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**Assessment of the 2016 Stability Programme for
Lithuania**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Lithuania's April 2016 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 29 April 2016 and covers the period 2015-2019. It was approved by the government and presented to the national parliament for a debate without a vote.

Lithuania is 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 budgetary objective.

This document complements the Country Report published on 26 February 2016 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 2016 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 and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Lithuania's stability Program's macroeconomic scenario covers the years 2016 – 2019. After a slowdown in 2015 with GDP growth reaching only 1.6%, Lithuania's real GDP is expected to recover to 2.5% in 2016 and accelerate further in 2017-2019. The main growth drivers in 2016 are expected to be private consumption and recovering exports, which were the main reason for slowdown in GDP growth in 2015 due to a significant loss of trade with Russia. Investment demand is forecast to accelerate to some 5% in 2017 and is expected to remain at that level for 2018 and 2019.

Compared to the macroeconomic projections included in 2015 stability Program, as well as to the similar projections in the 2016 Draft Budgetary Plan, GDP growth has been revised downwards by 0.7 pps. for 2016, by 0.3 pps. for 2017, and by 0.8 pps. for 2018. This reflects a more cautious view on employment growth and hence private consumption growth.

The output gap as recalculated by Commission following the commonly agreed methodology, is expected to be slightly negative in 2016. It is set to turn positive in 2017 and continue increasing in both 2018 and 2019. The opening of the output gap in the outer years is due to increasingly negative labour contribution to potential output.

Overall, the programme's macroeconomic projections, in particular real GDP growth and its composition are similar to those of the Commission. The Commission's GDP growth forecast for 2016 is somewhat more positive at 2.8%, while for 2017 it is slightly more negative than the Stability Programme at 3.1%. The composition of both forecasts are broadly similar, especially for private consumption, the tax base for consumption taxes. At the same time, wage growth and employment growth forecasts, the tax bases for personal income tax and social contributions respectively, are somewhat more optimistic than in the Commission's forecast. This is also reflected in higher projected revenue for the respective tax classes in 2017.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.6	1.6	2.8	2.5	3.1	3.2	3.1	3.1
Private consumption (% change)	4.9	4.9	4.3	4.3	3.9	4.1	4.0	3.9
Gross fixed capital formation (% change)	10.3	10.3	2.5	2.1	4.6	5.2	5.3	5.5
Exports of goods and services (% change)	1.2	1.2	3.1	3.6	3.8	4.4	4.5	4.8
Imports of goods and services (% change)	7.0	7.0	4.0	4.7	4.7	5.3	5.5	5.6
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	5.4	6.2	3.5	3.4	3.8	3.9	3.9	3.9
- Change in inventories	0.9	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- Net exports	-4.6	-4.6	-0.7	-0.9	-0.7	-0.7	-0.8	-0.8
Output gap ¹	0.1	0.1	0.5	0.0	1.1	0.1	0.3	0.6
Employment (% change)	1.3	1.3	0.2	0.6	0.1	0.3	0.1	0.1
Unemployment rate (%)	9.1	9.1	7.8	8.0	6.4	7.1	6.3	5.4
Labour productivity (% change)	0.3	0.3	2.6	1.9	3.0	2.9	3.0	3.1
HICP inflation (%)	-0.7	-0.7	0.6	0.7	1.8	2.2	2.5	2.5
GDP deflator (% change)	0.4	0.4	1.7	1.1	1.9	2.0	2.3	2.3
Comp. of employees (per head, % change)	4.1	4.1	4.6	5.6	5.1	6.2	6.4	6.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.4	1.3	2.4	0.5	2.7	-0.4	-1.4	-2.3
<u>Note:</u>								
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.								
<u>Source:</u>								
Commission 2016 spring forecast (COM); Stability Programme (SP).								

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

Lithuania's general government deficit amounted to 0.2% of GDP in 2015, after 0.7% of GDP a year before. The 2015 deficit outcome was significantly better than the 2016 Draft Budgetary Plan target of 0.9% of GDP and the target contained in the 2015 Stability Programme (1.2% 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, the excise collection was boosted by increased sales of fuel due lower prices and personal income tax was stronger than expected due to a higher-than-expected increase in the tax base on the back of growing wages and employment. The social insurance fund, SoDra, benefited from the robust labour market as well. Finally, one-off revenues and expenditures had a net positive effect on the general government deficit. While the Deposit Insurance Fund generated a surplus of 0.6% of GDP from liquidation proceeds, a one-off compensation of public wage cuts, that had been ruled unlawful by the constitutional court ruling, increased expenditure by 0.3% of GDP.

The structural balance improved by 1.1 pps. from -1.5% of GDP in 2014 to -0.4% in 2015, above the MTO (set at -1.0% of GDP), according to the Commission 2016 spring forecast.

3.2. Medium-term strategy and targets

The purpose of the programme is to achieve a headline surplus of 0.9% of GDP by the end of the programme period, which according to the authorities would result in a similar structural surplus (0.9% of GDP).

