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Assessment of the 2015 Stability Programme for

LITHUANIA

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

This document assesses Lithuania's April 2015 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 30 April 2015 and covers the period 2014-2018. It was approved by the government and presented to the national parliament for a debate without a vote.

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

This document complements the Country Report published on 26 February 2015 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 2015 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 Stability and Growth Pact, 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 and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

Lithuania's real GDP grew by 2.9% y-o-y in 2014, mainly driven by domestic demand, in particular private consumption, while net exports were negative following the Russian embargo on food products and the weakening of the Russian economy at the end of 2014. Going forward, the programme expects that private demand will be the main growth engine on the back of rising wages and employment. Net exports are expected to continue to weigh on growth, but are set to recover in 2016 when the negative effects from Russia are forecast to fade out and the European economy picks up[1].

Against this background, the programme assumes real GDP growth of 2.5% y-o-y in 2015, 3.2% in 2016, 3.5% in 2017 and 3.9% in 2018.

The output gaps as recalculated by Commission based on the information in the programme, following the commonly agreed methodology are negative for 2015‒2017 (-0.2%, -0.8%, and -0.2% of GDP, respectively) and turn positive at 0.9% of GDP in 2018[2]. In contrast, the Commission forecasts positive output gaps for both 2015 and 2016. The difference between the programme (recalculated) output gaps and the Commission 2015 spring forecast output gaps stems from higher programme (recalculated) potential GDP growth rates.

[1] The programme's external assumptions were taken from the European Commission's 2015 Winter forecast

[2] The programme itself projects output gaps of -0.2%, -0.4%, 0.6% and 1.9% for the years 2015-2018, respectively

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.9	2.9	2.8	2.5	3.3	3.2	3.5	3.9
Private consumption (% change)	5.6	5.6	3.9	3.7	4.3	4.3	5.7	5.7
Gross fixed capital formation (% change)	8.0	8.0	4.3	5.2	5.8	2.5	4.3	5.2
Exports of goods and services (% change)	3.4	3.4	3.1	-2.8	6.4	3.8	4.9	5.9
Imports of goods and services (% change)	5.4	5.4	4.2	-1.2	7.7	4.6	5.7	6.4
Contributions to real GDP growth:								
- Final domestic demand	5.2	4.5	3.7	3.8	4.3	3.7	4.1	4.4
- Change in inventories	-0.6	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- Net exports	-1.6	-1.6	-0.9	-1.4	-1.0	-0.5	-0.6	-0.5
Output gap[1]	0.6	0.7	0.4	-0.2	0.4	-0.8	-0.2	0.9
Employment (% change)	2.0	2.0	1.2	0.6	1.2	0.6	0.9	0.9
Unemployment rate (%)	10.7	n.a.	9.9	9.9	9.1	9.1	8.1	7.1
Labour productivity (% change)	0.9	0.9	1.6	1.9	2.1	2.5	2.6	3.0
HICP inflation (%)	0.2	0.2	-0.4	-0.4	1.7	1.7	1.9	2.2
GDP deflator (% change)	0.9	0.9	1.7	0.5	2.3	2.2	2.4	2.5
Comp. of employees (per head, % change)	4.4	4.0	4.6	4.9	4.7	5.3	5.7	6.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.3	3.0	1.8	3.6	0.9	1.0	0.0	-0.8

Note:

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

Source :

Commission 2015 spring forecast (COM); SP: Stability Programme (SP).

Overall, the programme's macroeconomic projections, in particular real GDP growth and its composition are similar to those of the Commission. The programme's real GDP growth is set at 2.5% in 2015 and 3.2% in 2016 compared with the Commission's 2.8% and 3.3%. Growth rates of private consumption as well as wages and salaries, the tax bases for personal income tax and social contributions respectively, are broadly in line with the ones contained in the Commission 2015 spring forecast. Thus, in the Commission's view, the programme's macroeconomic assumptions are plausible.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

Lithuania's general government deficit amounted to 0.7% of GDP in 2014, after 2.6% of GDP a year before. The 2014 deficit outcome was significantly better than the revised budgetary target of 1.3% of GDP and the target contained in the 2014 Convergence Programme (1.9% of GDP). The improvement was a result of several factors. Overall tax revenues were slightly higher than planned by the government. Although value added tax revenues turned out below plans, personal income tax was stronger than expected due to a sizeable increase in the tax base on the back of growing wages and employment. Also general government expenditures were lower, despite an increase in defence spending not foreseen at the beginning of the year, as local governments spent less than planned. The social insurance fund, SoDra, benefited from the robust labour market and had a lower deficit in 2014. Finally, one-off revenues and expenditures had a net positive effect on the general government deficit[3]. While the Deposit Insurance Fund generated a surplus of 1.2% of GDP from liquidation proceeds, the law on pension compensation following a Constitutional Court ruling increased expenditure by 0.8% of GDP.

The structural balance improved by 1.1 pps. and decreased from 2.3% of GDP in 2013 to 1.2% in 2014 according to the Commission 2015 spring forecast. As a consequence, Lithuania reached its medium-term objective (MTO) in 2014, a year earlier than planned.

3.2. Target for 2015 and medium-term strategy

The target for 2015

In its Stability Programme, Lithuania targets a general government deficit of 1.2% of GDP for 2015. Based on the (recalculated) structural balance[4] the programme foresees remaining at the MTO in 2015 with a structural deficit of 1.2% of GDP. Compared to last year's Convergence Programme the 2015 targets are less ambitious.

The Commission 2015 spring forecast has a less optimistic view on 2015 compared to the programme. It projects a general government deficit of 1.5% of GDP and a structural deficit of 1.9% of GDP, thereby entailing a deviation from the MTO.

