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Analysis of the updated Draft Budgetary Plan of Lithuania

Accompanying the document

COMMISSION OPINION

on the updated Draft Budgetary Plan of Lithuania

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1. INTRODUCTION

Lithuania submitted its updated Draft Budgetary Plan (DBP) for 2017 on 15 December 2016. The update was prompted by the fact that the DBP submitted on 17 October 2016 in compliance with Regulation (EU) No 473/2013 reflected budgetary projections for 2017 on the basis of unchanged policies given the caretaker nature of the government in place at the time of submission. According to the Commission Opinion of 16 November 2016 on the no-policy-change DBP, there was a risk of non-compliance with the provisions of the Stability and Growth Pact (SGP). In particular, the Commission forecast pointed to an expected significant deviation from the medium term budgetary objective (MTO) in 2017. On that basis, the Commission invited the national authorities to ensure full compliance with the SGP by submitting to the Commission and to the Eurogroup an updated DBP taking into account its Opinion as soon as a new government would take office.

The new government took office on 13 December 2016 and on 15 December 2016 submitted an updated Draft Budgetary Plan for 2017. The submission of the updated Draft Budgetary Plan did not take place in time for the Commission to adopt its opinion before the budget law was adopted by the parliament, which is not in line with section A.2 of the code of conduct of the Two-Pack. However, the situation for Lithuania is specific in view of the interplay between the timing of the recent elections and the applicable national timeline and legal requirements for the approval of the budget.

Lithuania is subject to the preventive arm of the SGP and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the ad-hoc Commission forecast updating the Commission 2016 autumn forecast with the draft 2017 budget measures[1]. The following section presents the recent and planned fiscal developments, according to the updated Draft Budgetary Plan, including an analysis of risks to their achievement based on the updated Commission 2016 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the SGP. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in July 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Lithuania's real GDP grew by 1.8% year-on-year (y-o-y) in 2015. The macroeconomic scenario underlying the updated DBP foresees an increase to 2.3% real GDP growth in 2016 followed by a further increase to 2.7% in 2017. The scenario assumes that domestic demand will continue to drive growth on the back of a robust increase of nominal wages (8.1% in 2016, 7.0% in 2017) combined with continued employment growth (2.1% in 2016, 0.8% in 2017). Inflation is forecast to be 0.7% in 2016, and 2.2% in 2017, reflecting the impact of strong wage growth and waning base effects. The updated macroeconomic scenario is the

[1] Hereafter referred to as the updated Commission 2016 autumn forecast.

same as the one underpinning the no-policy-change Draft Budgetary Plan for 2017 as submitted in October.

Compared to the scenario underlying the Stability Programme, the growth forecast for 2016 has been revised downwards by 0.2 pp. That revision mainly reflects the slower GDP growth during the first half of 2016 resulting from the weaker than expected investment, which suffered from a slowdown due to the end of the 2007-2013 EU programming period and the slow start of the 2014-2020 EU programming period. For 2017, the forecast has been revised downwards by 0.5 pp, as the uncertainty related to the outcome of the vote on the United Kingdom's membership of the European Union is expected to weaken external as well as domestic demand.

The output gaps as recalculated by the Commission following the commonly agreed methodology are positive for 2016-2017 (1.1%, 1.4% respectively). The updated Commission 2016 autumn forecast envisages a slightly lower positive output gap for 2016 and slightly higher one for 2017.

Overall, the updated DBP's macroeconomic projections, in particular real GDP growth and its composition are somewhat more positive for 2016 compared to those of the updated Commission 2016 autumn forecast, which projects real GDP growth of 2.0% and 2.7% for 2016 and 2017, respectively. The somewhat weaker outlook for 2016 is related to the poor performance of the third quarter, where y-o-y GDP growth reached only 1.7%. However, when looking at the growth composition, growth rates of private consumption as well as wages and salaries, the tax bases for personal income tax and social contributions, are broadly in line with the information contained in the updated Commission 2016 autumn forecast. Thus, in the Commission's view, the updated DBP is based on plausible macroeconomic assumptions.

