NATIONAL AUDIT
OFFICE OF LITHUANIA
• BRINGING BENEFITS •

To the Seimas of the Republic of Lithuania

OPINION ON THE STRUCTURAL ADJUSTMENT TARGET SET BY THE DRAFT LAW ON THE APPROVAL OF FINANCIAL INDICATORS OF THE STATE BUDGET AND MUNICIPAL BUDGETS AND ON THE NEED FOR ADDITIONAL MEASURES (IN MONETARY TERMS) NECESSARY TO FULFIL THIS TARGET

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Vilnius

The National Audit Office of Lithuania, implementing the functions of the fiscal institution (hereinafter referred as Fiscal Institution in the NAO), in accordance with the Constitutional Law on the Implementation of the Fiscal Treaty (hereinafter referred to as CL) and the Law on National Audit Office of the Republic of Lithuania, as well as taking into account that a draft amendment to the Law on the Approval of Financial Indicators of the 2021 State Budget and Municipal Budgets was submitted to the Seimas by a 14 May 2021 Government Resolution, submits to the Seimas its opinion on the structural adjustment target and its opinion on the general government financial indicators of 2021.

The Draft Amending Law on the Approval of the Financial Indicators of the State Budget and Municipal Budgets for 2021 is based on the Economic Development Scenario, published on 19 March 2021. The updated macroeconomic projections of the Ministry of Finance, which will be assessed by the Fiscal Institution in the NAO, will be announced in June. According to the most recent statistics[1], the macroeconomic projections are likely to be revised upwards, which would also contribute to a better general government balance indicator.

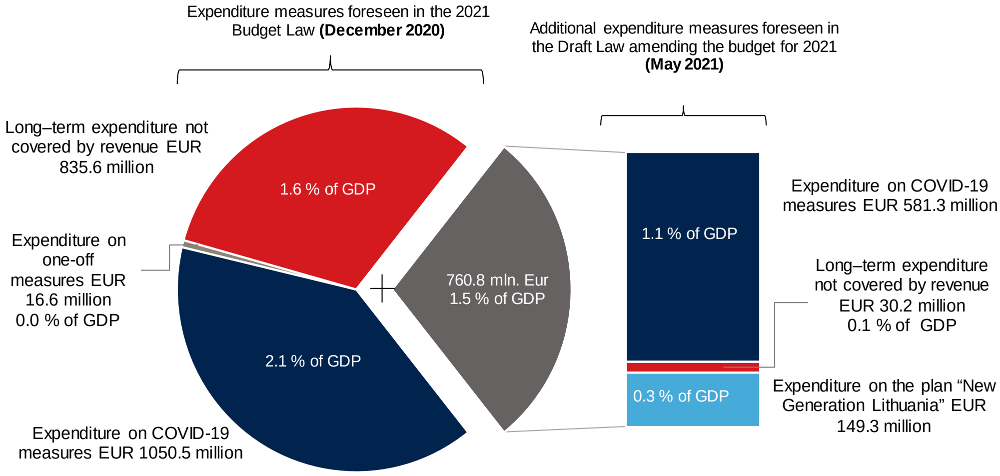
The Draft Law amending the budget for 2021 includes additional expenditure not only for COVID-19 measures, but also for other long–term liabilities[2], for which there are no long–term sources of revenue foreseen. In the Law adopted in December 2020, expenditures for long-term measures, which were not covered by revenue, amounted to 1.6 % of GDP (EUR 835.6 million) (see Figure 1). In the Draft Law amending the budget for 2021, it is foreseen to further increase such costs by EUR 30.2 million without provision of sustainable sources of revenue to cover it.

[1] According to the 30/04/2021 statistical information on gross domestic product (GDP) for the estimate of Q1 2021, despite the restrictions of the second quarantine, the economy grew at a rate of 1% compared to the last year.

[2] Long-term expenditure is permanent expenditure, such as compensation of employees, social benefits etc.

According to the Communication from the European Commission to the European Council[3] on 3 March 2021 it is said that "when Member States introduce permanent measures, they should properly fund them to ensure budgetary neutrality in the medium term". This means that the structural deficit must not be increased without COVID-19 measures or investment spending. This means that the structural deficit must not be increased by any measures other than related with COVID-19 or investment spending.