The programme foresees higher expenditures in 2015 as social and defence spending are set to increase together by 0.5% of GDP. At the same time, higher excise duties on cigarettes and alcohol as of spring 2015 and a reversal of preferential VAT on central heating starting in July should support tax revenues, but these additional revenues are not expected to cover new discretionary expenditure. The programme sets ambitious VAT collection plans for 2015, expecting that new measures to improve tax compliance introduced in May will lift revenues. Finally, it also includes one-off revenues of 0.3% of GDP from the deposit and insurance fund.

Based on past experience and the fact that tax compliance measures are difficult to quantify ex ante, the Commission 2015 spring forecast predicts significant lower tax revenues, in

[3] For more details see 'Measures underpinning the programme'.

[4] Commission calculations on the basis of the information in the programme according to the commonly agreed methodology.

particular VAT, which explains the higher general government and structural deficit compared to the programme.

The medium-term strategy

The purpose of the programme is to achieve a general government surplus of 0.7% of GDP by the end of the programme period, which according to the authorities, would result in a structural surplus of 0.1% of GDP. The programme maintains a MTO of a structural general government deficit of 1% of GDP, which reflects the objectives of the Stability and Growth Pact.

The programme foresees staying at the MTO in 2015 and 2016, with a structural deficit of around 1.1% of GDP. Further consolidation should result in a structural surplus in 2017 and 2018. Commission calculations on the basis of the information in the programme according to the commonly agreed methodology indicate a similar consolidation path with marginally weaker structural balances.

However, according to the Commission 2015 spring forecast, the structural deficit is set to deviate from the MTO in 2015 by 0.9% of GDP before returning to it in 2016 with an expected improvement in the structural balance of 0.7% of GDP. The Commission estimates a decrease in the structural deficit to 1.2% in 2016 compared to a (recalculated) structural deficit of the programme of 0.9% of GDP. The difference between the Commission's estimate and the (recalculated) structural deficit is mainly due to different output gap estimates. The Commission is of the view that Lithuania is set to have a positive output gap, while the programme assumes the opposite.

The planned nominal consolidation path in the 2015 Stability Programme is slower than presented in the previous one and back-loaded despite a better than planned 2014 general government deficit. The objective to reach a nominal surplus has been postponed from 2016 to 2018. The economic outlook is weaker than a year before, but still robust, while the postponement of consolidation coincides with upcoming parliamentary elections in 2016. The programme indicates the anticyclical nature of back-loaded consolidation.

For 2016, the Commission forecasts a nominal fiscal improvement of 0.6% of GDP. In the absence of significant policy measures, the Commission thus expects the general government deficit to narrow to 0.9% of GDP in 2016, compared with a programme target of 1.1% of GDP.

The revenue-to-GDP ratio in the 2015 Stability Programme is projected to improve slightly to 34.4% in 2015 before falling to 33.2% in 2016 and the expenditure-to-GDP ratio is expected to fall from 35.6% to 34.3% in the same years. These trends are broadly in line with the Commission 2015 spring forecast, which expects lower revenue- and expenditure-to-GDP ratios also partially due to lower one-off revenues and expenditures over the programme horizon.

The envisaged improvement in the fiscal position over the programme period is largely driven by expenditure growing slower than nominal GDP and robust economic growth towards the end of the period. The programme defines new specific discretionary revenue measures to be used in case of shortfalls (e.g. lowering general government expenditures, abolishing tax exemptions, adjusting excise taxes on alcohol, changing real estate tax base, adjusting environmental taxes). However, the main scenario assumes that revenues will be sustained through strengthened tax administration.

The programme applies for the application of the systemic pension reform clause under the preventive arm of the Stability and Growth Pact in 2016. Subject to a confirmation by

Eurostat that the pension reform fulfils the necessary conditions to be considered eligible for application of the systemic pension reform clause, the impact on structural adjustment path (0.1% of GDP) is set to be small.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**34.3**	**32.4**	**34.4**	**32.5**	**33.2**	**33.1**	**33.1**	**-1.2**
of which:								
- Taxes on production and imports	11.4	11.2	12.0	11.3	11.7	11.6	11.5	0.1
- Current taxes on income, wealth, etc.	5.1	5.1	5.2	5.2	5.4	5.5	5.6	0.5
- Social contributions	11.4	11.5	11.8	11.7	11.6	11.6	11.6	0.2
- Other (residual)	6.5	4.5	5.4	4.4	4.5	4.4	4.4	-2.1
Expenditure	**34.9**	**33.9**	**35.6**	**33.4**	**34.3**	**33.1**	**32.5**	**-2.4**
of which:								
- Primary expenditure	33.4	32.5	33.9	32.0	32.8	31.6	31.3	-2.1
of which:								
Compensation of employees	9.5	9.5	9.8	9.5	9.1	8.8	8.7	-0.8
Intermediate consumption	4.8	4.8	5.2	4.7	5.2	5.1	5.1	0.3
Social payments	12.5	12.0	12.9	11.7	12.5	11.9	11.4	-1.1
Subsidies	0.3	0.3	0.4	0.3	0.4	0.3	0.3	0.0
Gross fixed capital formation	3.5	3.5	3.6	3.5	3.6	3.5	3.8	0.3
Other (residual)	2.7	2.4	2.1	2.4	2.0	2.0	2.0	-0.7
- Interest expenditure	1.6	1.4	1.7	1.4	1.5	1.5	1.2	-0.4
General government balance (GGB)	**-0.7**	**-1.5**	**-1.2**	**-0.9**	**-1.1**	**0.0**	**0.7**	**1.4**
Primary balance	**0.9**	**0.0**	**0.5**	**0.5**	**0.5**	**1.5**	**1.9**	**1.0**
One-off and other temporary	0.3	0.2	0.1	0.1	0.1	0.0	0.0	-0.3
GGB excl. one-offs	**-0.9**	**-1.7**	**-1.3**	**-1.0**	**-1.2**	**0.0**	**0.7**	**1.6**
Output gap[1]	0.6	0.4	-0.2	0.4	-0.8	-0.2	0.9	0.3
Cyclically-adjusted balance[1]	-0.9	-1.7	-1.1	-1.0	-0.8	0.1	0.3	1.2
Structural balance (SB)[2]	**-1.2**	**-1.9**	**-1.2**	**-1.2**	**-0.9**	**0.1**	**0.3**	**1.5**
Structural primary balance[2]	0.4	-0.5	0.5	0.2	0.6	1.6	1.5	1.1

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by the 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 2015 spring forecasts (COM); Commission calculations.