Risks to the macroeconomic scenario underpinning the updated DBP are tilted to the downside due to increased economic uncertainty in the economic environment caused by the outcome of the vote on the United Kingdom's membership of the European Union and continued geopolitical tensions in the region. According to the updated Commission 2016 autumn forecast, those risks could be mitigated by the possibility that the supply of idle labour could be sufficient to provide room for further employment growth. Moreover, Lithuania's debt-to-GDP ratio is expected to decline over the medium term.

Box 1: The macroeconomic forecast underpinning the budget in Lithuania

Lithuania's budget and fiscal projections are based on the macroeconomic forecast of the Ministry of Finance. Such a macroeconomic scenario is prepared twice a year (by 18 March and 12 September in 2016). The Ministry of Finance receives comments on the draft scenario from the Ministry of Economy, the Ministry of Social Security and Labour, the national central bank, Statistics Lithuania and the National Audit Office. The final scenario is published on the website of the Ministry of Finance.

The National Audit Office of Lithuania carries the function of an independent fiscal institution via its Budget Policy Monitoring Department. It has issued a positive opinion of the economic scenario which was submitted to the Lithuanian parliament and forms the basis of the Draft Budgetary Plan. In its latest opinion the National Audit Office shared the views of the Ministry of Finance on the main downside risks to the macroeconomic scenario. The opinion was also posted on the website of the National Audit Office and the website of the Ministry of Finance.

The National Audit Office was granted the function of independent fiscal institution on 1 January 2015, following the adoption of the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania in November 2014. Relevant amendments were made to the Law on the National Audit Office. The procedure guiding the endorsement process was agreed in a Memorandum of Understanding between the Ministry of Finance and the National Audit Office signed on 29 April 2015.

The National Audit Office works under a legal framework that ensures its independence and has a long standing reputation as a body independent from the government. The function of a budget policy monitoring institution has been set up in a dedicated department of the National Audit Office, the Budget Policy Monitoring Department. The Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania provides that the monitoring institution should not accept instructions from any other institution or person.

Table 1. Comparison of macroeconomic developments and forecasts

	2015	**2016**			**2017**		
	COM	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**
Real GDP (% change)	1.8	2.5	2.3	2.0	3.2	2.7	2.7
Private consumption (% change)	4.1	4.3	5.5	4.4	4.1	4.2	3.7
Gross fixed capital formation (% change)	4.7	2.1	-2.6	-0.9	5.2	6.3	6.0
Exports of goods and services (% change)	-0.4	3.6	4.9	4.1	4.4	2.8	2.8
Imports of goods and services (% change)	6.2	4.7	4.0	0.9	5.3	4.4	4.5
Contributions to real GDP growth:							
- Final domestic demand	3.6	3.4	1.6	2.9	3.9	3.9	3.9
- Change in inventories	3.4			-3.2			0.0
- Net exports	-5.2	-0.9	0.7	2.4	-0.7	-1.2	-1.2
Output gap[1]	0.8	0.0	1.1	1.0	0.1	1.4	1.5
Employment (% change)	1.3	0.6	2.1	2.3	0.3	0.8	0.3
Unemployment rate (%)	9.1	8.0	8.0	7.6	7.1	7.2	7.4
Labour productivity (% change)	0.5	1.9	0.2	-0.3	2.9	1.9	2.4
HICP inflation (%)	-0.7	0.7	0.7	0.7	2.2	2.2	1.7
GDP deflator (% change)	0.2	1.1	0.7	1.4	2.0	2.2	1.7
Comp. of employees (per head, % change)	5.3	5.6	5.9	5.5	6.2	6.2	6.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.8	0.5	2.0	1.2	-0.4	1.6	0.5

Note:

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

For 2016, the updated DBP expects a slightly lower general government deficit of 0.6% of GDP compared to the 0.8% in the Stability Programme and 0.7% in the no-policy change DBP. That improvement is due to better-than-expected budgetary execution with revenue collection helped by a solid increase in tax-rich components of GDP growth such as employment and wages. The updated Commission 2016 autumn forecast expects the same general government deficit of 0.6% of GDP for 2016 supported by the trend of tax revenue collection, while spending discipline is expected to have been maintained.

