NATIONAL AUDIT OFFICE OF LITHUANIA

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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The National Audit Office of Lithuania, implementing the functions of the fiscal institution (hereinafter referred to as Fiscal Institution in the NAO), in accordance with the Constitutional Law on the Implementation of the Fiscal Treaty and the Law on National Audit Office of the Republic of Lithuania, as well as taking into account that Draft Law amending the Law on the Approval of Financial Indicators of the 2022 State Budget and Municipal Budgets of the Republic of Lithuania (hereinafter referred to as the Draft Law) was submitted to the Seimas by the 9 March 2022 Resolution of the Government of the Republic of Lithuania[1], hereby submits to the Seimas its opinion.

The Draft Law amending Article 14 of the Law was submitted in the context of growing geopolitical tensions, with a view to strengthening Lithuania's resilience and security. The Draft Law as presented provides for the Ministry of Finance to be authorised to borrow funds for the financing of defence and security on behalf of the State, up to 2.52% of GDP, according to the GDP projections for Lithuania provided by the Ministry of Finance. Defence spending accounted for around 1.6% of GDP in 2017–2019 and increased to 2.3% of GDP in 2020. In line with previous commitments[2] made by political parties, spending for defence was to be increased steadily to at least 2.5% of GDP by 2030. Given the geopolitical situation, the need for this spending is likely to grow faster than indicated in the parties' agreement. In the future, defence financing should be increased through additional structural general government revenue.

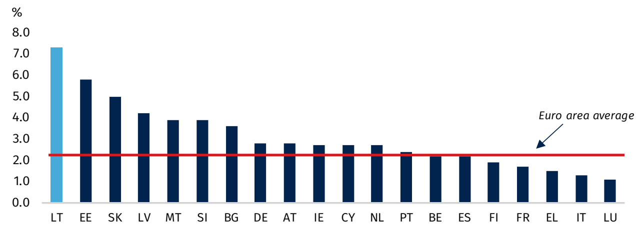
[1] On the submission to the Seimas of the Republic of Lithuania of the Draft Law amending Article 14 of Law on the Approval of Financial Indicators of the 2022 State Budget and Municipal Budgets No XIV-745. Internet access: https://e-seimas.lrs.lt/portal/legalAct/lt/TAP/3a995e519f8111ec9e62f960e3ee1cb6?.

[2] Agreement between the political parties represented in the Seimas of the Republic of Lithuania on Lithuanian Defence Policy Guidelines of 10 September 2018. Internet access: https://lrv.lt/uploads/main/documents/files/Partij%C5%B3%20susitarimas%20d%C4%97l%20Lietuvos%20gynybos%20politikos%20gairi%C5%B3.pdf.

In addition to rising defence spending, ageing–related expenditure and other commitments will put pressure on increasing long–term expenditure. Without additional sources of income, this will pose challenges to the sustainability of public finances. In accordance with the projections of the Fiscal Institution in the NAO[3], ageing–related expenditure on education, social and health care will grow from 25.2% to 26.5% of GDP between 2022 and 2030. They will grow not only as a result of demographic processes related to the ageing of the population but also as a result of political commitments, such as wage increases for education or healthcare workers, pensions, child-care benefits money or other increases.

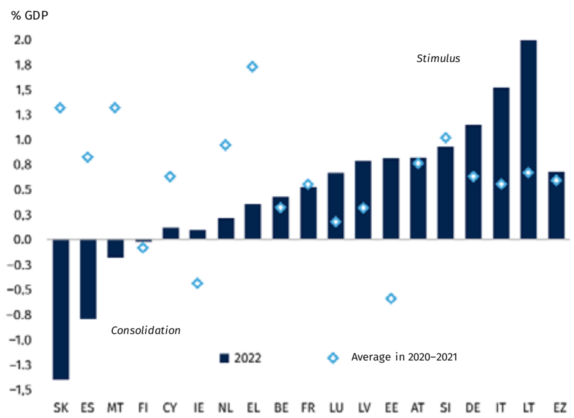
The fiscal indicators are not updated in the Draft Law and it is not clear how macroeconomic developments will affect the general government balance. The fastest increase in core inflation observed in Lithuania (Figure 1) in the euro area can be attributed to the largest surplus increase in current expenditures[4]. According to the European Commission Communication[5] of 24 November 2021, Lithuania has the highest surplus increase in current expenditures in the euro area (Figure 2). High inflation could lead to a slowdown in real GDP growth rate, with a corresponding negative impact on general government revenue collection. In addition, high inflation and declining real disposable income growth could increase the share of the shadow economy, which would have a negative impact on general government revenue. In terms of expenditure, high inflation increases pressure to increase social benefits and wages for public sector employees.

**Figure 1.** Net inflation in euro area countries in January 2022




Source: Eurostat

**Figure 2.** The share of growth in national current expenditure above medium–term potential GDP growth




Source: European Commission

The current leap in inflation, largely driven by energy and food prices, is affecting pensioners and low–income earners the hardest. The largest part of these people's expenditure consists of necessary expenses for food, heating and fuel. Consequently, against a background of rapid inflation, their purchasing power is declining and poverty rates may rise.

[3] Ageing–related expenditure had been modelled using the assumptions of macroeconomic and demographic projections developed by the Fiscal Institution in the NAO before Russia started the war in Ukraine.

[4] General government expenditure is divided into current and capital expenditure. Current expenditure include social benefits and other expenditure such as compensation for employees.

[5] Communication from the Commission to the Council. Internet access: https://ec.europa.eu/info/sites/default/files/economy-finance/draft_budgetary_plans_2022_-_overall_assessment.pdf.

Further increases in current spending not covered by sustainable income will accelerate core inflation and increase the risk of social tensions, economic crisis and higher unemployment. Given the growing need for long–term expenditure, both for defence and ageing, the draft project of the State budget for 2023 needs to include discretionary revenue measures to ensure long–term and sustainable sources of income. This would contribute to the appropriate management of the structural general government balance, without deviating from the medium–term objective and with a view to maintaining a sustainable general government debt-to-GDP ratio. Communication from the European Commission [6] of 2 March 2022 points out that in order to achieve this goal, there is a need for a high-quality fiscal measures and economic growth based on investments and reform.

*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 09/03/2022 assessment of the draft amendment to the Law on the Approval of Financial Indicators of the 2022 State Budget and Municipal Budgets submitted to the Seimas and prepared an opinion. Pursuant to provisions of Article 8(7)(2) of the Law on National Audit Office of the Republic of Lithuania, the Fiscal Institution hereby submits its opinion to the Seimas of the Republic of Lithuania.*

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[6] Communication from the Commission to the Council, on the fiscal policy guideline for 2023. Internet access: https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1476.