Firgure 1. Total discretionary spending measures in 2021



Source – Lithuania's Stability Programme for 2021, Lithuania's Draft Budget for 2021[4], Fiscal Institution's in the NAO calculations

Aside from the uncertainties in the assessment of the output gap and the structural balance, it is possible to analyse general government expenditure after elimination of interest payments on public debt, unemployment benefits and the EU and other financial support. In order not to worsen the general government balance indicator, such *net* expenditure should grow at the rate of potential GDP plus inflation, or faster if the greater growth in expenditure is offset by long-term revenue measures. After elimination of the effect of COVID-19 on general government expenditure, interest, unemployment benefits, the EU and other financial support, the projected expenditure growth accounts for 14.9% in 2021 (10.9% in 2020).

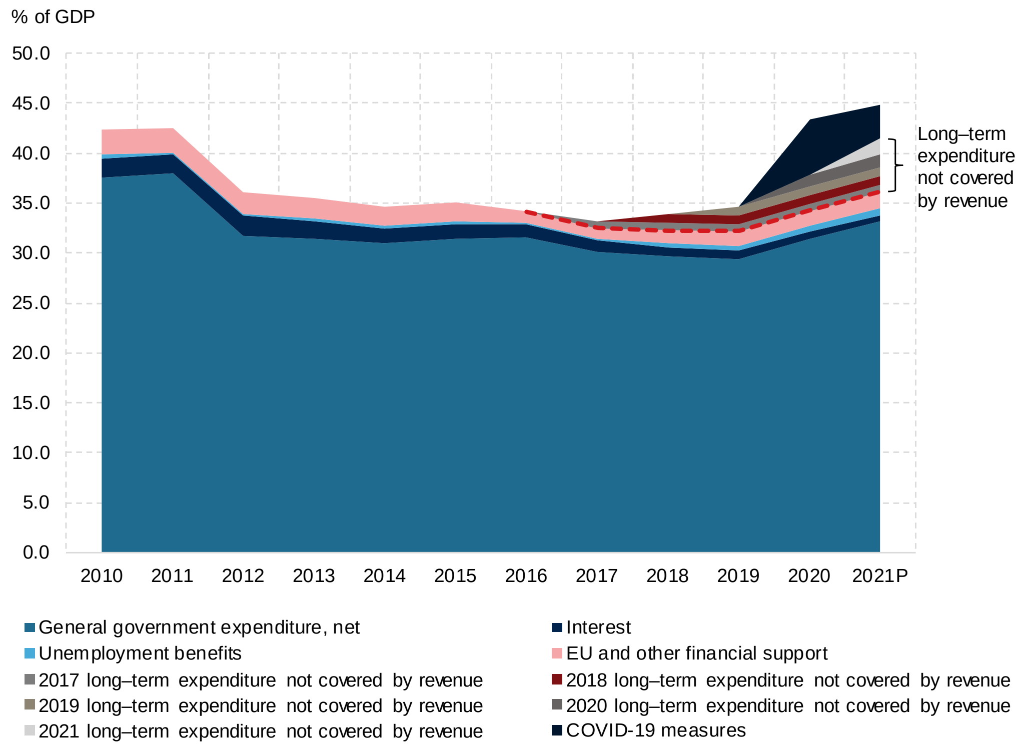
Over the last five years, the structural general government deficit which accounts for 5 % GDP was generated by long-term expenditure not covered by additional sources. In order not to worsen the structural balance of the general government, increases in discretionary spending need to be offset by long-term revenue measures over the medium term. During the period between 2017–2021, long-term expenditure grew by an average of 1% of GDP without ensuring sustainable source of financing (Figure 2). Such long-term expenditure was covered by cyclical revenues in 2017-2019 due to the Lithuanian economy, which was growing faster than potential GDP. 2.9% of GDP is

[3] Communication from the Commission to the Council of 03/03/2021. Internet access: https://ec.europa.eu/info/sites/info/files/economy-finance/1_en_act_part1_v9.pdf.

[4] Draft budgetary plan Lithuania 2021. Internet access: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2021_en.

allocated to long-term current expenditure of general government[5] for the period of 2020–2021, without the provision of sustainable sources of revenue.

