finances is set to pause in 2017 due to the costs of structural reforms. The objective to preserve headline surpluses from 2018 onwards and to attain a structural surplus by the end of the programme period has been maintained from the previous programme. The economic outlook is marginally weaker than predicted a year before, but growth remains robust, thus providing favourable conditions for a gradual fiscal consolidation. The Commission 2017 spring forecast projects some nominal fiscal consolidation in 2018 as well, although the structural deficit is expected to widen.

The envisaged improvement in the fiscal position over the programme period is driven by expenditures growing at a slower pace than revenues. Over the following four years, the expenditure-to-GDP ratio is expected to increase by 1.2 pps. of GDP, while the revenue-to-GDP ratio is projected to increase by 2.3 pps. of GDP. In case of revenue shortfalls, the stability programme also defines new specific discretionary revenue measures to be activated (such as reducing tax exemptions, lowering general government expenditures, broadening a real estate tax base and broadening the base of environmental taxes). The revenue growth is expected to be sustained through a strengthened tax administration and reducing tax exemptions. Specific measures in this regard are, however, not specified beyond 2017.

The Commission 2017 spring forecast does not assume an increase in either the revenue or the expenditure ratios in 2017 and 2018. It predicts a loss of revenues due to the legislated increase in non-taxable incomes and it contains lower estimates of the extra revenues from an improved tax administration. On the expenditure side, the Commission forecast assumes a continued restrained growth in spending.

The programme maintains a MTO of a structural deficit of 1% of GDP, in line with the objectives of the Stability and Growth Pact.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**34.5**	**34.0**	**36.0**	**33.8**	**36.4**	**36.3**	**36.7**	**2.3**
of which:								
- Taxes on production and imports	11.9	12.0	12.4	11.8	12.5	12.6	12.7	0.8
- Current taxes on income, wealth, etc.	5.7	5.4	5.6	5.4	5.5	5.8	5.8	0.1
- Social contributions	12.5	12.3	12.8	12.2	12.9	13.2	13.2	0.6
- Other (residual)	4.4	4.3	5.3	4.4	5.4	4.8	5.0	0.7
Expenditure	**34.2**	**34.3**	**36.3**	**34.0**	**36.0**	**36.0**	**35.4**	**1.2**
of which:								
- Primary expenditure	32.9	33.1	35.1	32.8	34.9	35.0	34.7	1.8
of which:								
Compensation of employees	9.8	9.8	9.7	9.8	9.5	9.4	9.3	-0.5
Intermediate consumption	4.8	4.7	5.5	4.7	5.5	5.3	5.3	0.5
Social payments	12.7	12.8	13.3	12.7	13.7	13.9	14.1	1.4
Subsidies	0.4	0.4	0.3	0.3	0.3	0.3	0.3	-0.2
Gross fixed capital formation	2.9	3.0	3.6	3.1	3.8	4.2	4.1	1.2
Other (residual)	2.2	2.4	2.7	2.2	2.2	2.0	1.7	-0.5
- Interest expenditure	1.4	1.2	1.3	1.2	1.0	1.0	0.7	-0.6
General government balance (GGB)	**0.3**	**-0.4**	**-0.4**	**-0.2**	**0.4**	**0.4**	**1.3**	**1.1**
Primary balance	**1.6**	**0.9**	**0.9**	**1.0**	**1.4**	**1.3**	**2.0**	**0.4**
One-off and other temporary	0.1	0.0	-0.1	0.2	0.2	0.0	0.0	-0.1
GGB excl. one-offs	**0.2**	**-0.4**	**-0.2**	**-0.4**	**0.2**	**0.3**	**1.3**	**1.1**
Output gap[1]	0.8	1.3	1.1	1.8	0.8	0.6	0.6	-0.2
Cyclically-adjusted balance[1]	-0.1	-0.9	-0.8	-0.9	0.1	0.1	1.1	1.2
Structural balance[2]	**-0.2**	**-0.9**	**-0.7**	**-1.1**	**-0.1**	**0.1**	**1.1**	**1.2**
Structural primary balance[2]	1.2	0.3	0.6	0.1	0.9	1.1	1.8	0.6

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

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

Source :

Stability Programme (SP); Commission 2017 spring forecasts (COM); Commission calculations.