The programme foresees staying above the MTO (set at -1% of GDP) in 2016 and 2017, with a structural deficit improving from 0.7% in 2016 to 0% of GDP in 2017. Further consolidation should result in a structural surplus in 2018 and 2019. The developments of the recalculated structural balance¹ indicate a similar consolidation path with marginally stronger consolidation in 2015 and 2016 and a somewhat weaker structural balances in 2018 and 2019.

According to the Commission 2016 spring forecast, the structural deficit is set to deviate from the MTO in 2016 by 0.2% of GDP before getting above the MTO in 2017 with a structural deficit of 0.8% of GDP in 2017. This compares to a (recalculated) structural deficit in the programme of 0% of GDP. The difference between the Commission's estimate and the (recalculated) structural deficit is mainly due to different output gap estimates. The Commission forecasts Lithuania to have a positive output gap, while the programme assumes the gap close to zero.

The planned nominal consolidation path in the 2016 Stability Programme is faster than presented in the previous one and in the 2016 Draft Budgetary Plan, i.e. in line with the Commission opinion on the DBP indicating the necessity to take measures to ensure compliance with the SGP. Improvement in the public finances, however, is set to pause in 2016 following overachieved consolidation targets in 2015. The objective to reach a nominal balance in 2017 has been maintained from the previous the programme. The economic outlook is weaker than a year before, but remains robust, thus providing favourable conditions for gradual fiscal consolidation.

The revenue-to-GDP ratio in the 2016 Stability Programme is projected to fall slightly to 34.6% in 2016 before improving to 35.2% in 2017 and the expenditure-to-GDP ratio is expected to fall from 35.4% to 35.2% in the same years. The 2016 trends are broadly in line with the Commission 2016 spring forecast, while under a no-policy-change assumption the Commission expects lower revenues and expenditures in 2017.

The envisaged improvement in the fiscal position over the programme period is driven by expenditure growing slower than nominal GDP and revenues increasing faster. The foreseen robust economic growth towards the end of the period also supports the consolidation. The programme defines new specific discretionary revenue measures to be used in case of shortfalls (such as reducing tax exemptions, lowering general government expenditures, adjusting excise taxes on tobacco, changing real estate tax base, broadening the base of environmental taxes).

The main programme scenario sets fiscal targets assuming that revenue growth will be sustained through a strengthened tax administration and an increase in growth friendly taxes, while such measures are not specified beyond 2017.

¹ Commission calculations on the basis of the information in the programme according to the commonly agreed methodology.

The programme requests to benefit from the so-called "structural reform clause" with an estimated impact on the structural adjustment path of around 0.6% of GDP in 2017 under the preventive arm of the stability and Growth Pact. However, the programme scenario does not assume an impact of these reforms, since the reform package is still under consideration by the national parliament.

The programme maintains an MTO of a structural deficit of 1% of GDP, which reflects the objectives of the stability and Growth Pact.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	34.9	34.2	34.6	34.1	35.2	35.7	35.3	0.4
<i>of which:</i>								
- Taxes on production and imports	11.8	11.9	11.9	12.0	12.2	12.3	12.2	0.4
- Current taxes on income, wealth, etc.	5.5	5.4	5.6	5.4	5.7	5.8	6.1	0.6
- Social contributions	12.0	12.0	12.2	12.0	12.3	12.4	12.5	0.5
- Other (residual)	5.6	4.9	4.9	4.8	5.0	5.2	4.5	-1.1
Expenditure	35.1	35.2	35.4	34.5	35.2	34.9	34.4	-0.7
<i>of which:</i>								
- Primary expenditure	33.6	33.7	34.0	33.1	33.9	33.9	33.4	-0.2
<i>of which:</i>								
Compensation of employees	9.7	9.6	9.7	9.5	9.6	9.7	9.5	-0.1
Intermediate consumption	5.2	5.1	5.3	5.2	5.2	5.3	5.3	0.1
Social payments	12.6	12.8	12.8	12.4	12.5	12.2	11.8	-0.7
Subsidies	0.4	0.4	0.3	0.4	0.3	0.3	0.3	-0.1
Gross fixed capital formation	3.6	3.5	3.5	3.5	4.0	4.3	4.3	0.7
Other (residual)	2.2	2.5	2.5	2.1	2.3	2.2	2.1	-0.1
- Interest expenditure	1.5	1.5	1.4	1.4	1.3	1.0	0.9	-0.6
General government balance (GGB)	-0.2	-1.1	-0.8	-0.4	0.0	0.8	0.9	1.1
Primary balance	1.3	0.4	0.6	1.0	1.3	1.8	1.9	0.6
One-off and other temporary	0.1	0.0	-0.1	0.0	0.0	0.3	0.0	-0.2
GGB excl. one-offs	-0.3	-1.0	-0.7	-0.4	0.0	0.5	1.0	1.3
Output gap ¹	0.1	0.5	0.0	1.1	0.1	0.3	0.6	0.5
Cyclically-adjusted balance ¹	-0.3	-1.3	-0.8	-0.8	0.0	0.7	0.7	0.9
Structural balance²	-0.4	-1.2	-0.7	-0.8	0.0	0.4	0.7	1.1
Structural primary balance ²	1.1	0.2	0.7	0.6	1.3	1.4	1.7	0.5
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 2016 spring forecasts (COM); Commission calculations.								

