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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Vilnius

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 the Draft amendment to 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) has been submitted to the Seimas by the 13 April 2022 Resolution of the Government of the Republic of Lithuania[1], hereby submits to the Seimas its opinion[2].

The Draft Law is based on the Economic Development Scenario of 31 March 2022. The next updated macroeconomic projections of the Ministry of Finance, which will be assessed by the Fiscal Institution in the NAO, will be announced in June. These projections will be revised in light of the latest statistical data, which may lead to a change in the general government balance.

The revised Draft Law indicates that additional expenditure is foreseen to mitigate the impact of price rises in energy and other commodities, for aid measures in relation to the war in Ukraine and for other purposes[3]. The projections for general government revenue are being improved, taking into account more favourable projections for the main tax bases and other factors than those foreseen in the Economic Development Scenario, published in September 2021. It is important to note that Article 14 of the Law is also amended to allow for increased borrowing for the purposes foreseen in the Law, such as compensation for electricity and gas prices, for the costs of the disruption of freight flows due to the war in Ukraine, or for the costs of business relations. Due to this reason,

[1] Government Resolution of 13/04/2022 No 345. Internet access: https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/c31cde90bb1111ec9f0095b4d96fd400.

[2] Fiscal Institution in the NAO must submit its opinion to the Seimas no later than 05/05/2022, inclusive.

[3] Explanatory note. Internet access: https://e-seimas.lrs.lt/rs/lasupplement/TAD/c31cde90bb1111ec9f0095b4d96fd400/c6042e23bb6011ec9f0095b4d96fd400/.

additional possible expenditure is included. In the Draft Law of the budget it is projected that general government deficit would be 4.9% of GDP. It should be noted that the Draft Law does not take into account the recommendation of the National Audit Office, which performs an audit function[4]: in order to ensure more transparent financial management, all planned expenditures should be presented in the State budget appropriations, rather than foreseeing part of the State budget from the borrowed funds on behalf of the State. The recommendations advocate amending the practice when the indicators of the State budget approved by the Seimas are amended not by the Seimas itself but by the Government, as it reflects shortcomings in planning, does not provide sufficient information for fiscal risk management and increases the risk of breaching fiscal discipline requirements when they are applied.

The Draft of the State budget includes horizontal expenditure measures intended for the compensation of gas and electricity costs, reduces incentives to consume resources rationally, stimulates domestic demand, which increases inflation. The compensation of gas and electricity costs is distributed to all taxpayers at the expense of the budget, which is unfair to those taxpayers who do not consume these resources, or who consume them less. Additional general government revenues are needed to keep the government balance unchanged. The need for packages of this kind may recur, therefore the question of 'who will pay' should not be postponed to the future. In addition to rising defence spending, ageing-related expenditure and other commitments will put pressure on increasing long-term expenditure.

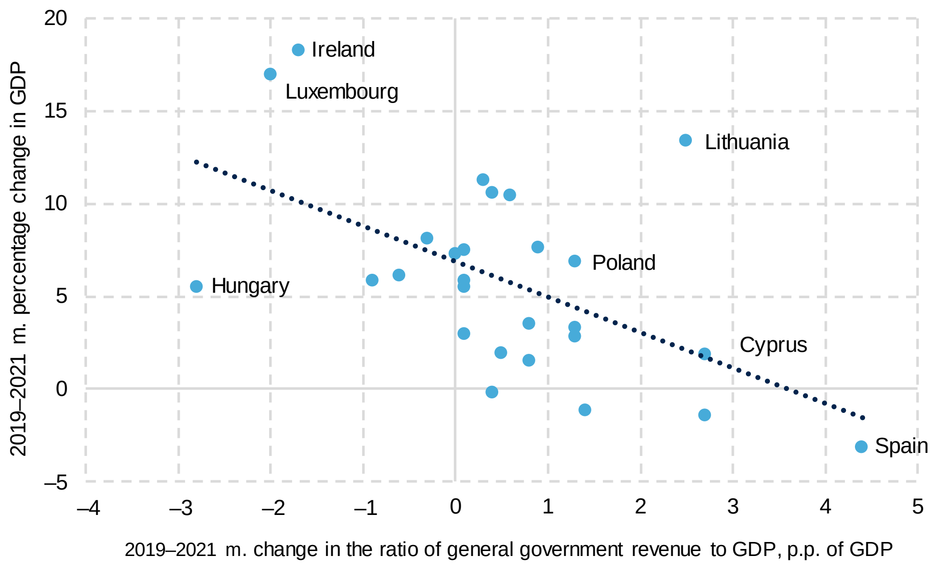
The increase in the revenue of the general government in 2021–2022 is temporary and linked to unsustainable expenditure growth, one-off factors and a favourable economic cycle. The Fiscal Institution in the NAO notes that in 2020, Lithuania's general government expenditure growth was the highest in the European Union, which helped to mitigate the effects of the pandemic and contributed to the favourable economic results in 2021. In 2021, the Lithuanian economy was already above pre-pandemic levels, with a general government deficit of 1.0% of GDP, instead of the 6.9% of GDP estimate approved in the Budget Law of 2021 [5]. This result was mainly driven by an increase in revenue collection in 2021 and failure to implement all planned expenditures[6]. The level of general government revenue rose to 37.7% of GDP in 2021, up from 35.2% in 2019, or an average of 34.5% between 2004 and 2021. Revenue growth from major taxes in Lithuania is above the multi-year average (Annex 1). Other European Union countries have also experienced growth in the revenue-to-GDP ratio, but, unlike Lithuania, they have experienced a significant decline in GDP (Figure 1). The increase in general government revenue is likely to be temporary, due to one-off factors linked to strong growth in general government expenditure and a favourable economic cycle.