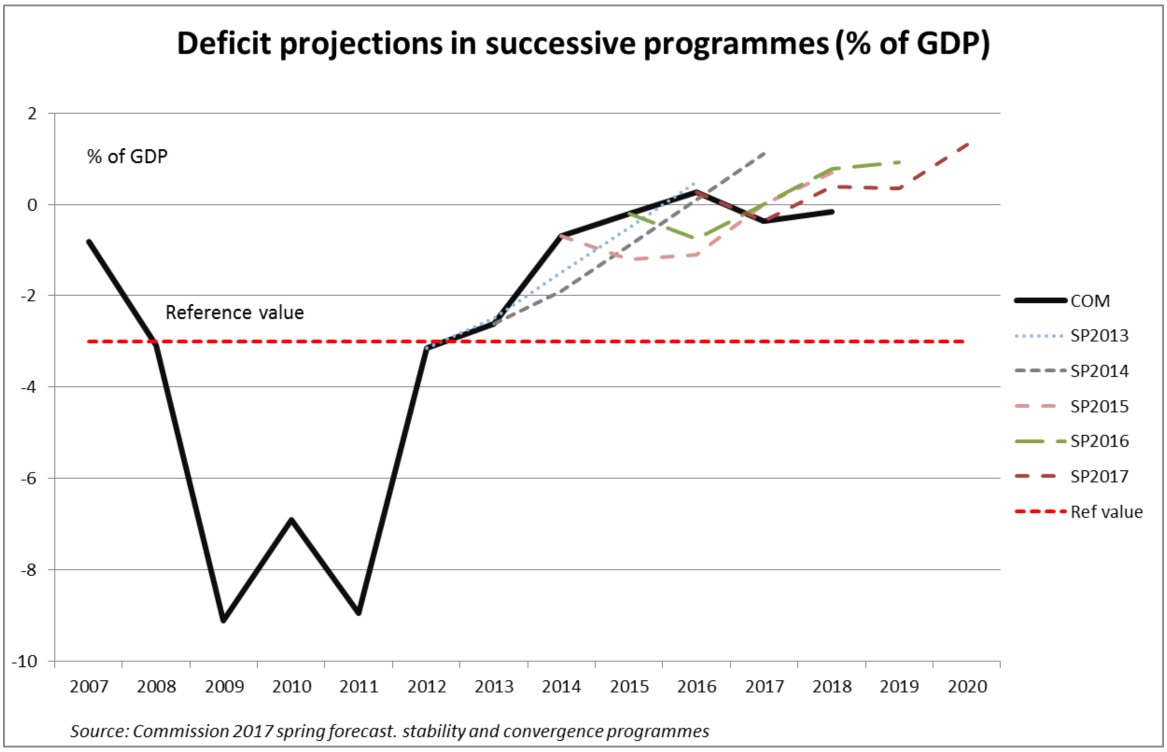
In its stability programme, Lithuania targets a general government deficit of 0.4% of GDP for 2017. Based on the (recalculated) structural balance, the programme foresees remaining above the MTO in 2017 with a structural deficit of 0.7% of GDP.

The Commission 2017 spring forecast for 2017 is broadly in line with the programme. It projects a general government deficit of 0.4% of GDP and a slightly higher structural deficit of 0.9% of GDP partly due to a lower estimate of the one-off expenditures.

The programme foresees higher expenditures in 2017 as pensions, defence spending, public wages and investment are expected to increase, while a further increase in the non-taxable income threshold is set to add to tax revenue losses. At the same time, higher excise duties on cigarettes and alcohol as of March 2017 are set to increase indirect tax revenues, but not sufficiently to cover the structural reform costs. The programme envisages that measures to improve tax compliance that were reinforced at the end of 2016 will continue boosting revenues in 2017.

Based on the experience and the fact that tax compliance measures are difficult to quantify ex ante, the Commission 2017 spring forecast predicts somewhat lower tax revenues, while it expects the boost in revenues from tax-rich economic growth to cover the higher spending on public wages and pensions.

Figure 1: Government balance projections in successive programmes (% of GDP)



In the past, fiscal targets in Lithuania's stability and convergence programmes tended to be softened, but this trend was halted with the 2016 stability programme. The 2017 programme consolidation path is similar to the one of 2016 once adjusted for the costs of structural reform. In addition, Lithuania has overachieved its budgetary targets over the last three years.

3.3. MEASURES UNDERPINNING THE PROGRAMME

The programme specifies several measures on the revenue and the expenditure side, which can be split into one-off and permanent measures. The one-off revenue and expenditure flows from the State Deposit Insurance Funds improved the general government balance by 0.1% of GDP in 2016, but are bound to increase the deficit by 0.1% of GDP in 2017, before improving the balance by 0.3% of GDP in 2018.