For 2017, the updated DBP plans a general government deficit of 0.7% of GDP, which is 0.7% of GDP higher than in the Stability Programme and 0.4% higher than in the no-policy-change DBP. The increase compared to the Stability Programme results from the inclusion of the costs of a structural reform[2] (0.5% of GDP) which was adopted after the submission of the Stability Programme, as well as from a number of new discretionary fiscal measures, in particular an increase in the non-taxable income threshold and in public wages.

The updated Commission 2016 autumn forecast predicts a general government deficit of 0.8% of GDP for 2017. It takes into account the measures included in the updated DBP, although the Commission estimates the expected extra revenues from increased tax compliance more conservatively.

According to the updated Commission 2016 autumn forecast, risks to the public finance forecast are tilted to the upside and are linked to expectations of robust growth in the tax base, but only if expenditure growth is contained.

In structural terms, the updated DBP projects a (recalculated) structural balance[3] of -1.1% of GDP in 2016 and -1.3% of GDP, compared to -0.7% and 0% respectively in the Stability Programme due to a different assessment of Lithuania's potential output and higher general government deficit in 2017. The no-policy-change DBP projected (recalculated) structural balances for 2016 and 2017 at -1.2% and -0.9% of GDP due to different general government deficit levels. The Commission forecasts a structural balance of -1.0% of GDP in 2016, deteriorating to -1.4% of GDP in 2017[4].

The National Audit Office of Lithuania, in its capacity as an independent fiscal institution, assessed the interim State budget for 2017 on 15 November. The National Audit Office noted that the envisaged increase in the structural deficit in 2017 led to a deviation from the MTO and was in contrast with the national legislation requirement to achieve a structural improvement of 0.1% of GDP. It also stressed that the multiannual planning system was in place only in a formal sense, since three-year budgetary indicators only described but did not define, fiscal targets for the outer years. It also proposed to review the budgetary structure by mid-2017 with a view to improving the link between fiscal plans and results.

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[2] The reform encompasses labour market and pension system reforms.

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

[4] The main differences between the (recalculated) structural balance of the Stability Programme and the (recalculated) updated DBP as well as the updated Commission 2016 autumn forecast stem from a different assessment of Lithuania's potential output, since the updated assessment points to higher positive output gaps for both 2016 and 2017.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Lithuania currently standing at 0.8%[5]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the updated DBP, interest expenditure in Lithuania is expected to fall from 1.5% of GDP in 2015 to 1.4% in 2016 and is projected to decrease further next year, to 1.3% of GDP, well below the 2.0% recorded in 2012 at the height of the euro area sovereign debt crisis. The development of the interest expenditure as included in the updated DBP is broadly confirmed by the updated Commission 2016 autumn forecast.

A modest change in interest expenditure would not lead to a pronounced deviation between developments in the primary structural balance and the structural balance in 2016-17.