Firgure 2. Structure of general government expenditure



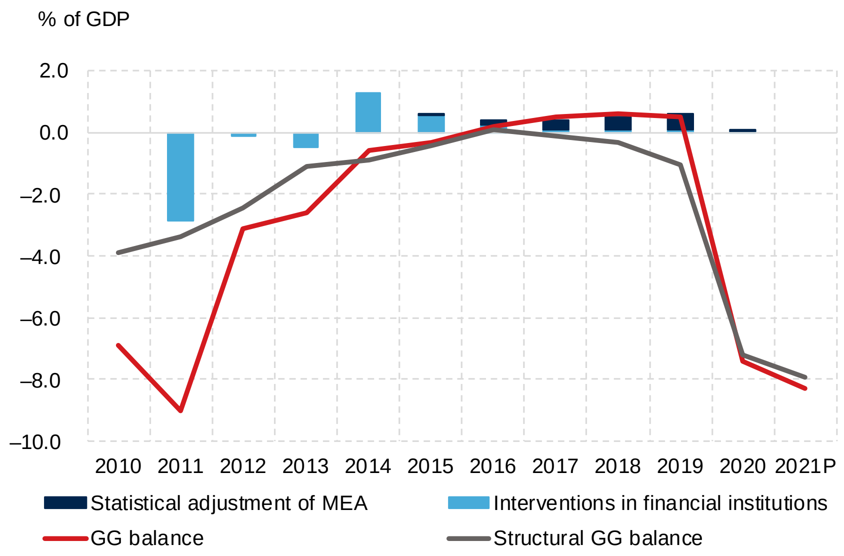
----- indicates a boundary of expenditure to COVID-19 measures and long-term expenditure not covered by revenue.

Source – Fiscal Institution's in the NAO calculations

Statistical aspects of the representation of financial transactions has largely affected the decline of the nominal general government deficit since 2012. The general government deficit of 9% of GDP in 2011 was result of the bankruptcy of a bank 'Snoras' AB. The loan granted to the state-owned enterprise 'Deposit and Investment Insurance' was accounted for as general government expenditure (2.8% of GDP). The successful sale of the bank's assets in the following years led to the repayment of the loan that was accounted for as general government revenue, which created an illusion of improved general government balance. It should also be noted that loan repayments and the statistical adjustment related to the acquisition of military equipment (hereafter – 'statistical adjustment of MEA') were the main statistical factors contributing to the general government surplus according to ESA 2010 over the period of 2016–2019 (Figure 3). Such soft loans granted to companies during the COVID-19 pandemic, which are accounted for as assets on the balance sheet, would have a negative impact on the general government balance if loans were not repaid. This creates an additional negative risk to the general government balance in future.

[5] There are two types of general government expenditure: current and capital expenditure.

Firgure 3. Statistical factors affecting the general government balance according to ESA 2010



Source – Eurostat, Fiscal Institution's in the NAO calculations

After the cancellation of exceptional circumstances, public finances will face a major challenge of reducing the structural deficit. Without additional discretionary revenue measures the growth of public debt will not change its trajectory. After the global financial crisis, the reduction in the structural deficit was achieved through consolidation, followed by a "freeze"[6] on real spending growth. The general government structural deficit which accounted 3.3% of GDP in 2011 is projected to reach 7.9% of GDP in 2021. A structural increase in revenues is needed to avoid a real "freeze" in government spending and further borrowing to finance current expenditure. The situation is further complicated by the fact that long-term commitments, such as the introduction of pension indexation, will inevitably require additional spending.

In response to the impact of the COVID-19 pandemic on the economy and general government finances, the application of fiscal discipline rules has been temporarily narrowed over the period 2020–2022. The general escape clause of the Stability and Growth Pact has been activated at the level of the European Union, allowing countries to deviate from the requirements for the general government budgets[7]. It is planned to return to the application of fiscal discipline rules in 2023. As of 26 March 2020, Lithuania has also introduced exceptional circumstances during which deviations in fiscal indicators can be disregarded as long as they do not endanger fiscal sustainability in the medium term.

- In accordance with Article 6(7) of the CL, no structural adjustment targets shall be set for the year of exceptional circumstances.
- In accordance with Article 3(1) of the CL, in case of exceptional circumstances, surplus general government rule for the 2021 is not applied reasonably.
- The expenditure growth limitation rule in 2021 is not applied reasonably as the circumstances for its exclusion provided for in Article 3(3)(1) and Article 3(3)(5) of the CL have arisen.