Revenue measures of a permanent nature had a positive contribution to the general government balance of around 0.2% in 2016, but discretionary expenditure measures added around 0.5% of GDP in new spending. For 2017, the programme estimates that new tax measures will more than cover revenue loss due to an increase in non-taxable allowance.

The 2017 stability programme estimates an additional 0.2% of GDP in tax revenues in 2016 and 0.3% in 2017 from measures to improve tax collection. The Commission forecasts a lower positive effect from such measures in 2016 and 2017 since it is difficult to disentangle their impact from a solid increase in tax rich components of GDP growth.

In its stability programme, Lithuania has applied to avail in 2017 of an allowance linked to the structural reform clause. Lithuania considers that the cost of ongoing structural labour market and social reforms (including pensions) should be taken into account under the preventive arm of the Stability and Growth Pact. The Programme estimates a cost for 2017 of around 0.5% of GDP.

Main budgetary measures (as a % of GDP)

Revenue	**Expenditure**
2016	
• Increase in non-taxable allowance (-0.2% of GDP) • One-off asset liquidation proceeds by the Deposit Insurance Fund (+0.2% of GDP) • Measures to improve indirect tax collection (+0.1% of GDP) • Measures to improve personal income tax collection (+0.1% of GDP) • Set of changes in excise taxes (+0.2% of GDP)	• One off compensations paid by State Deposit Insurance Fund to insured depositors (+0.1% of GDP) • Increase in motivational contribution to the private pension funds (+0.1% of GDP). Lithuania was granted a temporary deviation from the matrix-based adjustment for a pension reform clause. • Increase in pensions and social payments (+0.3% of GDP) • Increase in wages for specific groups of public employees (+0.1)
2017	
• Increase in non-taxable allowance (-0.3% of GDP) • One-off asset liquidation proceeds by the State Deposit Insurance Fund (+0.1% of GDP) • Measures to improve indirect tax collection (+0.3% of GDP) • Set of increases in excise taxes (+0.2% of GDP)	• Costs of the structural reforms (+0.5% of GDP). Programme asks for the application of these expenditures under the systemic pension reform clause. • One off compensations paid by State Deposit Insurance Fund to insured depositors (+0.2% of GDP) • Increase in wages for specific groups of public employees (+0.2)
2018	
• One-off asset liquidation proceeds by the Deposit Insurance Fund (+0.3% of GDP)	
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. DEBT DEVELOPMENTS

Lithuania's stability programme envisages a gradual decline in gross government debt over the program period (Table 3). From 40.2% of GDP in 2016, gross debt is expected to decline to 33.8% by 2020. This trend is driven by fiscal consolidation and helped by robust economic growth projections. A pronounced drop in the debt level in 2020 is explained by pre-financing 2020 bond redemptions in 2019 and by the targeted headline surplus of 1.1% of GDP in 2020. The assessment of short-term future debt dynamics is broadly shared by the Commission in its 2017 spring forecast, although for 2018 the Commission forecasts a higher debt level. This is based on a no-policy-change assumption leading to a headline deficit of 0.2% of GDP in 2018, as opposed to the programme target of 0.4% of GDP surplus for the same year.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**39.8**	**40.2**	**42.4**	**42.4**	**38.9**	**38.4**	**39.1**	**33.8**
Change in the ratio	1.3	-2.5	2.2	2.2	-3.5	-4.0	0.7	-5.3
Contributions[2] :								
1. Primary balance	**1.4**	**-1.6**	**-0.9**	**-0.9**	**-1.0**	**-1.4**	**-1.3**	**-2.0**
2. "Snow-ball" effect	**-0.3**	**-0.1**	**-1.0**	**-0.6**	**-1.1**	**-0.7**	**-0.6**	**-0.8**
Of which:								
Interest expenditure	1.7	1.4	1.2	1.3	1.2	1.0	1.0	0.7
Growth effect	-1.3	-0.9	-1.1	-1.0	-1.3	-1.0	-0.9	-0.9
Inflation effect	-0.7	-0.5	-1.1	-0.9	-1.0	-0.7	-0.6	-0.6
3. Stock-flow adjustment	**0.3**	**-0.8**	**4.1**	**3.8**	**-1.4**	**-1.8**	**2.6**	**-2.5**
Of which:								
Cash/accruals diff.								
Acc. financial assets								
Privatisation								
Val. effect & residual								

Notes:

[1] End of period.