Measures underpinning the programme

The programme specifies a couple of measures on the revenue and the expenditure side, which can be split into permanent and one-off measures. In 2014 and 2015, a significant impact is expected to come from one-off measures related to the Deposit Insurance Fund (liquidation proceeds and insurance payments) and to a pension compensation ordered by the Constitutional Court. Taken together, these items reduced the general government budget deficit in 2014 by 0.4% of GDP. For 2015, flows from the Deposit Insurance Fund are set to improve the deficit by 0.3% and 0.1% for 2016. Measures of a permanent nature had a negative contribution to the general government balance of around 0.2% in 2014, while for 2015 the contribution is estimated to be negative (around -0.4% of GDP) and neutral in 2016.

Main budgetary measures

Revenue	**Expenditure**
2014	
• One off asset liquidation proceeds by the Deposit Insurance Fund (+1.4% of GDP) • Increase in non-taxable allowance (-0.1% of GDP)	• One off compensations paid by State Deposit Insurance Fund to insured depositors (+0.2% of GDP) • One off pension compensation ordered by the Constitutional Court (accrual) (+0.8% of GDP) • Partial reversal of public wage freeze (+0.2% of GDP) • Reduction of transfers to the second pillar pension funds (-0.1% of GDP)
2015	
• One-off asset liquidation proceeds by the Deposit Insurance Fund (+0.3% of GDP) • New taxes on interest and capital gains and new limit on offsetting earlier losses in corporate income tax; an increase in excise taxes on tobacco and alcohol (+0.1% of GDP)	• Increase in defence spending (+0.3% of GDP) • Increase in social spending (pensions, sickness allowance) (+0.2% of GDP)
2016	
• One off asset liquidation proceeds by the Deposit Insurance Fund (+0.1% of GDP) • Restoration of full VAT rate for centralised residential heating (+0.1% of GDP)	• Increase in motivational contribution to the private pension funds (+0.1% of GDP). Programme applies for the application of these expenditures under the systemic pension reform clause.
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.	

In addition, the programme emphasises efforts to enforce tax collection to sustain and raise revenues over the programme period. However, estimates have not been provided in that respect. The same applies to measures related to streamline expenditures. While the measures listed in the table on 'Main budgetary measures' and their respective estimated impact can be considered as sufficiently detailed and plausible to be taken into account in the Commission 2015 spring forecast, this is not the case for tax compliance measures and the streamlining of expenditures, explaining part of the difference between the Commission forecast and the Stability Programme.

In its Stability Programme, Lithuania has applied to avail in 2016 from an allowance linked to its 2012 pension reform. In 2012 Lithuania has changed the funding of the second pillar: as of 2014 three sources are used to fund it – a transfer of contributions from the first pillar;

additional contributions paid by the members and contributions paid by the State. Lithuania considers that the increase in the contribution paid by the State from 1% to 2% of the average wage in Lithuania from 2016 onwards should be taken into account under the preventive arm of the Stability and Growth Pact.

3.3. Debt developments

Lithuania's Stability Programme highlights a temporary hike in gross government debt targets in 2015 (Table 3). Having stood at 40.9% of GDP in 2014, gross debt is expected to rise to 42.2% in 2015, before declining to 37.7% in 2016. This is mainly due to higher pre-financing of EU fund expenditures in 2015, the end of year pre-financing of 2016 bond redemptions, and an extra 0.3 pp. and 0.2 pp. increase in defence and social spending, respectively, in 2015 compared to 2014. Going forward, Lithuania's debt is set to fall in 2016 as the pre-financing ends. This assessment of short-term future debt dynamics is also shared by the Commission in its 2015 spring forecast, although setting slightly lower gross debt targets (i.e. 41.7% of GDP and 37.3%, for 2015 and 2016, respectively).

Lithuania's previous Convergence Programmes had the tendency to predict the short-term debt dynamics quite well, while medium-term outturns were somewhat higher than predicted in past programmes (Figure 1), but always substantially below the 60% of GDP reference value of the Treaty.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**36.2**	**40.9**	**41.7**	**42.2**	**37.3**	**37.7**	**39.4**	**32.9**
Change in the ratio	4.8	2.1	0.8	1.3	-4.4	-4.5	1.7	-6.5
Contributions[2] :								
1. Primary balance	**4.4**	**-0.9**	**0.0**	**-0.5**	**-0.5**	**-0.5**	**-1.5**	**-1.9**
2. "Snow-ball" effect	**0.6**	**0.2**	**-0.3**	**0.5**	**-0.8**	**-0.5**	**-0.6**	**-1.2**
Of which:								
Interest expenditure	1.7	1.6	1.4	1.7	1.4	1.6	1.5	1.2
Growth effect	-0.5	-1.1	-1.1	-1.0	-1.3	-1.3	-1.2	-1.4
Inflation effect	-0.7	-0.3	-0.7	-0.2	-0.9	-0.9	-0.9	-0.9
3. Stock-flow adjustment	**-0.1**	**2.9**	**1.2**	**1.3**	**-3.0**	**-3.4**	**3.8**	**-3.4**
Of which:								
Cash/accruals diff.								
Acc. financial assets								
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual								