[6] Net general government expenditure grew at a rate close to inflation.

[7] The EC Communication of 03/03/2021 indicates that the general clause of the Stability and Growth Pact will remain in force in 2022.

- According to Article 4(2) and Article 4(3) of the CL, draft budgets of the State Social Insurance and Compulsory Health Insurance Funds for the year 2021 were prepared in compliance with the rules for the budgets attributable to the general government.
- The compliance of municipalities' 2021 *ex-ante* budgets with fiscal discipline rules will be assessed in June 2021.

The National Audit Office of the Republic of Lithuania, in its capacity as the budget policy monitoring institution responsible for monitoring the compliance with the rules of fiscal discipline laid down in the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania, carried out an 14/05/2021 assessment of the draft amendment to the Law on the Approval of Financial Indicators of the 2021 State Budget and Municipal Budgets submitted to the Seimas and prepared an opinion. Pursuant to provisions of Article 9(6)(2) of the Law on National Audit Office of the Republic of Lithuania, the Fiscal Institution in the NAO hereby submits its opinion to the Seimas of the Republic of Lithuania.

The opinion is accompanied by the heatmap of the Lithuanian economy and the scoreboard of fiscal risks.

Auditor General Mindaugas Macijauskas

ANNEXES

Lithuania's fiscal risks scoreboard

The fiscal risks scoreboard provides an overview of fiscal risks over the historical and short-term projection period and allows monitoring of changes in internal and external imbalances[8].

Lithuania's fiscal risks scoreboard

Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021P
MACROECONOMIC INDICATORS, % of GDP (unless otherwise specified)																
Real GDP growth %	7.4	11.1	2.6	–14.8	1.7	6.0	3.8	3.5	3.5	2.0	2.5	4.3	3.9	4.3	–0.9	2.6
Unemployment rate %	5.8	4.3	5.8	13.8	17.8	15.4	13.4	11.8	10.7	9.1	7.9	7.1	6.2	6.3	8.5	7.5
House price index %		26.3	9.0	–29.9	–7.4	6.6	–0.2	1.2	6.4	3.7	5.4	8.9	7.3	6.8	7.3	
Real effective exchange rate %	–0.3	3.0	6.1	6.8	–5.4	1.7	–6.7	–0.6	1.7	4.2	5.3	2.6	6.6	3.8	6.9	
Current account balance	–10.6	–13.0	–13.0	–8.8	–3.7	–0.5	–1.7	–1.2	1.2	0.9	0.0	–1.0	–0.1	1.4	4.0	5.7
Gross external debt	60.5	72.1	72.4	86.8	86.3	80.3	77.9	70.7	70.6	76.7	86.2	82.7	78.1	67.7	74.4	
Private sector credit flow	37.7	29.0	11.2	–9.0	–5.9	–2.2	0.4	–0.2	0.2	2.6	4.4	4.5	4.3	3.0		
FISCAL INDICATORS, % of GDP																
GG balance	–0.3	–0.8	–3.1	–9.1	–6.9	–8.9	–3.1	–2.6	–0.6	–0.3	0.2	0.5	0.6	0.5	–7.4	–8.3
Structural GG balance	–3.1	–5.4	–7.8	–6.0	–3.9	–3.3	–2.5	–1.1	–0.9	–0.4	0.1	–0.1	–0.3	–1.1	–7.2	–7.9
GG debt	17.2	15.9	14.6	28.0	36.2	37.1	39.7	38.7	40.5	42.5	39.7	39.1	33.7	35.9	47.1	52.4
Gross financing needs	4.0	3.0	5.6	13.7	11.0	11.1	8.5	8.2	4.5	6.6	4.6	2.7	4.3	1.3	12.7	12.9
Reserve funds	1.5	1.0	1.1	2.1	1.5	1.2	0.7	0.3	0.4	0.4	0.5	0.6	1.1	2.0	1.6	3.3

High level of risk | Medium level of risk | Low level of risk | No data available