[5] 10-year bond yields as of 11 January 2017. Source: Bloomberg

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**34.9**	**34.6**	***35.5***	**34.5**	**35.2**	***36.0***	**35.0**	**1.1**
of which:								
- Taxes on production and imports	11.8	11.9	*12.0*	11.8	12.2	*12.5*	12.0	0.7
- Current taxes on income, wealth, etc.	5.5	5.6	*5.8*	5.7	5.7	*5.6*	5.5	0.1
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.9	12.2	*12.4*	12.4	12.3	*12.7*	12.5	0.8
- Other (residual)	5.7	4.9	*5.3*	4.7	5.0	*5.2*	5.2	-0.5
Expenditure	**35.1**	**35.4**	**36.1**	**35.1**	**35.2**	**36.7**	**35.8**	**1.6**
of which:								
- Primary expenditure	33.5	34.0	34.7	33.6	33.9	35.4	34.4	1.9
of which:								
Compensation of employees	9.6	9.7	9.9	9.9	9.6	9.8	10.0	0.2
Intermediate consumption	5.2	5.3	5.4	5.3	5.2	5.6	5.5	0.4
Social payments	12.5	12.8	13.0	12.8	12.5	13.3	13.3	0.8
Subsidies	0.4	0.3	0.4	0.4	0.3	0.3	0.4	-0.1
Gross fixed capital formation	3.6	3.5	3.5	3.6	4.0	3.8	3.7	0.2
Other (residual)	2.2	2.5	2.5	1.6	2.3	2.6	1.5	0.4
- Interest expenditure	1.5	1.4	1.4	1.5	1.3	1.3	1.4	-0.2
General government balance (GGB)	**-0.2**	**-0.8**	**-0.6**	**-0.6**	**0.0**	**-0.7**	**-0.8**	**-0.5**
Primary balance	**1.3**	**0.6**	**0.8**	**0.9**	**1.3**	**0.6**	**0.7**	**-0.7**
One-off and other temporary measures	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1
GGB excl. one-offs	**-0.3**	**-0.7**	**-0.6**	**-0.6**	**0.0**	**-0.7**	**-0.8**	**-0.4**
Output gap[1]	0.8	0.0	1.1	1.0	0.1	1.4	1.5	0.7
Cyclically-adjusted balance[1]	-0.5	-0.8	-1.1	-1.0	0.0	-1.3	-1.4	-0.8
Structural balance (SB)[2]	**-0.7**	**-0.7**	**-1.1**	**-1.0**	**0.0**	**-1.3**	**-1.4**	**-0.6**
Structural primary balance[2]	0.9	0.7	0.3	0.5	1.3	0.0	0.1	-0.9

Notes:

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

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission forecast (COM); Commission calculations

In view of the planned implementation of major structural reforms with a positive impact on the long-term sustainability of public finances, the updated DBP is accompanied by a formal request to benefit from a temporary deviation under the preventive arm for 2017 pursuant to the "Commonly agreed position on Flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council in February 2016. The updated DBP estimates the budgetary costs of the structural reforms at around EUR 220 million, which amounts to around 0.5% of GDP in 2017. Compared to the no-policy-change DBP the costs are 0.1% of GDP lower due to the delayed start of part of the reform package.

A complete assessment of the fulfilment of the eligibility criteria will take place within the normal European Semester cycle in the context of the assessment of the 2017 Stability Programme. At this stage, the reforms appear to have a positive impact on the sustainability of public finances, if implemented fully and in a timely manner. What follows is an initial and provisional analysis, which is without prejudice to the Commission's formal evaluation of that request.

The eligibility conditions for the flexibility available under the structural reform clause include a requirement that the country must respect the Treaty's deficit reference value of 3% of GDP and should preserve an appropriate safety margin with respect to the deficit reference value if the requested deviation were to be granted. Moreover, the structural balance in the year preceding the application of the clause should be within a maximum distance of 1.5% of GDP from the MTO. Based on the updated Commission 2016 autumn forecast, the general government deficit of Lithuania is projected to be at 0.8% of GDP in 2017, well below the 3% of GDP Treaty reference value. The Commission forecasts Lithuania's structural balance to amount to -1.4% 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 - currently fixed at -1.0% of GDP - as the structural balance is forecast to be at the MTO. Thus, Lithuania would be considered to have sufficient fiscal space to benefit from a temporary deviation in the following year, subject to respecting the constraint of the minimum benchmark.