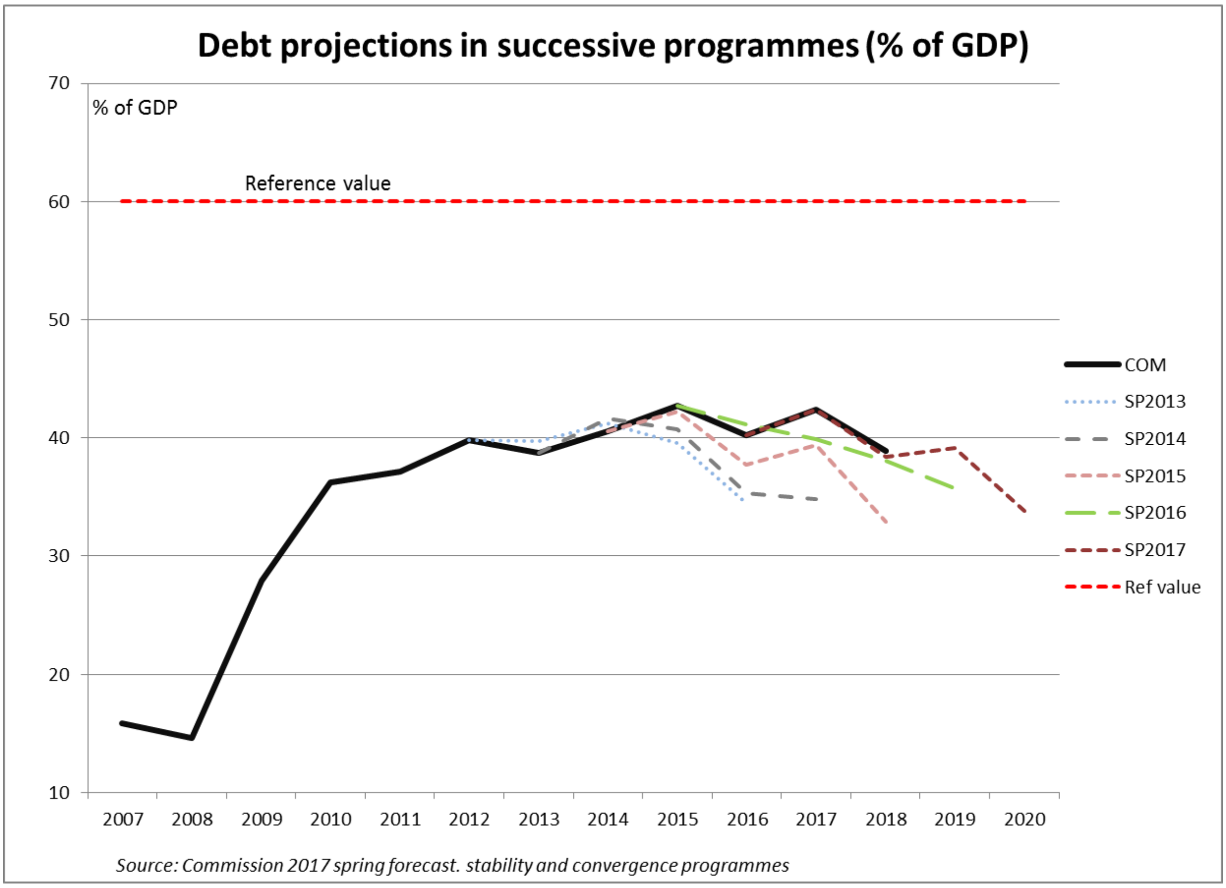
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2017 spring forecast (COM); Stability Programme (SP), Comission calculations.

Lithuania's previous convergence and stability programmes generally predicted the short-term debt dynamics quite well, while medium-term outturns were somewhat higher than projected in past programmes (Figure 2), both the projections and the outcomes always remained substantially below the 60% of GDP reference value of the Treaty.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

The economic growth and fiscal projections of the 2017 stability programme are broadly in line with the Commission 2017 spring forecast. However, the projected consolidation path beyond 2017 for the general government deficit, as well as the structural balance are subject to some risks on the revenue as well as the expenditure side.

First, the planned increase in the revenue level by more than 2% of GDP over the programme period depends mostly on a sustained improvement in tax compliance and on a yet to be legislated broadening of tax base, including a cancelation of some tax exemptions. This might prove to be overly optimistic as not all measures might reach the desired yield, especially if tax evasion remains more persistent than anticipated, and the political will to reduce tax exemptions and increase the tax base might be too weak.

Second, the consolidation path depends on a restrained growth in expenditure over the programme period, which is expected to increase by 1 pp of GDP less than revenues. Given the projected robust economic growth and tight labour market, the pressure to increase public wages is likely to rise on the back of strong wage growth in the private sector. In addition, rising inflation is bound to put pressure on increasing social spending.