Notes:

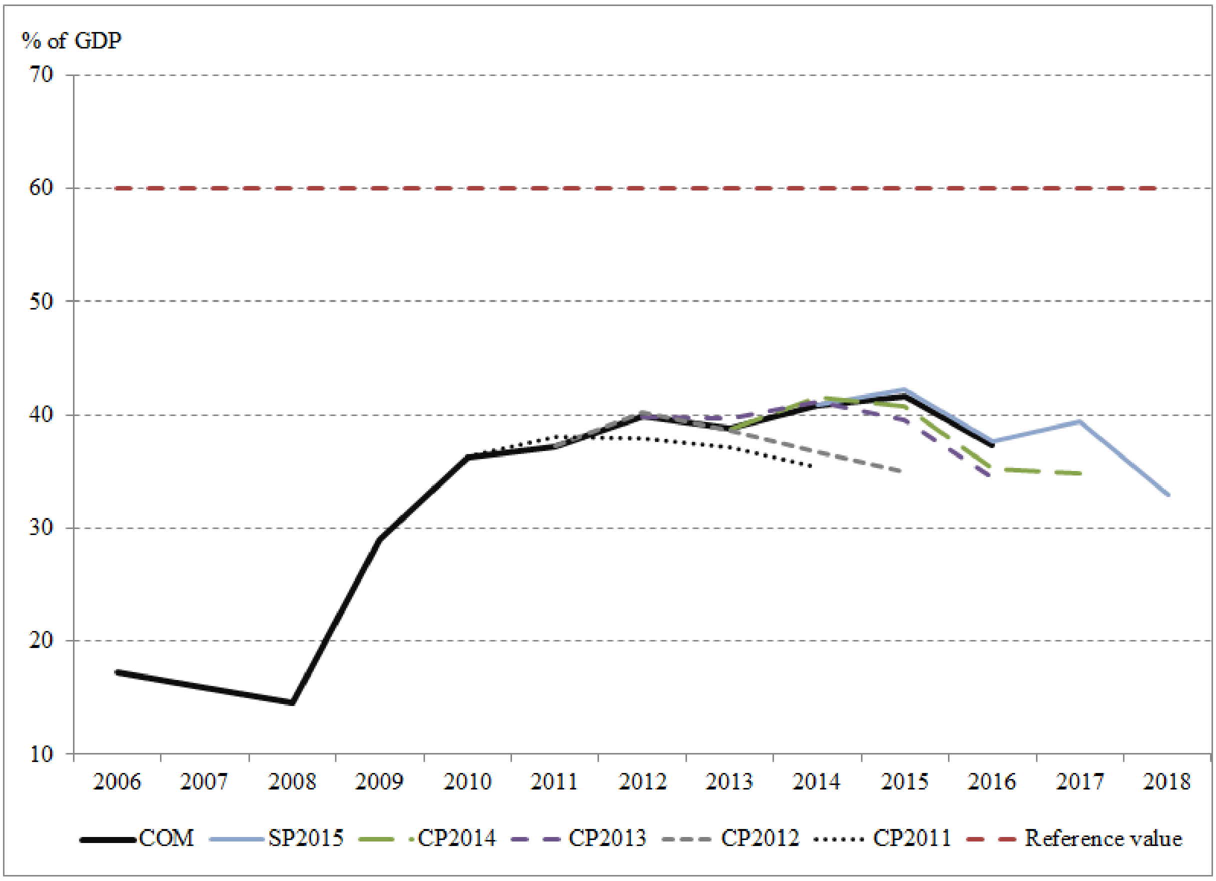
[1] End of period.

[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 2015 spring forecast (COM); Stability Programme (SP); Comission calculations.

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



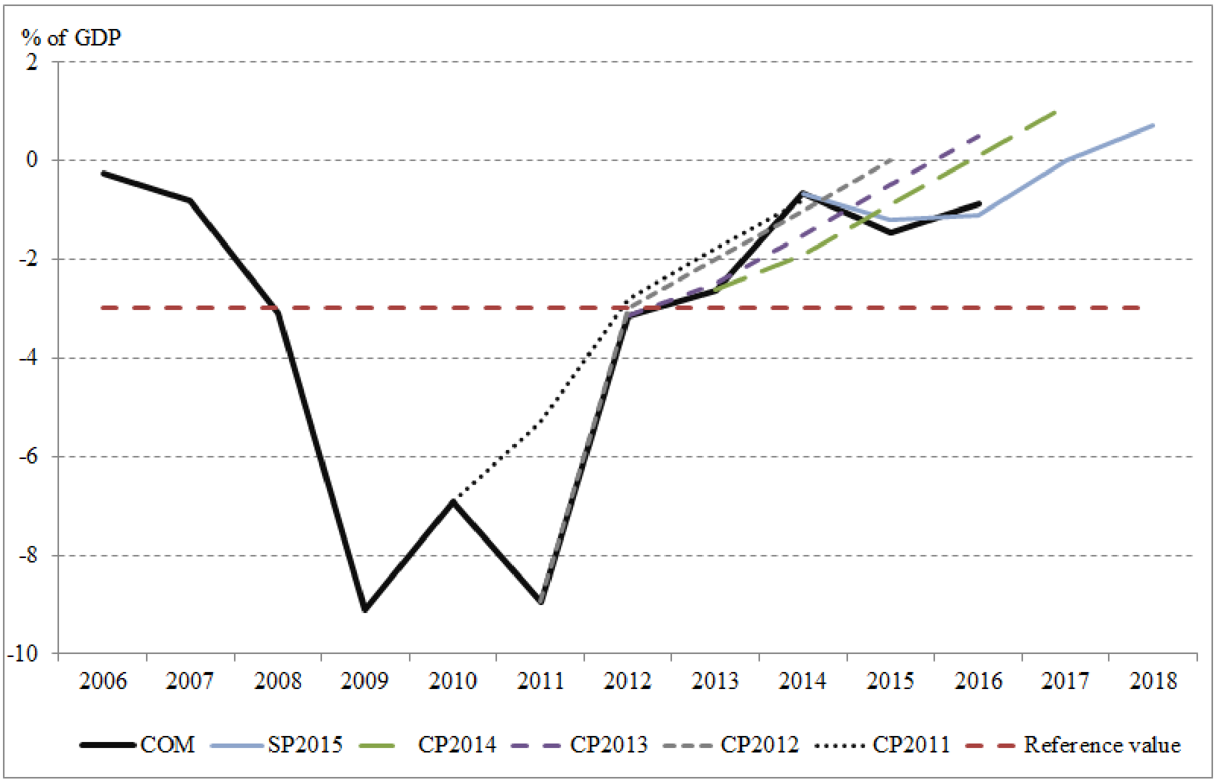
Source: Commission 2015 spring forecast; Stability or Convergence Programmes.