Lithuania requests the maximum allowed temporary deviation based on the structural reform clause (0.5% of GDP). However, Lithuania was previously already granted a temporary deviation (of 0.1% of GDP) linked to the pension reform clause on account of a systemic reform introducing a multi-pillar system. In total, the maximum allowed temporary deviation under the two clauses will be limited by the requirement that the structural balance respect the minimum benchmark.

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 independent social scientists, who proposed the original reform plan, have presented an evaluation showing positive effects from those reforms. The government has calculated the expected cost of the reform based on the proposed and adjusted reform package.

Most measures related to the reform have entered into force at the start of 2017, while some of the reform measures set to enter into force in mid-2017.

The pension part of the structural reform package will strengthen a rules-based pension indexation system enacting increases based on labour market trends and available financing. The reform also envisages the gradual increase of the required length of pensionable service from 30 to 35 years, responding to a worsening dependency ratio. Individual pensions will be more directly linked to actual payments. An average annual pension expenditure savings is estimated to range from 0.8% of GDP in the short run increasing up to 3.8% of GDP in the long run, compared to the average annual pension expenditure of the unreformed system.

The labour market part of the reform seeks to modernise labour relations making them more flexible by introducing new types of employment contracts, establishing shorter periods of notice, lowering severance allowances for dismissed employees and introducing a more flexible regulation for working hours. At the same time, the reform strengthens the coverage and adequacy of the unemployment and social insurance benefits. It expands the scope of active labour market policy measures, as well as reducing the level of illegal and uninsured employment. Estimates of the medium term results foresee an increase in an average annual number of the employed by up to 10% and the average annual number of the employees working standard annual hours by up to 7%.

3.2. Debt developments

The general government debt projections for 2016 are similar in the updated DBP and the updated Commission 2016 autumn forecast. For 2017, the debt projections are also close when adjusted for the forecast differences in the forecast deficit and in estimates of stock flow adjustments. The debt decrease of 0.3% of GDP in 2016 compared to the Stability Programme can be explained by the lower general government deficit. The debt stock is 3.6 pp higher in 2017 than planned in the Stability Programme because of a planned shift in the timing of pre-financing forthcoming bond redemptions and higher 2017 general government deficit of the updated DBP. The higher planned pre-financing of forthcoming bond redemptions and the higher 2017 planned general government deficit also explains by 0.6 pp of GDP higher debt in 2017 compared to the no-policy-change DBP.

Risks related to the debt projections are balanced as public guarantees are at just 1.1% of GDP in 2016 and 1.4% of GDP in 2017. The updated DBP does not foresee contingent liabilities linked to the financial sector.

Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**42.7**	**41.1**	**40.8**	**40.8**	**39.9**	**43.5**	**43.3**
Change in the ratio	2.2	-1.6	-1.9	-1.9	-1.2	2.7	2.5
Contributions[2] :							
1. Primary balance	**-1.3**	**-0.6**	**-0.8**	**-0.9**	**-1.3**	**-0.6**	**-0.7**
2. "Snow-ball" effect	**0.7**	**-0.1**	**0.1**	**0.1**	**-0.7**	**-0.6**	**-0.3**
Of which:							
Interest expenditure	1.5	1.4	1.4	1.5	1.3	1.3	1.4
Growth effect	-0.7	-1.0	-1.0	-0.8	-1.2	-1.0	-1.1
Inflation effect	-0.1	-0.5	-0.3	-0.6	-0.8	-0.9	-0.6
3. Stock-flow adjustment	**2.8**	**-0.9**	**-1.2**	**-1.1**	**0.8**	**3.9**	**3.4**
Of which:							
Cash/accruals difference							
Net accumulation of financial		0.0			0.0		
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The updated DBP includes seventeen discretionary revenue and thirteen discretionary expenditure measures, with a net negative budgetary impact of around 0.5% of GDP in 2017 (see Table 4). The costs of salary increases and additional social spending are assumed to be mostly covered by a range of adopted multiannual gradual tax increases and by the expected revenues from a set of tax compliance measures, even accounting for lost revenues due to an increase in the non-taxable income threshold. The costs of legislated structural reform, however, are not offset by discretionary revenue or expenditure measures.