Source – Fiscal Institution's in the NAO calculations

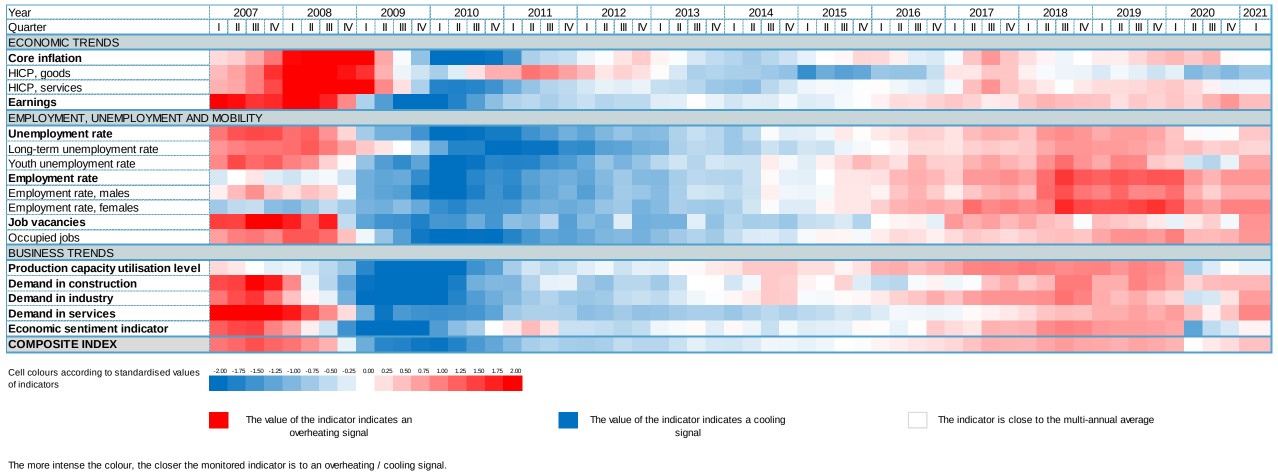
With the COVID-19 pandemic prevailing in 2020, all fiscal indicators warned of high to medium fiscal risks to public finances. The general government balance turned deficit at 7.4% of GDP in 2020. The general government structural deficit increased by 6.1% of GDP over the year. Such developments were the results of the pandemic mitigation measures, which increased government spending and led to a slower growth of revenue. In order to finance increased spending, the government debt and the gross financing needs increased by 11,4 % and 11,5 % accordingly.

Contrary to the macroeconomic indicators, the majority of the projected fiscal indicators show a high level of risk in 2021. The general government deficit could reach 8.3% of GDP in 2021.

[8] The methodology and indicators for the compilation of the scoreboard are described in the National Audit Office's Report No BP-6-1 "2019 Assessment of General Government Financial Indicators" of 8 November 2018. The fiscal reserves analysed include the Reserve (Stabilisation) Fund, the SSIF, the CHIF, the Guarantee Fund and the Long-Term Employment Benefit Funds The years with high, medium and low risk in the scoreboard are highlighted in red, yellow and green respectively. From 2021, the current account 3-year moving average is used in the fiscal risks scoreboard.

The heatmap of the Lithuanian economy

The heatmap of the Lithuanian economy



Source – Eurostat, Statistics Lithuania, Fiscal Institution's in the NAO calculations

Data of Q1 2021 indicate that the temperature of the Lithuanian economy[9] remained lower than in 2017–2019. However, it shows a 0.1 percentage points higher temperature than the average level in 2020. Average monthly gross earnings (excluding individual enterprises) increased by 9.9% in Q1 compared to Q1 2020. According to SODRA's data, average annual earnings increased by 14.4% in April 2021. Registered unemployment amounted to 14.3% in April (11.2% in April 2020) The unemployment rate reached 7.5% in Q1 while youth – 12.5%.

The industrial capacity utilisation level, which has been declining since the start of the COVID-19 pandemic, started to increase. Business sentiment is improving. Prices of goods fell by 0.3%, while the growth rate of prices of services reached 3.2% in Q1 2021, as compared to the last year. Core inflation at the beginning of the year remained unchanged and amounted to 1.8% in Q1.

The positive assessment of the Lithuanian composite index in Q1 2021 is determined by the relatively high rate of employment and relatively stable demand for construction, industry and services.

[9] The methodology for drawing up the map and the description of the indicators are set out in the National Audit Office's Opinion No BP-5 "On the Approval of the Economic Development Scenario" of 20 September 2018. The map shows quarters with values above the long-term average in red and quarters with values below the long-term average in blue. The more intense the colour, the closer the monitored indicator is to an overheat or cool signal.