External risks are broadly balanced, as geopolitical uncertainties are offset by improving economic outlook in Lithuania's main export markets. On the positive side, in the short run, risks to the public finance forecast are tilted to the upside due to the expected robust tax rich growth, but only if expenditure discipline is maintained. In addition, the stability programme's macroeconomic projections of real GDP growth in 2017 and 2018 are on the cautious side and slightly below those of the Commission. Moreover, Lithuania overachieved its fiscal targets for the last three years, reversing its previous negative track record.

The realisation of risks to the budgetary deficit targets mentioned above would also have a negative impact on the public debt level.

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

Lithuania is currently under the preventive arm of the Stability and Growth Pact.

Box 1. Council recommendations addressed to Lithuania

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

4.1. Compliance with the MTO

Assessment of structural reform clause

In view of the ongoing implementation of major structural reforms with a positive impact on the long-term sustainability of public finances, the programme is accompanied by a formal request to benefit from a temporary deviation under the preventive arm for 2017 pursuant to the "Commonly agreed position on Flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council in February 2016. The programme estimates the budgetary costs of the structural reforms at around EUR 220 million, which amounts to around 0.5% of GDP in 2017.

In order to be eligible for the flexibility available under the structural reform clause, the Member State must respect the Treaty's deficit reference value of 3% of GDP and should preserve an appropriate safety margin with respect to the deficit reference value if the requested deviation was to be granted. Moreover, the structural balance in the year preceding the application of the clause should be within a maximum distance of 1.5% of GDP from the MTO. Based on the Commission 2017 spring forecast, the general government deficit of Lithuania is projected to be at 0.4% of GDP in 2017, and the structural balance to amount to -0.2% of GDP in 2016, to -0.9% in 2017 and to -1.1% in 2018, which are above the minimum benchmark of -1.5% of GDP. Finally, Lithuania's structural balance is also estimated to remain within a maximum distance of 1.5% of GDP from the MTO in 2016 - currently fixed at -1.0% of GDP - as the structural balance is above the MTO. Thus, Lithuania is eligible to benefit from a temporary deviation in 2017, subject to respecting the constraint of the minimum benchmark.

The main aims of the ongoing reform address the recurring points made within the country-specific recommendations and encompass economy-wide issues, including strengthening the sustainability and adequacy of the pension system and addressing labour market regulatory bottlenecks. A group of independent social scientists, who proposed the original reform plan, have presented an evaluation showing direct positive effects on growth from those reforms. The government has calculated the expected cost of the reform based on the proposed and adjusted reform package. Measures related to the pension reform are implemented from the start of 2017, while the labour market and associated reform measures are legislated to enter into force in July 2017.

The pension part of the structural reform package strengthens 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 pensionable service from 30 to 35 years to counteract a worsening dependency ratio. Individual pensions will be more directly linked to actual payments to motivate orderly contributions. The average annual pension expenditure savings is estimated to range from 0.8% of GDP in the medium run increasing up to 3.8% of GDP in the long run, compared to the average annual pension expenditure of the unreformed system.

The labour market part of the reform updates the regulation of labour relations to fit the needs of a catching-up economy. The reform introduces new types of employment contracts, establishes shorter periods of notice, lowers severance allowances and sets more flexible rules for working hours. At the same time, the reform strengthens the coverage and adequacy of the unemployment and social insurance benefits. It expands the scope of active labour market policy measures, as well as seeks to reduce the level of illegal and uninsured employment. Estimates of the medium-term results foresee an increase in an average annual number of the employed by up to 10% and the average annual number of the employees working standard annual hours by up to 7%.

The Commission analysis finds it broadly plausible that the structural reform is set to have a positive impact on the sustainability of public finances, including on the sustainability of public debt, if implemented fully and in a timely manner. On this basis, Lithuania can currently be assessed as qualifying for the requested temporary deviation in 2017, provided that it adequately implements the agreed reforms, which will be monitored under the European Semester.

Lithuania requests the maximum allowed temporary deviation based on the structural reform clause (0.5% of GDP). However, Lithuania was already granted a temporary deviation (of 0.1% of GDP) in 2016 linked to the pension reform clause on account of a systemic reform reinforcing a multi-pillar system. In total, the maximum allowed temporary deviation under the two clauses is limited by the requirement that the structural balance respects the minimum benchmark, which is set at a structural deficit of 1.5% of GDP. Lithuania's MTO is set at structural deficit of 1% of GDP. Therefore, Lithuania can be granted a temporary deviation of 0.4% of GDP for 2017 considering the already granted 0.1% of GDP deviation linked to the pension reform clause[2].