The measures included in the updated DBP have been incorporated in the updated Commission 2016 autumn forecast, although the Commission has more conservative estimates of revenues from improved tax compliance and the preferential VAT rate for heating is assumed to be abolished only from mid-2017, rather than from the beginning of the year, while the 2016 autumn forecast assumed an extension of the preferential rate for the whole year. Those differences explain the somewhat more negative budget deficit as forecast by the Commission.

Table 4. Main discretionary measures reported in the updated DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Taxes on production and	0.3	0.6	n.a.
Current taxes on income,	0.1	-0.3	n.a.
Capital taxes	0.0	0.0	n.a.
Social contributions	n.a.	0.0	n.a.
Property Income	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
Total	0.4	0.4	n.a.

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Compensation of employees	0.2	0.2	n.a.
Intermediate consumption	n.a.	n.a.	n.a.
Social payments	0.4	0.6	n.a.
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	n.a.	n.a.
Gross fixed capital formation	n.a.	n.a.	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
Total	0.6	0.9	n.a.

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2017

COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Lithuania is subject to the preventive arm of the SGP and should ensure sufficient progress towards its MTO defined as a structural deficit of 1% of GDP. Box 2 reports on the latest country specific recommendations in the area of public finances.

Box 2: Council recommendations addressed to Lithuania
On 12 July 2016, the Council adopted recommendations to Lithuania in the context of the European Semester. In particular, in the area of public finances, the Council recommended to Lithuania to ensure that the deviation from the MTO is limited to the allowance linked to the systemic pension reform in 2016 and in 2017.

In 2016, Lithuania benefited from a temporary deviation of 0.1% of GDP from the required adjustment path towards the MTO linked to the pension reform clause and started from an initial position above its MTO. According to the updated DBP the (recalculated) structural balance is expected to deteriorate in 2016 by 0.4% of GDP, which is less than the allowed deterioration of 0.7% of GDP. The growth rate of government expenditure, net of discretionary revenue measures, in 2016, is expected not to exceed the applicable expenditure benchmark rate (4.1%). Therefore, the assessment of the (recalculated) updated DBP[6] points to compliance with the provisions of the SGP in 2016.

This is also confirmed by the updated Commission 2016 autumn forecast which projects that both pillars will be complied with in 2016. Both signals are consistent. Lithuania is thus considered to be compliant with the provisions of the SGP in 2016.

For 2017, Lithuania's updated DBP was accompanied by a formal request to benefit from 0.5% of GDP flexibility under the structural reform clause (see section 3.1) in addition to the 0.1% of GDP flexibility linked to the pension reform granted earlier. The following assessment of compliance with the required adjustment towards the MTO in 2017 is, however, carried out on the basis of the preventive arm requirement enshrined in the fiscal country-specific recommendation (see Box 2).

In 2017, based on the agreed freezing principles, Lithuania also starts from an initial position 0.1% of GDP above its MTO. The (recalculated) projections of the updated DBP indicate that both the structural deficit and the expenditure benchmark pillars point to a risk of some deviation over one year. Therefore the overall assessment points to a risk of some deviation.

According to the updated Commission 2016 autumn forecast, the structural balance is set to deteriorate by 0.4% of GDP to -1.4% in 2017. This is 0.2% of GDP more than the allowed deterioration of 0.2%, which is based on the starting position above the MTO and the temporary deviation allowance linked to the systemic pension reform, thus pointing to a risk of some deviation. Net expenditure growth in 2017 is expected to exceed the applicable benchmark rate (2.2%), leading to a deviation of 0.7% of GDP and pointing to a risk of a significant deviation. That situation calls for an overall assessment. The structural balance in 2017 is flattered by temporary revenue windfalls[7] (0.2% of GDP), mostly reflecting strong

[6] The (recalculated) updated DBP is based on recalculated output gaps, making use of the information provided in the DBP and the commonly agreed methodology.