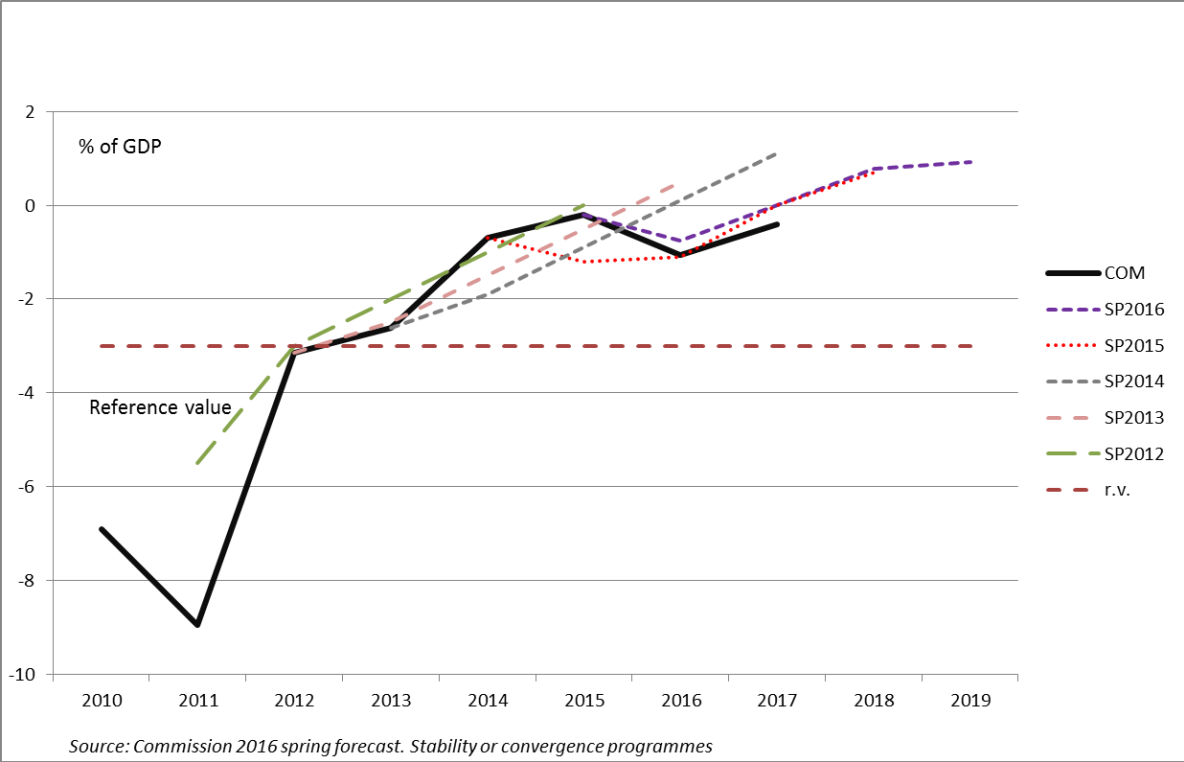
In its Stability Programme, Lithuania targets a general government deficit of 0.8% of GDP for 2016. Based on the (recalculated) structural balance the programme foresees remaining above the MTO in 2016 with a structural deficit of 0.7% of GDP.

The Commission 2016 spring forecast has a less optimistic view on 2016 compared to the programme. In the absence of significant policy measures, it projects a general government deficit of 1.1% of GDP and a structural deficit of 1.2% of GDP, which is assessed to be at the MTO (-1% of GDP) due to the 0.25% of GDP margin of tolerance.

The programme foresees slightly higher expenditures in 2016 as pensions, defence spending and public wages are set to increase. At the same time, higher excise duties on cigarettes, alcohol and some fuels as of 2016 should support tax revenues, but not sufficiently to cover new discretionary expenditure. The programme envisages that measures to improve tax compliance introduced in mid-2015 along with new tax enforcement measures will continue lifting revenues in 2016.

Based on past experience and the fact that tax compliance measures are difficult to quantify *ex ante*, the Commission 2016 spring forecast predicts somewhat lower tax revenues, especially from taxes on labour, which partially explains the higher general government and structural deficits compared to the programme.

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



Fiscal targets of Lithuania's stability and convergence programmes over the past four years tended to be softened, but this trend was halted with the 2016 Stability Programme. In addition, Lithuania has overachieved consolidation targets of last two programmes in 2014 and 2015.