Compliance with the MTO

For 2016, Lithuania benefits from a temporary deviation of 0.1% of GDP from the structural adjustment path towards the MTO (set a -1.0% of GDP) under the pension reform clause.

In 2016, the structural balance improved by 0.4% of GDP to a structural deficit 0.2% of GDP and remained above the MTO. At the same time, net expenditure growth complied with the benchmark.

For 2017, the stability programme plans to remain above the MTO as the recalculated structural deficit is projected to be at 0.7% of GDP, while the Commission 2017 spring

[2] For a Member State which is at its MTO, the temporary deviations are carried forward for a period of three years.

forecast also projects a structural deficit above the MTO, at 0.9% of GDP. According to the information provided in the stability programme and the Commission 2017 spring forecast, growth of government expenditure, net of discretionary revenue measures and one-offs, in 2017 will not exceed the applicable expenditure benchmark. The allowed adjustment path incorporates the systemic pension reform starting in 2016 and 2017. It reflects an additional temporary deviation of 0.4% of GDP granted thanks to major structural labour market and pension reforms.

For 2018, the recalculated structural balance based on the 2017 stability programme is set to turn to a surplus of 0.1% of GDP and therefore is projected to remain above the MTO, while the expenditure benchmark remains respected with a wide margin. The Commission 2017 spring forecast also predicts full compliance with the structural balance and the expenditure benchmark pillars. That means that the underlying projected fiscal position is consistent with an allowed nominal growth rate of net primary government expenditure of 6.4% in 2018, corresponding to an allowed deterioration in the structural balance of -0.6% of GDP.

Overall, Lithuania complied with the provisions of the SGP in 2016 and is projected to comply with them in 2017 and 2018.

Table 4: Compliance with the requirements under 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		-1.1	
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	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-0.7	-1.3		-0.6	
Change in structural balance[6]	0.4	-0.4	-0.7	0.5	-0.2
One-year deviation from the required adjustment [7]	1.1	0.9	0.6	1.1	0.4
Two-year average deviation from the required adjustment [7]	1.0	1.0	0.8	1.0	0.5
Expenditure benchmark pillar					
Applicable reference rate[8]	4.1	5.7		6.4	
One-year deviation adjusted for one-offs[9]	0.3	0.3	0.7	0.2	0.6
Two-year deviation adjusted for one-offs[9]	0.0	0.3	0.5	0.3	0.7
PER MEMORIAM: One-year deviation [10]	0.3	0.1	0.6	0.6	0.9
PER MEMORIAM: Two-year average deviation [10]	-0.1	0.4	0.4	0.3	0.7
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Compliance	Compliance
Conclusion over two years	Overall assessment	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 2014) is carried out on the basis of Commission 2015 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 :

Stability Programme (SP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

Lithuania does not appear to face fiscal sustainability risks in the short run according to the S0 indicator, which captures short-term risks of fiscal stress stemming from the fiscal, as well as the macro-financial and competitiveness sides of the economy.

Based on the Commission forecast and a no-fiscal policy change scenario beyond the forecasts, the government debt, at 40.2% of GDP in 2016, is expected to rise gradually to 48.6% of GDP in 2027, thus remaining below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2027. This highlights low risks for the country from a debt sustainability analysis in the medium term. The full implementation of the stability programme would nonetheless put the debt on a decreasing path by 2027, remaining well below the 60% of GDP reference value in 2027.

The medium-term fiscal sustainability risk indicator S1 is at 0.5 pps. of GDP, primarily related to the projected ageing costs contributing with 1.7 pps. of GDP, thus indicating medium risks in the medium term. The full implementation of the stability programme would put the sustainability risk indicator S1 at -2.5 pps. of GDP, leading to lower medium-term risk. Overall, the risks to fiscal sustainability over the medium-term are assessed as being medium. Fully implementing the fiscal plans in the stability programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 3.2 pps. of GDP. In the long-term, Lithuania therefore appears to face medium fiscal sustainability risks, primarily related to the projected costs of ageing contributing 2.8 pps. of GDP. Full implementation of the programme would nonetheless put the S2 indicator at 1.2 pps. of GDP, leading to a lower long-term risk.