[7] For further details regarding the calculation of revenue windfalls and shortfalls please see the Code of Conduct of the Stability and Growth Pact, pages 51-54 under the following link: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf .

wage growth. Moreover, developments in government investment lead to a more positive reading of the fiscal effort based on the structural balance compared to the expenditure benchmark pillar. The expenditure benchmark is thus a better indicator of the underlying budgetary position. Therefore, the overall assessment points to a risk of significant deviation from the adjustment path towards the MTO in 2017, based on the updated Commission 2016 autumn forecast.

The slight difference between the updated (recalculated) DBP and the updated Commission 2016 autumn forecast structural balance indicators for 2017 can mostly be explained by the slightly higher general government deficit forecast by the Commission. The more pronounced difference in the expenditure benchmark stems mostly from the higher estimates for revenues from discretionary measures in the updated DBP, compared to the updated Commission 2016 autumn forecast, in particular from improved tax compliance and earlier cancellation of the preferential VAT rate for heating.

In conclusion, according to the updated Commission 2016 autumn forecast, the required adjustment towards the MTO is not projected to be delivered, pointing to a risk of significant deviation from the adjustment path towards the MTO in 2017.

Notwithstanding those findings, the fulfilment of the eligibility criteria for flexibility under the structural reform clause could be a factor that would be taken into account in future assessments. The complete assessment of the request for flexibility will be taken within the normal European Semester cycle in the context of the assessment of the 2017 Stability Programme.

In the updated Draft Budgetary Plan, Lithuania has requested a temporary deviation from the required adjustment path towards the MTO in 2017 in view of a legislated structural reform with expected direct long-term positive budgetary effects. Lithuania estimates the budgetary costs of the structural reform at around 0.5% of GDP in 2017. Lithuania appears to have fiscal space to benefit from a temporary deviation under the structural reform clause, when taking account of the existing allowance for pension reforms and the minimum benchmark ceiling of a structural deficit of -1.5% of GDP. If the temporary deviation from the required adjustment path towards the MTO in 2017 linked to the implementation of structural reforms were taken into account, the planned structural adjustment under the (recalculated) updated DBP would point to compliance in 2017 and such an adjustment under the updated Commission 2016 autumn forecast would point to a risk of some deviation in 2017.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2015	2016		2017	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-0.7	-1.0		-1.4	
Structural balance based on freezing (COM)	-0.4	-0.9		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	0.2	-0.7		-0.2	
Change in structural balance[6]	1.1	-0.4	-0.3	-0.2	-0.4
One-year deviation from the required adjustment [7]	0.9	0.3	0.4	-0.1	-0.2
Two-year average deviation from the required adjustment [7]	0.8	0.6	0.6	0.1	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	1.4	4.1		2.2	
One-year deviation [9]	-0.5	0.0	0.4	-0.2	-0.7
Two-year average deviation [9]	0.3	-0.2	0.0	-0.1	-0.1
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Compliance	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Overall assessment	Compliance	Overall assessment	Overall assessment

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 27.).

[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) was 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.

Source :

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

4. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The Council, in the context of the 2016 European Semester, has recommended to Lithuania a number of fiscal structural reform measures, such as reducing the tax burden on low-income earners by shifting the tax burden to other sources less detrimental to growth and improving tax compliance, in particular in the area of VAT.

The updated DBP explicitly refers to those structural CSRs. A special section provides details on measures envisaged in the 2017 budget, targeted at the recommendations.