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 measures and permanent ones. A significant impact in 2015 came from a positive one-off measure related to the Deposit Insurance Fund (liquidation proceeds and insurance payments) and to a negative one-off measure related to the public wage cut compensation ordered by the Constitutional Court. On balance, these items reduced the general government budget deficit in 2015 by around 0.3% of GDP. The flows from the Deposit Insurance Fund are set to improve the deficit by 0.1% in both 2016 and 2017. Measures of a permanent nature had a positive contribution to the general government balance of around 0.2% in 2015, while for 2016 the contribution is estimated to be negative (around -0.1% of GDP) and broadly neutral in 2017. Consecutive minimum wage increases are bound to increase the public wage bill, but these expenses are covered by higher personal income and social tax revenues. A gradual increase in indirect taxes is estimated to add to tax revenues 0.1% of GDP in 2015, 2016 and 2017.

The Stability Programme expects an additional 0.2% of GDP in tax revenues in 2016 and 0.1% in 2017 from measures to improve tax collection, adding to an expected yield of 0.2% of GDP in 2015. The Commission forecast has a lower positive effect from such measures in 2016 and 2017 since the impact of these measures can hardly be disentangled in advance from a solid increase in tax rich components of GDP growth. In turn, this increases the Commission's budget deficit forecast for 2016 and 2017.

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 envisaged 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 0.6% of GDP. However, the reform package was yet to be adopted at the time of the submission of the Stability Programme, therefore these costs were not reflected in the programme's baseline scenario.

Main budgetary measures

Revenue	Expenditure
2015	
<ul style="list-style-type: none"> • One-off asset liquidation proceeds by the Deposit Insurance Fund (+0.6% of GDP) • Set of increases in indirect taxes (+0.1% of GDP) • Measures to improve indirect tax collection (+0.2% of GDP) 	<ul style="list-style-type: none"> • One off compensations paid by State Deposit Insurance Fund to insured depositors (+0.1% of GDP) • One off public wage compensation ordered by the Constitutional Court (accrual) (+0.3% of GDP) • Increase in pensions and social payments (+0.1% of GDP)
2016	
<ul style="list-style-type: none"> • One-off asset liquidation proceeds by the Deposit Insurance Fund (+0.2% of GDP) • Increase in non-taxable allowance (-0.2% of GDP) • Measures to improve indirect tax 	<ul style="list-style-type: none"> • 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). Programme applies for the application of

<ul style="list-style-type: none"> collection (+0.1% of GDP) • Measures to improve personal income tax collection (+0.1% of GDP) • Set of increases in indirect taxes (+0.1% of GDP) 	<ul style="list-style-type: none"> these expenditures under the systemic 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	
<ul style="list-style-type: none"> • One-off asset liquidation proceeds by the Deposit Insurance Fund (+0.2% of GDP) • Set of increases in indirect taxes (+0.1% of GDP) • Measures to improve indirect tax collection (+0.1% of GDP) 	<ul style="list-style-type: none"> • One off compensations paid by State Deposit Insurance Fund to insured depositors (+0.1% of GDP)
<p><u>Note:</u> 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.</p>	

3.4. Debt developments

Lithuania's Stability Programme envisages a gradual decline in gross government debt over the program period (Table 3). From 42.7% of GDP in 2015, gross debt is expected to decline to 35.7% by 2019. This trend is driven by fiscal consolidation and helped by robust economic growth projections. The assessment of short-term future debt dynamics is broadly shared by the Commission in its 2016 spring forecast, although for 2017 a higher gross debt level accounts for the usual end of year pre-financing of 2018 bond redemptions. In the 2016 Stability Programme debt targets are defined without a possible pre-financing of bond redemptions, eliminating fluctuations in debt levels indicated in the previous Stability Programme.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	38.5	42.7	41.1	41.1	42.9	39.9	38.1	35.7
Change in the ratio	2.3	2.0	-1.6	-1.6	1.9	-1.2	-1.8	-2.4
<i>Contributions² :</i>								
1. Primary balance	2.7	-1.3	-0.4	-0.6	-1.0	-1.3	-1.8	-1.9
2. “Snow-ball” effect	-0.3	0.7	-0.4	-0.1	-0.5	-0.7	-1.0	-1.0
<i>Of which:</i>								
Interest expenditure	1.8	1.5	1.5	1.4	1.4	1.3	1.0	0.9
Growth effect	-1.2	-0.6	-1.2	-1.0	-1.2	-1.2	-1.2	-1.1
Inflation effect	-0.8	-0.2	-0.7	-0.5	-0.7	-0.8	-0.9	-0.8
3. Stock-flow adjustment	0.0	2.6	-0.8	-0.9	3.4	0.8	1.1	0.5
<i>Of which:</i>								
Cash/accruals diff.								
Acc. financial assets				0.0		0.0	0.0	0.0
<i>Privatisation</i>								
Val. effect & residual								

Notes:

¹ End of period.