3.4. Risk assessment

The projected consolidation path for the general government deficit as well as the structural balance is subject to a number of risks, in particular on the expenditure side. First, the planned expenditure compression could be subject to revisions as pressure to increase public wages are expected to rise on the back of strong wage growth in the private sector and implementation risks in view of upcoming elections. Second, in 2015 the Lithuanian government might decide to compensate public wage cuts executed during the economic crisis and considered unconstitutional by the constitutional court. If enacted, this would increase the 2015 deficit by around 0.3% of GDP. Finally, the programme expects additional revenues following additional tax compliance measures introduced in May 2015, which might not have the desired impact.

Lithuania's Fiscal Council assessed that the programme economic scenario did 'not contradict the patterns of the economy'.

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



Source: Commission 2015 spring forecast; Stability or Convergence Programmes.

The risks to the budgetary deficit targets mentioned above would also have an impact on public debt.

4. Compliance with the provisions of the Stability and Growth Pact

Lithuania exited the EDP in 2013. Its general government deficit has been below the 3% of GDP Treaty reference value since then and is forecast to remain so in 2015 and 2016 according to the Commission 2015 spring forecast. Lithuania's government debt was 40.9% of GDP at the end of 2014, well below the 60% of GDP Treaty reference value. The Stability Programme as well as the Commission 2015 spring forecast expects debt to be on a declining path in the coming years.

Box 1. Council recommendations addressed to Lithuania

On 8 July 2014, 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 reinforce the budgetary measures for 2014 in the light of expenditure growth exceeding the benchmark and the emerging gap of 0.3 % of GDP in terms of structural effort based on the Commission services 2014 spring forecast, pointing to a risk of significant deviation relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, strengthen the budgetary strategy to ensure the required adjustment of 0.5 % of GDP towards the medium-term objective. Thereafter ensure that the medium-term objective is adhered to. Complement the budgetary strategy with a further strengthened fiscal framework, in particular by ensuring binding expenditure ceilings when setting the medium-term budgetary framework. Further review the tax system and consider increasing those taxes that are least detrimental to growth, such as recurrent property and environmental taxation, while continuing to improve tax compliance.

In 2014, the structural balance improved by 1.1% of GDP, well above the required structural improvement of 0.5% of GDP, while net expenditure growth was below the benchmark. With a structural balance of 1.2% of GDP, Lithuania reached its medium-term objective (MTO) – a structural deficit of 1% of GDP - already in 2014. Over the years 2013 and 2014, both the structural balance and the expenditure benchmark pillars were met. The ex-post assessment suggests that the adjustment path towards the MTO was appropriate and in line with the requirements in 2014.

For 2015, the Stability Programme plans to remain at the MTO as the recalculated structural deficit is projected to remain unchanged, at 1.2% of GDP. However, the required 0.2% of GDP improvement in the structural balance - based on the initial position slightly below the MTO as estimated by the Commission, is expected to be missed (gap of 0.2% of GDP). Based on the Commission 2015 spring forecast, the projected 0.7% of GDP deterioration of the structural balance points to a significant deviation from the required adjustment in 2015. The difference between the Commission's and the programme's assessment is based on a divergent view on the cyclical position and a higher general government deficit forecast by Commission for 2015.

According to the information provided in the Stability Programme and recalculated by the Commission, the growth rate of government expenditure, net of discretionary revenue measures, will not exceed the applicable expenditure benchmark rate (1.4%) in 2015. However, the Commission 2015 spring forecast indicates a 0.3% of GDP excess of net expenditure growth over the benchmark indicating a risk of some deviation from the required adjustment towards MTO.

In conclusion, based on the recalculated structural balance, the programme's efforts to maintain the MTO are appropriate. Nevertheless, based on the Commission 2015 spring forecast the structural balance points to a significant deviation, while the expenditure benchmark suggests some deviation from the requirements. Therefore an overall assessment is warranted. The difference between the two pillars is mostly due to significant revenue shortfalls, scaling down the effort measured by the structural balance pillar. Hence, the overall assessment suggests that Lithuania is at risk of some deviation in 2015.

For 2016, the recalculated structural deficit based on the Stability Programme is set to improve by 0.4% of GDP and therefore is projected to remain at the MTO. In the meantime, the recalculated structural adjustment slightly falls short of the 0.5% of GDP required improvement (defined on the basis of the Commission forecast for the initial structural balance position). Based on the Commission 2015 spring forecast, the structural balance is set to improve by 0.7% of GDP in 2016, i.e. 0.2% above the requirement.

The expenditure growth rate in 2016 as recalculated by Commission based on the information in the programme is below the benchmark. However, the Commission 2015 spring forecast indicates an excess of 0.4% of GDP of net expenditure growth over the benchmark indicating a risk of some deviation from the required adjustment.