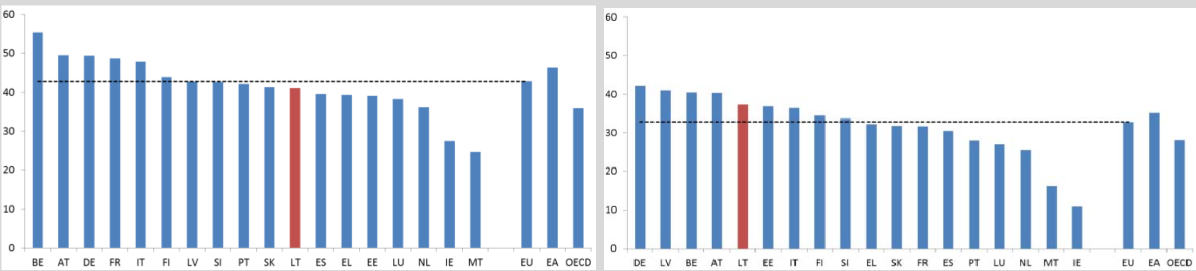
On the fiscal side, a number of measures have been envisaged to strengthen the tax administration. In particular a systematic cross-check of VAT invoices has been expanded. A smart tax administration information system is set to be launched in full. The government has planned an increase of the non-taxable income threshold to alleviate the tax burden of low-income individuals. However, only part of that planned reduction appears be covered by the tax shift.

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

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against that background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate those numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Lithuania for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Lithuania at the average wage and a low wage (2015)



Notes: Data for Latvia, Lithuania and Malta is for 2014. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2016 European Semester, the Council recommended Lithuania to "(..) Reduce the tax burden on low-income earners by shifting the tax burden to other sources less detrimental to growth and improve tax compliance, in particular in the area of VAT".

Lithuania's updated Draft Budgetary Plan refers to the following measures that affect the tax wedge on labour:

Lithuania increased the non-taxable personal income threshold from currently EUR 200 to EUR 310 per month, as of 1 January 2017. In addition, the government has also increased the amount of parents' non-taxable income for each child, from currently EUR 120 to EUR 200 per month. Lithuania also raised the tax exempt amount for disabled people. These measures, and in particular those affecting the thresholds for non-taxable personal labour income, mostly target low income earners. As a result of those measures, the government expects an increase in real disposable income for low wage earners.

Lithuania is set to reduce the social insurance tariff by 1 pp from mid-2017. Most of those savings for employees and employers will be offset by the higher unemployment insurance tariff and payments to the new unemployment insurance fund. They, in turn, will strengthen unemployment protection, while losses of social insurance revenue will not be fully offset by revenue-enhancing or expenditure-reducing measures.

Bonuses of the members of supervisory boards are set to become subject to social insurance taxes, thus marginally increasing social insurance revenue at the expense of high income earners, while such earners will benefit from newly set ceiling on social insurance contributions.

5. OVERALL CONCLUSION

Following an overall assessment of the (recalculated) updated DBP, the indicated structural adjustment points to compliance with the MTO in 2016 and a risk of some deviation in 2017. The updated Draft Budgetary Plan is accompanied by a formal request to avail of the structural reform clause. A complete assessment of the fulfilment of the eligibility criteria will take place within the normal European Semester cycle in the context of the assessment of the 2017 Stability Programme. If the temporary deviation from the required adjustment path towards the MTO in 2017 linked to the implementation of structural reforms were taken into account, the planned structural adjustment would point to compliance in 2017.

Based on the updated Commission 2016 autumn forecast, the structural adjustment points to compliance with the MTO in 2016.

Regarding 2017, the updated Commission 2016 autumn forecast indicates a risk of significant deviation from the adjustment path towards the MTO following an overall assessment, before considering the request for flexibility. However, if the temporary deviation from the required adjustment path towards the MTO in 2017 linked to the implementation of the structural reforms were taken into account, the overall assessment based on the updated Commission 2016 autumn forecast would point to a risk of some deviation in 2017.