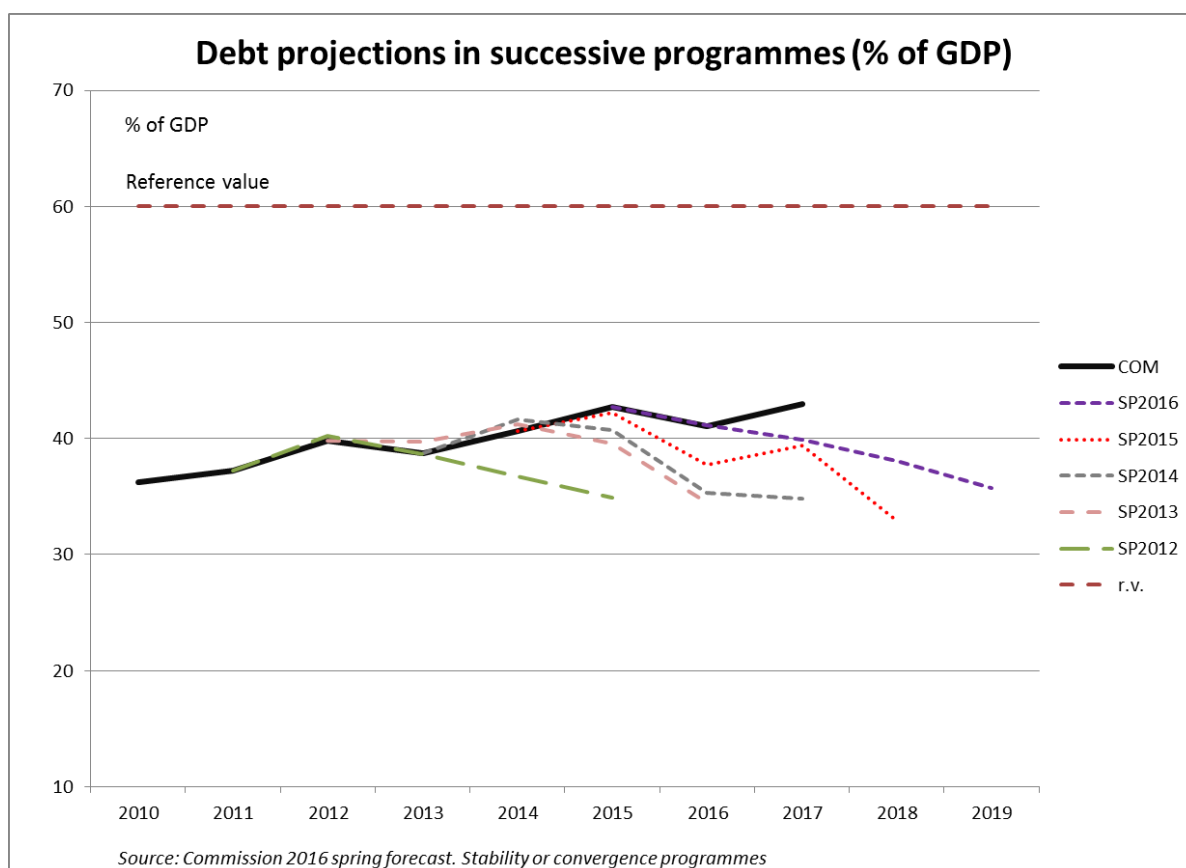
² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and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

Source :

Commission 2016 spring forecast (COM); Stability Programme (SP), Commission calculations.

Lithuania's previous Convergence and Stability Programmes generally predict the short-term debt dynamics quite well, while medium-term outturns were somewhat higher than projected in past programmes (Figure 2), they 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 Stability Programme are broadly in line with the Commission spring forecast. However, the projected consolidation path for the general government deficit as well as the structural balance is subject to a number of risks on the revenue as well as the expenditure side.

First, the planned increase in the revenue level by around 0.4% of GDP over the programme period depends mostly on a sustained improvement in tax compliance. This might prove to be too optimistic as not all measures might reach the desired yield, especially if the economic situation worsens or if tax evasion remains more persistent than anticipated. Second, the expenditure reduction of 0.7% of GDP over the programme period at the expense of social payments could be subject to revisions as the level of social spending is very sensitive to changes in economic, political and social situation. Even if economic growth remains robust, the pressure to increase public wages is expected to rise on the back of strong wage growth in the private sector. Finally, overall risks to the economic forecast are tilted to the downside and stem from possible decline in global trade and a prolonged recession in Russia which could dampen export growth. On the positive side, in the short run, risks to the public finance forecast are tilted to the upside due to the expected robust growth of the tax base, but only if expenditure discipline will not be challenged given the upcoming elections. The risks to the budgetary deficit targets mentioned above would also have an impact on 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 14 July 2015, 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 avoid deviating from the medium-term budgetary objective in 2015 and ensure that the deviation in 2016 is limited to the allowance linked to the systemic pension reform. Broaden the tax base and improve tax compliance.

4.1. Compliance with the MTO or the required adjustment path towards the MTO

Assessment of eligibility to the structural reform clause

In its Stability Programme, Lithuania has requested a temporary deviation from the required adjustment path towards the MTO in 2017 in view of an envisaged structural reform with expected direct long-term positive budgetary effects. Lithuania estimates the budgetary costs of the structural reform at around EUR 233 million which amounts to roughly 0.6% of GDP in 2017.