Over the years of 2015 and 2016 together, the structural balance is set to deviate by 0.2% of GDP from the required adjustment as recalculated by Commission based on the information in the programme. According to the Commission 2015 spring forecast both the structural balance and expenditure growth significantly deviate from the required adjustment path pointing to a risk of significant deviation in 2016. According to the programme's (recalculated) assumptions, efforts to remain at the MTO in 2016 are appropriate, whereas, based on the Commission 2015 spring forecast, there is a risk of a significant deviation from the adjustment path towards the MTO in 2016.

Lithuania has applied to avail in 2016 from an allowance linked to its 2012 pension reform. The programme estimates the additional budgetary costs stemming from this reform at 0.1% of GDP in 2016. Subject to a confirmation by Eurostat that the pension reform fulfils the necessary conditions to be considered eligible, Lithuania could benefit from the requested temporary deviation in 2016. However, this would in all likelihood not eliminate the risk of significant deviation from the required adjustment in 2016.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.2	-1.9		-1.2	
Structural balance based on freezing (COM)	-1.2	-1.9		-	
Position vis-a -vis the MTO[3]	Not at MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2014**	**2015**		**2016**	
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.5	0.0		0.5	
Required adjustment corrected[5]	0.5	0.2		0.5	
Change in structural balance[6]	1.1	0.0	-0.7	0.4	0.7
One-year deviation from the required adjustment [7]	0.6	-0.2	-0.9	-0.1	0.2
Two-year average deviation from the required adjustment [7]	0.5	0.2	-0.1	-0.2	-0.3
Expenditure benchmark pillar					
Applicable reference rate[8]	0.4	1.4		0.4	
One-year deviation [9]	1.2	0.6	-0.3	0.2	-0.4
Two-year average deviation [9]	0.8	0.9	0.4	0.4	-0.3
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Compliance	Overall assessment	Overall assessment	Significant deviation

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = 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 28.).

[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.

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

[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 not at its MTO.

[9] 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 2015 spring forecasts (COM); Commission calculations.

Assessment of eligibility for the pension reform clause

Lithuania is currently under the preventive arm of the Stability and Growth Pact, and has requested in its Stability Programme a temporary deviation from the required adjustment path towards the medium-term objective (for 2016 only) in view of its 2012 pension reform. Several conditions have to be fulfilled before the pension reform can be taken into account.

First, the pension system reform needs to be systemic, i.e. *a reform introducing a multi-pillar system that includes a mandatory, fully funded pillar and the net cost of the publicly managed pillar*. This eligibility assessment requires Eurostat to confirm that the 2012 pension reform fulfils all the stated conditions. Lithuania has asked Eurostat to assess the eligibility of its 2012 pension reform, but an answer is still outstanding. Second, Lithuania is also required not to be subjected to an Excessive Deficit Procedure (EDP) in 2016 (i.e. the year of the deviation). Based on the Commission 2015 spring forecast Lithuania is expected not to enter in EDP in 2016 as its general government deficit is projected to be at 0.9% of GDP, below the 3% of GDP Treaty reference value, as well as the associated safety margin. The safety margin ensures that Lithuania's structural balance in 2016 is projected to remain above its minimum benchmark. The Commission forecasts Lithuania's structural balance to amount to -1.2% of GDP in 2016, which is above its current minimum benchmark of -1.8% of GDP. Finally, Lithuania's structural balance is also expected to remain within a maximum distance of 1.5% of GDP from MTO in 2015, this currently fixed at -1.0% of GDP, while the structural balance is set to be at 1.9% of GDP.

Subject to a confirmation by Eurostat that the pension reform fulfils the necessary conditions to be considered eligible, Lithuania could therefore benefit from the requested temporary deviation in 2016. The allowed deviation from the adjustment path towards the MTO or from the MTO itself would amount to the direct net costs of the reform. There is no cap for the amount of allowed deviation in this case. Lithuania estimates the budgetary costs of the pension reform at around EUR 38.3 million which amounts to roughly 0.1% of GDP in 2016. These additional funds are directed to extra motivational contribution paid by the State to the contributions to the private pension funds. The additional payments start from 2016. Lithuania highlights that the impact of this particular increase can be directly associated with the 2012 pension reform, the latter which Lithuania forecasts to result in a decrease of pension expenditure by 0.1% of GDP in 2040, and 0.2% of GDP both in 2050 and in 2060.