[4] Assessment of the regularity of 2020 sets of consolidated financial and budget execution reports. Internet access: https://www.valstybeskontrole.lt/LT/Product/24037/2020-metu-valstybes-konsoliduotuju-finansiniu-ir-biudzeto-vykdymo-ataskaitu-rinki.

[5] In December 2021, when the budget was approved, the general government balance was set at 7.0% of GDP; in June 2021, the Law was amended to project a balance of 6.9% of GDP.

[6] Lower than planned expenditure on COVID-19 pandemic management, in particular on grants, lower implementation of co-financing from EU and other international financial assistance.

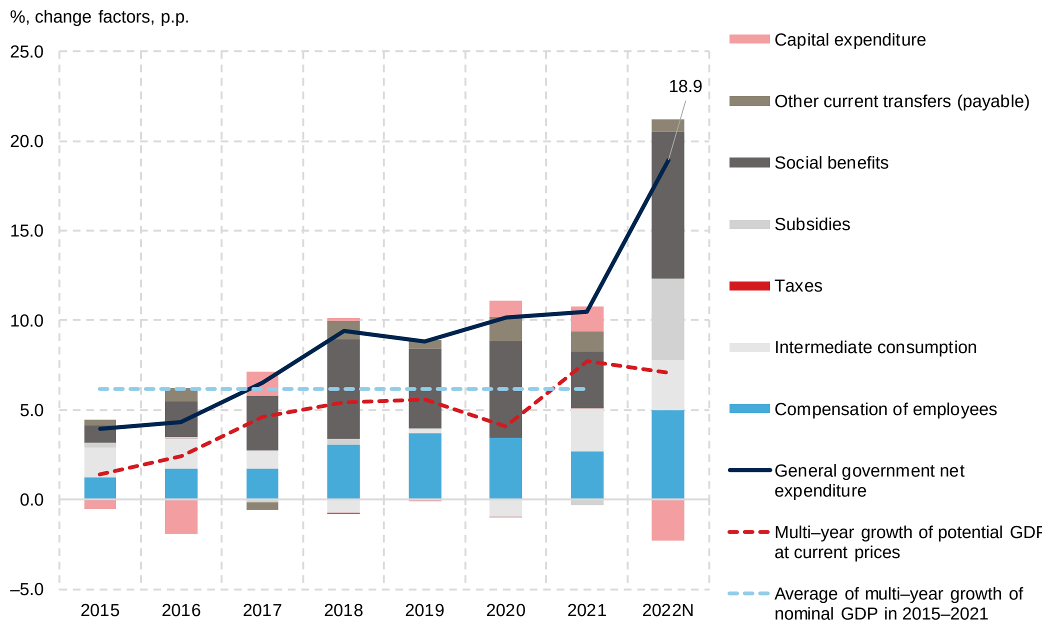
Firgure 1. Changes in the ratio of general government revenue to GDP in EU countries in 2019–2021



Source: Eurostat, calculations by the Fiscal Institution in the NAO

The growth of the structural deficit is driven by a surplus increase in current expenditure. Given the high uncertainty about the development of the economy and the output gap and the temporary nature of the increase in collected general government revenues, it is difficult to assess the structural budget balance, which is why it is worthwhile to analyse the dynamics of *net* general government expenditure. This expenditure is the total of expenditure after eliminating interest payments on public debt, unemployment benefits, EU and other international financial assistance, and COVID-19 related expenditure. In order not to worsen the general government balance, the fiscal discipline rules of the Stability and Growth Pact (SGP) refer to multi-year growth of potential GDP at current prices, i.e. *net* expenditure should grow at the rate of this estimate or may grow faster if compensated by additional revenue measures. Between 2018 and 2021, general government net expenditure has significantly exceeded the reference expenditure growth rate (Figure 2), which may pose challenges for the future in terms of widening and financing the structural deficit. In 2022, the general government *net* expenditure growth projected by the Fiscal Institution in the NAO is 18.9%, largely driven by social benefits and compensations for employees.