Several conditions have to be fulfilled for the structural reform to be taken into account. The reform should be major, with direct long-term positive budgetary effects, and implemented. Furthermore, the deviation – allowed under the clause – should not lead to a breach of the 3% of GDP deficit threshold and a safety margin to this threshold should be continuously preserved. 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 2016 spring forecast, the general government deficit of Lithuania is projected to be at 0.4% of GDP in 2017, well below the 3% of GDP Treaty reference value. The Commission forecasts Lithuania's structural balance to amount to -0.8% of GDP in 2017, which is above its current minimum benchmark of -1.5% of GDP. Finally, Lithuania's structural balance is also expected to remain within a maximum distance of 1.5% of GDP from the MTO in 2016, which is currently fixed at -1.0% of GDP, as the structural balance is foreseen to be -1.2% of GDP.

The main aims of the envisaged reform are in line with the country specific recommendations and encompass economy-wide issues, including critical labour market reforms. A group of scientists, who proposed the original reform plan, have presented an evaluation of expected positive effects independently from the government. The government has calculated the expected cost of the reform based on the proposed reform package. The direct long-term positive budgetary effects of the planned reform and the actual costs, however, cannot be fully assessed in advance. The reform package was still under intensive consideration by the national authorities at the time of this assessment and the eventual set-up of the reform was not yet determined. Therefore, pending a final agreement, uncertainty on the set of reform measures as well as their implementation remains.

Thus, while Lithuania has sufficient fiscal space to benefit from a temporary deviation, it currently does not appear to fulfil the eligibility criterion related to the implementation of the reform to avail from the structural reform clause. Moreover, it is currently not possible to assess the plausibility of the impact of the reform estimated by the government.

Compliance with the MTO

In 2015, the structural balance improved by 1.1% of GDP, well above the required structural improvement of 0.2% of GDP. With a structural balance of 0.4% of GDP in 2015, Lithuania was above its medium-term objective (MTO) – a structural deficit of 1% of GDP. Net expenditure growth was above the benchmark due to the fall in one-off revenues. After correcting for this factor, the net expenditure growth complies with the benchmark. Over the years 2014 and 2015, both the structural balance and the expenditure benchmark pillars were met. Therefore the assessment suggests that the adjustment path towards the MTO in 2015 was respected.

For 2016, the Stability Programme plans to remain above the MTO as the recalculated structural deficit is projected be at 0.7% of GDP. For 2016, Lithuania is eligible for a pension reform clause allowing for a deviation of 0.1% of GDP from the matrix-based adjustment.

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 (4.1%) in 2016. The Commission 2016 spring forecast indicates respect of the benchmark in 2016, while pointing to a 0.2% of GDP excess of net expenditure growth over the benchmark over two years (2015 and 2016). The expenditure benchmark over two years is negatively affected by a one-off factors related to lower capital transfers to the deposit insurance fund. After correcting for this factor, the expenditure benchmark over one and two years is in line with the benchmark

Based on the Commission 2016 spring forecast, the projected 0.8% of GDP deterioration of the structural balance results in a structural deficit of 1.2% of GDP in 2016, which implies that Lithuania is assessed to be at its MTO (-1% of GDP) thanks to the 0.25% of GDP margin of tolerance. Net expenditure growth is forecast to meet the benchmark. Over the years of 2015 and 2016 taken together, the structural balance pillar points to compliance (positive average gap of 0.4% of GDP), while the expenditure benchmark points to a risk of some deviation (average gap of -0.2% of GDP). The expenditure benchmark over two years is negatively affected by a one-off factors related to lower capital transfers to the deposit insurance fund. After correcting for this factor, the expenditure benchmark is in line with the benchmark. Therefore, the overall assessment points to compliance with the provisions of the Pact over 2015 and 2016 taken together.

For 2017, the recalculated structural deficit based on the Stability Programme is set to improve by 0.7% of GDP, well above the 0.1% of GDP required improvement (defined on the basis of the Commission forecast for the initial structural balance position) and therefore is projected to remain above the MTO.

The expenditure growth rate in 2017 and over two years (2016 and 2017) as recalculated by Commission according to the agreed methodology is below the expenditure benchmark.

Based on the Commission 2016 spring forecast, Lithuania is forecast to achieve a structural balance of -0.8% of GDP, i.e. it is assessed to be above its MTO. Net expenditure growth is forecast to be below the benchmark rate both in 2017 and over 2016 and 2017 taken together. Therefore, Lithuania is expected to respect the provisions of the Pact in 2017.