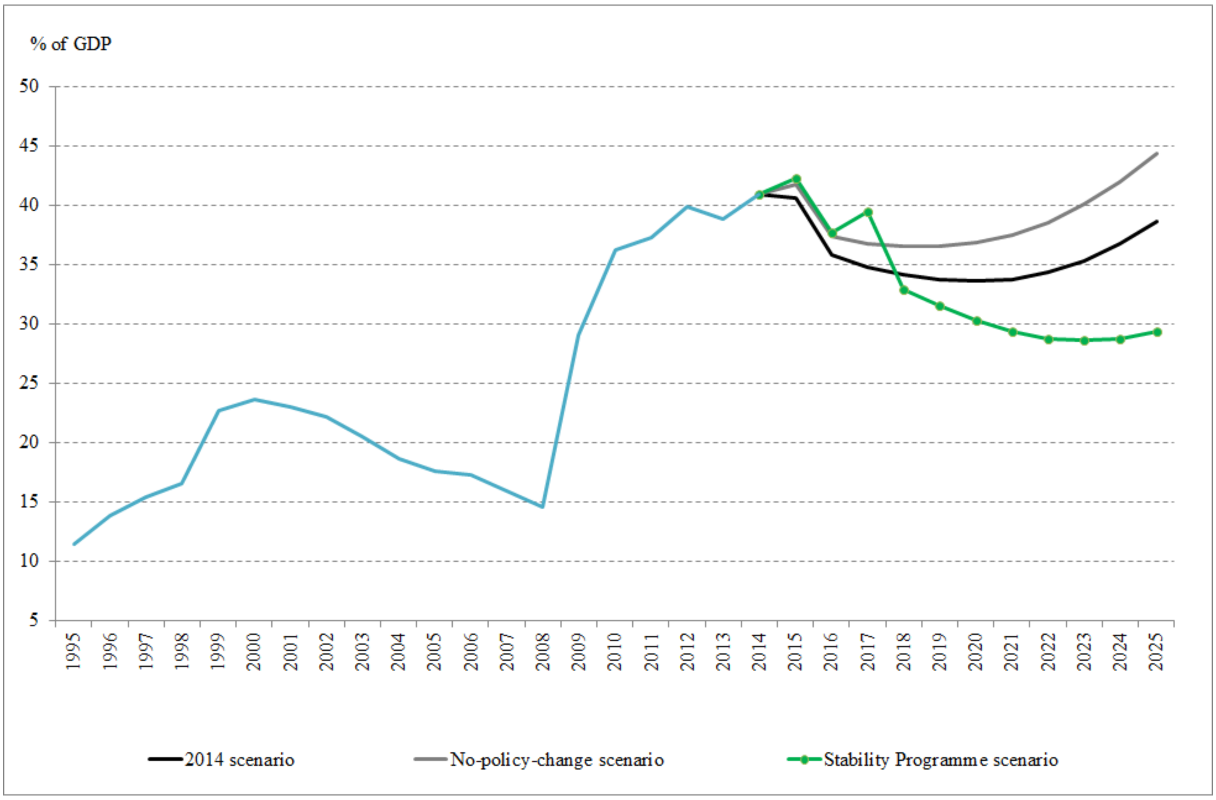
Subject to verification of these numbers by the Eurostat, the underlying macroeconomic and systemic assumptions seem reasonable and the additional reform measures may be considered as a part of a major structural reform, given that over the long term overall pension reform lowers State spending on the mandatory state pension pillar by strengthening mandatory and voluntary private pension pillars.

5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report[5] published on 12 May. It therefore updates the assessment made in the Country Reports[6] published on 26 February.

Government debt stood at 40.9% of GDP in 2014. It is expected to rise to 44.4% in 2025 remaining below the 60% of GDP Treaty threshold. However, the full implementation of the programme would put debt on a decreasing path by from 2017, remaining below the 60% of GDP reference value in 2025.

Figure 3: Gross debt projections (% of GDP)



Source: Commission 2015 spring forecast; Stability Programme; Commission calculations.

Lithuania appears to face medium fiscal sustainability risks in the medium-term. The medium-term sustainability gap is at 0.3% of GDP, primarily related to the projected ageing costs contributing with 1.4 pps. of GDP until 2030.

In the long-term, Lithuania appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs contributing with 2.8 pps. of GDP over the very long run. The long-term sustainability gap shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path is at 3.2% of GDP.

[5] See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

[6] See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Risks would be higher in the event of the structural primary balance reverting to negative values observed in the past, such as the average for the period 2004-2013. Further containing age-related expenditure growth appears necessary to contribute to the sustainability of public finances in the medium/long term.

The projected ageing costs pose a challenge in Lithuania. While considering the adequacy of pensions, a pension reform should ensure fiscal sustainability taking into account changes in life-expectancy by e.g. linking the statutory retirement age with life expectancy indicator and provide clear rules for pension indexation.

Table 5: Sustainability indicators

	Lithuania			European Union		
	2014 scenario	**No-policy-change scenario**	**Stability Programme scenario**	**2014 scenario**	**No-policy-change scenario**	**Stability/ Convergence Programme scenario**
S2*	2.7	3.2	1.9	1.4	1.7	0.4
of which:						
Initial budgetary position (IBP)	0.2	0.4	-0.8	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	2.5	2.8	2.8	1.0	1.1	1.1
of which:						
pensions	0.9	1.2	1.2	0.0	0.1	0.1
healthcare	0.2	0.1	0.1	0.8	0.7	0.6
long-term care	0.8	0.8	0.7	0.7	0.7	0.6
others	0.7	0.8	0.9	-0.4	-0.3	-0.2
S1**	-0.3	0.3	-2.0	1.4	1.8	0.5
of which:						
Initial budgetary position (IBP)	-0.3	0.3	-1.5	-0.4	-0.3	-1.6
Debt requirement (DR)	-1.0	-1.4	-2.0	1.7	1.9	1.8
Long-term cost of ageing (CoA)	1.0	1.4	1.5	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.12	:		:		
Fiscal subindex	0.00	:		:		
Financial-competitiveness subindex	0.17	:		:		
Debt as % of GDP (2014)	40.9			88.6		
Age-related expenditure as % of GDP (2014)	16.4			25.6		

Source: Commission, 2015 Stability Programme

Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability 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.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the foercast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES7

6.1. Fiscal framework

As highlighted in the Commission's assessment in the 2015 Country Report (section 2.1), Lithuania advanced in complementing its fiscal framework in 2014, but doubts remain. In November 2014, the country transposed the rules of the Fiscal Compact into a constitutional law and two additional laws amending existing legislation, including the law on expenditure rule. This package, which entered into force from 2015, places the structural budget-balance rule at constitutional level, and is intended to strengthen the binding character of the medium-term framework. However, the rule does not appear to be clearly centred on compliance with the medium term objective and its adjustment path. In this respect, it is not unequivocally anchored to the EU fiscal framework. The credibility of the new fiscal framework is also weakened by loosely defined escape clauses, in particular in the event of a negative output gap and the lack of progress in the establishment of binding expenditure ceilings as recommended in the 2014 CSR. The budgetary cycle in 2015 will be the first test of the new fiscal framework and its effectiveness.