The pension part of the structural reform package, which entered into force in 2017, is likely to mitigate medium-term fiscal sustainability risks, but the precise impact has not been quantified yet and, as such, it is not yet reflected in the calculations of the aforementioned sustainability indicators. The reform strengthens a rules-based pension indexation system enacting increases based on labour market trends and available financing to ensure financial soundness of pension system. The reform also envisages a gradual increase of the required length of pensionable service from 30 to 35 years to counteract a worsening dependency ratio. The average annual pension expenditure savings are estimated to range from 0.8% of GDP in the medium run to 3.8% of GDP in the long run. However, the reforms stopped short of establishing an automatic link between the retirement age and life expectancy, thus leaving Lithuania exposed to long-term sustainability risks, including the risk that pensions become inadequate due to a lack of financing.

Table 5: Sustainability indicators

Time horizon			No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.2			
Fiscal subindex			0.0	LOW risk		
Financial & competitiveness subindex			0.3	LOW risk		
Medium Term			**MEDIUM risk**			
DSA [2]			LOW risk			
S1 indicator [3]			0.5	MEDIUM risk	-2.5	LOW risk
of which						
	Initial Budgetary Position		0.3		-2.0	
	Debt Requirement		-1.5		-2.2	
	Cost of Ageing		1.7		1.7	
	of which					
		Pensions	1.0		1.0	
		Health-care	0.2		0.1	
		Long-term care	0.2		0.2	
		Other	0.3		0.3	
Long Term			**MEDIUM risk**		**LOW risk**	
S2 indicator [4]			3.2		1.2	
of which						
	Initial Budgetary Position		0.4		-1.4	
	Cost of Ageing		2.8		2.6	
	of which					
		Pensions	1.2		1.1	
		Health-care	0.0		0.0	
		Long-term care	0.7		0.7	
		Other	0.9		0.9	

Source: Commission services; 2017 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.

6. FISCAL FRAMEWORK

As highlighted in the Commission's assessment in the 2017 Country Report (section 3.1.2), Lithuania has reinforced its budgetary framework, since the rules of the Fiscal Compact and the Two Pack regulation entered into force when the country joined the euro area and the structural balance rule was raised to the level of a constitutional law. Lithuania went through the second cycle of budget planning with the reinforced fiscal framework and in general adhered to the national procedures and strengthened their implementation capacities.

The Fiscal Council, which is set up in the National Audit Office (NAO), has provided an increasing contribution to the scrutiny of public finance development. In June 2016, it issued its first Fiscal Sustainability Report assessing the sustainability of the general government finances over the period 2016–2036. The report found that the general government debt development was unsustainable. At unchanged policies, the debt was bound to increase to 54.2% of GDP by 2036, due to ageing costs and a snowball effect. The report noted that the debt ratio would decrease if Lithuania implemented measures to strictly comply with the fiscal discipline rules. However, it also considered that strict compliance with the fiscal rules, while maintaining low taxes, would risk pushing a large part of the population below the poverty line.

Based on the information provided in the stability programme, fiscal performance in Lithuania appears to generally comply with the requirements of the applicable national numerical fiscal rules. In particular, Lithuania appears to have complied with the requirements of the applicable national numerical fiscal rules in 2016, when the structural balance overachieved the MTO. With regard to 2017, the NAO highlighted some concerns in the planning phase. In November 2016, the Fiscal Council completed the assessment of the 2017 draft budget and submitted to the Parliament its opinion on the compliance with the structural improvement target. According to the NAO, given that the structural balance was expected to be above the MTO in 2016, the government had valid reasons not to set a structural improvement target. The Fiscal Council also concluded that the national expenditure rule did not apply to 2017 due to the occurrence of one of the escape clauses. At the same time, the NAO pointed out that the planned increase in the structural deficit in 2017 was in in contradiction with the surplus general government rule. In particular, not only the structural balance was not planned to decrease, but a deviation from the MTO might be observed (the DBP foresaw a structural deficit of 1.3% of GDP). The Fiscal Council also considered that the medium-term budget planning was only an indicative exercise, while the connection between the government's goals and financial indicators was weak. The NAO agreed with the Ministry of Finance to carry out a fundamental review of the budget structure linking the expenditure with the targeted results.

On March 29 2017, the Fiscal Council presented its opinion[3] to the Parliament endorsing the economic development scenario underpinning the 2017 stability programme. The Ministry of Finance had released the economic development scenario to the public on March 20. NAO assessed that the 2017 programme economic scenario was based on the recent available statistical data and did not contradict economic trends.

Finally, Lithuania considers its stability programme, together with its National Reform Programme, as its national medium-term fiscal plan in the sense of the Two-Pack Regulation 473/2013. The national medium-term fiscal plan includes indications on the expected

[3] Išvada dėl ekonominės raidos scenarijaus tvirtinimo, https://www.vkontrole.lt/bp/isvada.aspx?id=10135

economic returns on non-defence public investment projects that have a significant budgetary impact as required by Article 4(1) of the above-mentioned regulation.