Lithuania has applied to benefit in 2017 from an allowance linked to structural reform. The programme estimates the additional budgetary costs stemming from this reform at 0.6% of GDP in 2017. The programme's adjustment path, however, does not reflect the planned structural reform in 2017. As the Commission is not in a position to assess the plausibility of

reform's positive impact on the long-term sustainability of public finances, the impact of these reforms has not yet been reflected in the required adjustment towards the MTO for 2017.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2015	2016		2017	
Initial position¹					
Medium-term objective (MTO)	-1,0	-1,0		-1,0	
Structural balance ² (COM)	-0,4	-1,2		-0,8	
Structural balance based on freezing (COM)	-0,4	-1,2		-	
Position vis-a-vis the MTO³	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	2015	2016		2017	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0,0	0,0		0,0	
Required adjustment corrected ⁵	0,2	-0,7		0,1	
Change in structural balance ⁶	1,1	-0,3	-0,8	0,7	0,4
<i>One-year deviation from the required adjustment⁷</i>	0,9	0,4	-0,1	0,5	0,3
<i>Two-year average deviation from the required adjustment⁷</i>	0,8	0,7	0,4	0,5	0,1
Expenditure benchmark pillar					
Applicable reference rate ⁸	1,4	4,1		1,4	
<i>One-year deviation⁹</i>	-0,5	0,6	0,0	0,2	0,1
<i>Two-year average deviation⁹</i>	0,3	0,0	-0,2	0,4	0,1
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Overall assessment	Compliance	Compliance
Conclusion over two years	Compliance	Compliance	Overall assessment	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 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.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2016 spring forecast (COM); Commission calculations.</i>					

5. FISCAL SUSTAINABILITY

Lithuania does not appear to face fiscal sustainability risks in the short run.

Based on Commission forecasts and a no-fiscal policy change scenario beyond forecasts, government debt, at 42.7% of GDP in 2015, is expected to rise gradually to 51.3% in 2026, thus remaining below the 60% of GDP Treaty threshold. This highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would put debt on a clearly decreasing path by 2026, i.e. remaining well below the 60% of GDP reference value in 2026.

The medium-term fiscal sustainability risk indicator S1 is at 0.5 pp. of GDP, primarily related to the projected ageing costs contributing with 1.5 pps. of GDP, thus indicate medium risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at -2.3 pps. of GDP, leading to lower medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, 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 2.8 pps. of GDP. In the long-term, Lithuania therefore appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs contributing with 2.8 pps. of GDP. Full implementation of the programme would put the S2 indicator at 1.5 pps. of GDP, leading to a lower long-term risk.

Table 5: Sustainability indicators

<i>Time horizon</i>	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.2			
Fiscal subindex (2015)	0.2	LOW risk		
Financial & competitiveness subindex (2015)	0.2	LOW risk		
Medium Term	MEDIUM risk			
DSA ^[2]	LOW risk			
S1 indicator ^[3]	0.5	MEDIUM risk	-2.3	LOW risk
<i>of which</i>				
IBP	0.2		-1.9	
Debt Requirement	-1.1		-2.0	
CoA	1.5		1.6	
Long Term	MEDIUM risk		LOW risk	
S2 indicator ^[4]	2.8		1.5	
<i>of which</i>				
IBP	0.0		-1.2	
CoA	2.8		2.7	
<i>of which</i>				
Pensions	1.2		1.1	
HC	0.1		0.0	
LTC	0.7		0.7	
Other	0.8		0.9	

Source: Commission services; 2016 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 2016 forecast until 2017. 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 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.

[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. See Fiscal Sustainability Report 2015.

[3] 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 forecast 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 2017) 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.

[4] 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.

6. FISCAL FRAMEWORK

As highlighted in the Commission's assessment in the 2016 Country Report (section 2.1), Lithuania has strengthened its budgetary framework, as the rules of the Fiscal Compact and the Two Pack regulation entered into force when the country joined the euro area. The budgetary cycle in 2015 was the first test of the new fiscal framework, which shows some remaining weaknesses, in particular with regard to its clarity, loosely defined escape clauses and lack of progress in the establishment of binding expenditure ceilings.

On March 30, 2016 the Fiscal Council, which is set up in the National Audit Office, presented its opinion² to the Parliament approving economic development scenario underpinning the 2016 Stability Programme, as well as underpinning 2016 Draft Budgetary Plan. Lithuania's Fiscal Council assessed that the 2016 programme economic scenario did 'not contradict the patterns of the economy'.

Last November³ the Council has argued for setting a more ambitious MTO (-0.5% of GDP) to comply with the national Constitutional law⁴ Article 5 point 3 requirements reflecting the Commission assessment of long-term sustainability risk of Lithuania's general government finances. The more ambitious MTO had also to ensure a robust reduction of public debt. The government kept the MTO at -1.0% of GDP, in line with the minimum MTO, arguing that its Stability Programme defined low long-term sustainability risk. Nevertheless, in 2016 Stability Programme the government set structural deficit targets above -0.5% of GDP from 2017 onwards.

The Council also recommended a more transparent definition of output gap calculation. The Ministry of Finance has set-up a special inter-institutional working group to oversee the application of output gap calculation rules. The 2015 structural balance appears to fulfil the provisions on the structural balance rule in the Constitutional Law on the implementation of the Fiscal Compact. On the other hand, the fiscal council also pointed out that national expenditure rule had repeatedly been circumvented using widely defined escape clauses. The information provided in the Stability Programme is not sufficient for assessing whether the past, planned and forecast fiscal performance in Lithuania appears to comply with the requirements of the applicable national numerical fiscal rules.