Lithuania has given its National Audit Office the task of setting up an independent fiscal council with a view to following the requirements contained in the Two pack regulation. It presented the first opinion to the Parliament approving economic development scenario underpinning the Stability Programme. The fiscal council is set up as an entity within the National Audit Office, and it is up to the Office to ensure the council's independence and autonomy. However, the de facto independence of the council's work and funding has still to be ensured. This is of particular relevance given that there are no additional regulations formally ensuring the independence of the fiscal council within the existing National Audit Office.

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 economic returns on non-defence public investment projects that have a significant budgetary impact as required by art. 4.1 of the above mentioned regulation.

6.2. Quality of public finances

The impact of the plans to streamline expenditures and improve tax compliance contained within the programme is not sufficiently detailed to confirm substantial effect on either the effectiveness of government expenditure, or the structure of the tax revenues. The issues with Lithuania's tax system are discussed in more detail in the 2015 Country Report.

[7] This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability programme

7. CONCLUSIONS

In 2014, Lithuania achieved an improvement of the structural balance of 1.1% of GDP, above the required structural improvement of 0.5% of GDP, and reached its MTO. The growth rate of government expenditure net of discretionary revenue measures was below the applicable expenditure benchmark rate. Hence, Lithuania complied with the requirements.

Lithuania plans to remain at the MTO in 2015 and 2016, with structural deficits of around 1.1% of GDP, and undertake further consolidation efforts in 2017 and 2018 achieving a structural surplus at the end of the programme.

The planned efforts to remain at the MTO appear appropriate based on the programme's (recalculated) assumptions. However, according to the Commission 2015 spring forecast, there is a risk of some deviation in 2015. Over the years of 2015 and 2016, both the structural balance and expenditure growth significantly deviate from the required adjustment path pointing to a risk of significant deviation in 2016.

Lithuania could benefit from the requested temporary deviation from the MTO or from the adjustment path towards the MTO in 2016 amounting to the direct net costs of the systemic pension reform – around 0.1% of GDP – subject to a confirmation by Eurostat.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	5.0	7.9	1.3	3.8	3.3	2.9	2.8	3.3
Output gap [1]	-0.5	1.6	-1.4	-1.2	0.2	0.6	0.4	0.4
HICP (annual % change)	4.0	1.4	5.3	3.2	1.2	0.2	-0.4	1.7
Domestic demand (annual % change) [2]	5.6	9.6	0.3	-0.2	2.9	4.6	3.7	4.3
Unemployment rate (% of labour force) [3]	13.6	10.2	11.4	13.4	11.8	10.7	9.9	9.1
Gross fixed capital formation (% of GDP)	21.9	22.9	21.6	17.3	18.2	19.2	19.5	20.0
Gross national saving (% of GDP)	12.9	15.9	16.6	18.2	20.6	19.3	18.8	18.6
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**n.a**	**-0.7**	**-5.8**	**-3.1**	**-2.6**	**-0.7**	**-1.5**	**-0.9**
Gross debt	**20.2**	**19.2**	**26.6**	**39.8**	**38.8**	**40.9**	**41.7**	**37.3**
Net financial assets	**20.3**	**7.7**	**-4.4**	**-24.8**	**n.a**	**n.a**	**n.a**	**n.a**
Total revenue	n.a	33.5	34.8	33.0	32.9	34.3	32.4	32.5
Total expenditure	n.a	34.1	40.6	36.1	35.5	34.9	33.9	33.4
of which: Interest	n.a	0.8	1.2	2.0	1.8	1.6	1.4	1.4
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-6.3**	**-5.6**	**3.4**	**6.6**	**8.2**	**n.a**	**n.a**	**n.a**
Net financial assets; non-financial corporations	**-87.1**	**-88.9**	**-95.9**	**-79.3**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-2.0**	**-2.2**	**1.6**	**0.9**	**n.a**	**n.a**	**n.a**	**n.a**
Gross capital formation	15.4	15.7	13.9	12.0	11.6	n.a	n.a	n.a
Gross operating surplus	25.1	32.8	34.8	38.6	38.7	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.5**	**-0.2**	**-1.7**	**-2.2**	**-2.5**	**n.a**	**n.a**	**n.a**
Net financial assets	**40.1**	**42.6**	**40.8**	**47.0**	**n.a**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	31.4	32.6	33.6	30.9	31.0	n.a	n.a	n.a
Net property income	13.1	18.0	13.6	16.0	15.8	n.a	n.a	n.a
Current transfers received	11.7	11.3	16.4	14.1	15.0	n.a	n.a	n.a
Gross saving	3.2	3.0	1.4	0.9	1.4	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-8.6**	**-6.5**	**-3.0**	**2.0**	**4.5**	**3.3**	**1.8**	**0.9**
Net financial assets	**29.2**	**41.3**	**58.7**	**57.3**	**n.a**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-8.7	-7.2	-6.2	0.9	1.3	0.3	0.6	0.0
Net primary income from the rest of the world	-1.9	-1.7	-2.2	-3.0	-2.6	-3.0	-2.9	-3.0
Net capital transactions	0.0	0.8	3.1	2.9	3.0	2.7	2.0	1.9
Tradable sector	53.3	55.5	53.1	58.1	57.6	56.6	n.a	n.a
Non tradable sector	35.2	34.6	36.9	32.3	32.9	33.5	n.a	n.a
of which: Building and construction sector	6.3	6.8	7.4	5.4	5.9	6.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	80.9	93.7	105.4	98.4	101.0	103.8	102.9	104.0
Terms of trade goods and services (index, 2000=100)	89.5	97.8	100.6	98.2	98.2	99.0	100.5	100.8
Market performance of exports (index, 2000=100)	64.2	78.3	93.4	115.9	125.0	124.7	123.4	124.5

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 2015 spring forecast.