7. SUMMARY

In 2016, Lithuania maintained a structural balance above its MTO in line with the requirements of the preventive arm of the Stability and Growth Pact.

Lithuania plans to remain above the MTO over the period 2017-2020. Based on the Commission 2017 spring forecast, the structural balance is projected to respect the MTO in 2017-2018. Therefore, Lithuania is projected to meet the requirements under the preventive arm of the SGP in both 2017 and in 2018.

8. ANNEXES

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	5.3	7.1	0.0	3.5	1.8	2.3	2.9	3.1
Output gap [1]	-2.6	5.0	-5.2	1.0	0.6	0.8	1.3	1.8
HICP (annual % change)	0.7	4.9	2.8	0.2	-0.7	0.7	2.8	2.0
Domestic demand (annual % change) [2]	4.9	9.4	-2.7	3.4	7.1	2.1	3.9	3.3
Unemployment rate (% of labour force) [3]	14.9	7.0	14.4	10.7	9.1	7.9	7.6	7.2
Gross fixed capital formation (% of GDP)	20.8	25.4	17.8	18.5	19.3	18.6	19.1	19.4
Gross national saving (% of GDP)	13.7	16.1	17.8	22.5	17.7	14.7	14.5	15.0
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.5**	**-1.2**	**-6.1**	**-0.7**	**-0.2**	**0.3**	**-0.4**	**-0.2**
Gross debt	**22.3**	**16.8**	**36.0**	**40.5**	**42.7**	**40.2**	**42.4**	**38.9**
Net financial assets	**12.7**	**9.0**	**-17.8**	**-25.3**	**-24.1**	**n.a**	**n.a**	**n.a**
Total revenue	34.7	34.0	34.1	34.1	34.9	34.5	34.0	33.8
Total expenditure	37.2	35.2	40.3	34.8	35.1	34.2	34.3	34.0
of which: Interest	1.4	0.7	1.7	1.6	1.5	1.4	1.2	1.2
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.0**	**-6.8**	**8.9**	**11.1**	**6.1**	**6.7**	**6.4**	**6.4**
Net financial assets; non-financial corporations	**-85.3**	**-94.8**	**-89.5**	**-73.1**	**-79.6**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-2.0**	**-1.4**	**1.9**	**-0.3**	**0.6**	**n.a**	**n.a**	**n.a**
Gross capital formation	13.9	18.1	10.3	10.6	11.9	8.1	8.8	9.2
Gross operating surplus	28.5	33.2	36.7	37.4	35.3	33.9	34.3	34.8
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.1**	**-1.1**	**0.4**	**-3.9**	**-5.0**	**-7.1**	**-7.4**	**-7.3**
Net financial assets	**40.8**	**38.1**	**52.8**	**52.0**	**58.0**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	31.4	33.8	32.2	31.5	32.9	33.8	33.8	33.9
Net property income	16.1	15.2	15.0	12.9	12.5	12.5	12.6	12.7
Current transfers received	11.6	13.2	17.5	15.5	14.9	15.0	15.1	15.0
Gross saving	2.8	1.8	2.9	-0.4	-1.1	-2.6	-3.0	-2.9
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-6.5**	**-9.1**	**3.2**	**6.5**	**0.8**	**-0.1**	**-1.4**	**-1.0**
Net financial assets	**34.3**	**49.4**	**53.2**	**47.1**	**45.5**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-6.6	-9.8	-0.8	1.9	-0.7	1.4	0.3	0.2
Net primary income from the rest of the world	-1.8	-2.5	-1.9	-1.3	-4.0	-4.2	-4.0	-3.9
Net capital transactions	0.1	1.4	3.5	2.7	3.0	1.0	0.6	0.9
Tradable sector	54.4	53.6	55.7	56.1	54.9	55.0	n.a	n.a
Non tradable sector	34.5	36.5	34.5	34.2	35.0	34.7	n.a	n.a
of which: Building and construction sector	5.8	8.4	5.7	6.6	6.5	5.9	n.a	n.a
Real effective exchange rate (index, 2000=100)	84.8	102.6	101.9	104.3	106.0	110.2	111.4	112.4
Terms of trade goods and services (index, 2000=100)	92.2	101.4	99.0	99.0	102.2	104.7	104.5	104.7
Market performance of exports (index, 2000=100)	64.2	81.2	108.0	124.1	118.6	117.1	115.6	114.6

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2017 spring forecast