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.

² Išvada dėl ekonominės raidos scenarijaus tvirtinimo, URL: <http://www.vkontrole.lt/failas.aspx?id=3514>

³ Ataskaita dėl 2016 metų valdžios sektoriaus finansinių rodiklių, URL: <http://www.vkontrole.lt/bp/isvada.aspx?id=10032>

⁴ Republic of Lithuania Constitutional Law on The Implementation of The Fiscal Treaty, http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=1012060

7. CONCLUSIONS

In 2015, Lithuania achieved an improvement of the structural balance of 1.1% of GDP, above the required structural improvement of 0.2% of GDP, and the structural balance fell well below its MTO. Following an overall assessment, it appears that the adjustment path towards the MTO in 2015 was appropriate and in line with the requirements of the preventive arm of the Pact.

Lithuania plans to remain at the MTO over the period 2016-2019. The planned efforts would ensure continued compliance with the provisions of the SGP. Based on the Commission 2016 spring forecast the structural balance is forecast to be at -1.2 % of GDP in 2016, which can be considered as close to the MTO, and at -0.8% of GDP in 2017, above the MTO. Lithuania is expected to be in line with the provisions of the SGP in both 2016 and 2017.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	4,7	8,7	-0,1	3,5	3,0	1,6	2,8	3,1
Output gap ¹	-1,8	4,2	-3,6	0,0	1,0	0,1	0,5	1,1
HICP (annual % change)	2,0	2,5	4,7	1,2	0,2	-0,7	0,6	1,8
Domestic demand (annual % change) ²	4,5	10,9	-2,7	3,2	2,9	6,4	3,5	3,8
Unemployment rate (% of labour force) ³	15,1	8,3	13,2	11,8	10,7	9,1	7,8	6,4
Gross fixed capital formation (% of GDP)	21,2	24,5	19,3	18,5	18,9	20,7	20,5	20,8
Gross national saving (% of GDP)	13,5	16,4	16,8	20,6	22,2	17,1	18,5	19,0
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-2,9	-0,8	-6,2	-2,6	-0,7	-0,2	-1,1	-0,4
Gross debt	21,6	18,0	31,4	38,8	40,7	42,7	41,1	42,9
Net financial assets	15,6	9,4	-11,3	-25,8	-25,3	n.a	n.a	n.a
Total revenue	35,8	33,4	34,5	32,9	34,1	34,9	34,2	34,1
Total expenditure	38,7	34,3	40,8	35,6	34,8	35,1	35,2	34,5
<i>of which: Interest</i>	1,4	0,9	1,5	1,8	1,6	1,5	1,5	1,4
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-5,2	-6,7	6,1	9,6	10,8	n.a	n.a	n.a
Net financial assets; non-financial corporations	-85,6	-92,2	-92,6	-79,5	-72,9	n.a	n.a	n.a
Net financial assets; financial corporations	-1,9	-2,1	2,0	1,9	-0,5	n.a	n.a	n.a
Gross capital formation	14,5	17,5	11,8	11,6	10,2	n.a	n.a	n.a
Gross operating surplus	26,5	33,2	35,5	38,3	37,9	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	0,4	-0,6	0,2	-2,4	-3,5	n.a	n.a	n.a
Net financial assets	40,3	39,5	48,2	56,8	55,3	n.a	n.a	n.a
Gross wages and salaries	31,6	33,1	32,9	31,1	31,3	n.a	n.a	n.a
Net property income	14,8	16,4	14,4	14,5	14,1	n.a	n.a	n.a
Current transfers received	11,7	12,2	17,5	15,9	15,6	n.a	n.a	n.a
Gross saving	3,4	2,4	2,7	1,2	0,1	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-7,6	-8,1	0,0	4,5	6,6	1,4	2,4	2,7
Net financial assets	32,1	45,8	54,3	46,9	44,0	n.a	n.a	n.a
Net exports of goods and services	-7,7	-8,7	-3,4	1,3	1,9	-0,1	-0,4	-1,3
Net primary income from the rest of the world	-1,7	-2,3	-2,0	-2,6	-1,2	-3,9	-2,3	-1,8
Net capital transactions	0,1	1,1	3,2	3,1	2,7	3,0	2,4	2,6
Tradable sector	53,6	54,7	54,4	57,1	55,9	55,0	n.a	n.a
Non tradable sector	34,9	35,4	35,7	33,4	34,4	34,6	n.a	n.a
<i>of which: Building and construction sector</i>	6,0	7,7	6,5	5,9	6,8	6,8	n.a	n.a
Real effective exchange rate (index, 2000=100)	82,8	97,9	103,9	101,7	103,9	104,3	105,6	105,8
Terms of trade goods and services (index, 2000=100)	90,6	99,2	100,2	98,3	99,0	102,2	102,7	102,4
Market performance of exports (index, 2000=100)	61,8	78,9	100,9	124,7	124,1	120,9	119,9	118,8
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 2016 spring forecast								