Firgure 2. Growth in *net* general government expenditure and its change factors



Source: calculations by the Lithuanian Department of Statistics, Ministry of Finance, Fiscal Institution in the NAO

There are no sustainable long-term sources of revenue foreseen for increasing long-term expenditure. Revenues resulting from above-potential economic growth or increased public support are not considered sustainable. The Draft Law foresees an increase in long-term general government expenditure related to raising disposable personal income. This does not respect the principle[7] of including additional sources of revenue in long-term expenditure decisions.

In the future, as large scale expenditure of a temporary nature ceases and the economy moves towards potential, cyclical and one-off measures will reduce the share of revenue collection, while the need for other long-term expenditures, related to defence or population ageing, will increase. Additional discretionary revenue and expenditure measures are needed to ensure that the structural deficit does not widen and deviate from the medium-term objective and that the debt-to-GDP ratio is sustainable.

Regarding the compliance with the rules of fiscal discipline set out in the Constitutional Law on the Implementation of the Fiscal Treaty:

1. Under exceptional circumstances, in 2020–2022 the surplus general government rule and expenditure growth limiting rule are not applied for justified reasonsonably. The European Commission's decision[8] is that the general escape clause of the Stability and Growth Pact applies in 2022 and assumes that the exceptional circumstances are lifted in 2023 and the fiscal discipline rules will be applied in full. The European Commission plans to inform about its decision on May.

[7] 03/03/2021 Communication from the Commission to the Council. Internet access: https://eur-lex.europa.eu/legal-content/LT/TXT/HTML/?uri=CELEX:52021DC0105&from=EN.

[8] 02/06/2021 European Semester Spring Package 2021. Internet access: https://ec.europa.eu/info/publications/european-semester-spring-package-2021-economic-coordination_en.

2. In 2022, draft budgets of the State Social Insurance Fund and Compulsory Health Insurance Fund were prepared in compliance with the rules for the budgets attributable to the general government sector.

3. The compliance of municipal budgets for 2021 and 2022 with fiscal discipline rules will be assessed in the first half of 2022.

Lithuania's fiscal framework system needs to be simplified and made more transparent. The International Monetary Fund's Fiscal Transparency Evaluation (FTE), published in May 2019, noted that Lithuania's fiscal framework is very complex with many rules and escape clauses[9]. In Lithuania, fiscal discipline is set out in the Constitutional Law on the Implementation of the Fiscal Treaty (CL) and the Law on Fiscal Discipline (FDL), which aim to ensure the sustainability of government finances, the stable development of the economy, and the application of the European Union's fiscal policy legislation. It should be underlined that the expenditure growth limitation rules in these laws are not identical to the SGP expenditure growth limitation rule. National expenditure growth limitation rules apply to the cash-flow growth of the totality of budget allocations, while the rules of SGP apply to the projections under ESA 2010[10]. The SGP expenditure growth limitation rule complements the medium-term objective (MTO) rule by defining the *net* increase in general government expenditure at a sustainable pace, thus contributing to achieving or maintaining the MTO itself. The general escape clause of SGP's allows for a derogation from the MTO during a period of exceptional circumstances and does not apply the SGP's expenditure growth limitation rule. The national rules set in the CL and the FDL on limiting the growth of expenditure do not directly refer to exceptional circumstances. There is a need for an unambiguous and clear legal regulation on whether they should be applied during a period of exceptional circumstances. Also, these rules have a different package of circumstances of non-application[11]. The Draft Law does not indicate that the proposed amendments are consistent with the FDL. According to the assessment of the Fiscal Institution in the NAO, if the Ministry of Finance projects an HICP of 9.8% in 2022, the Draft Law would not ensure the compliance with the rule of limiting the growth of expenditures as specified in the FDL, as none of the circumstances of non-application of the rule are applicable. If exceptional circumstances would not be applied and in consideration of the Fiscal Institution in the NAO estimation of positive output gap indicator, the expenditure growth limitation rule set in the CL would not be satisfied.

The provisions of the Constitutional Law on the Implementation of the Fiscal Treaty have been extended by subordinate legislation several times. The amendments to Article 17(5) of Law on Budget Structure, adopted on 28 June 2018, amend the national rule on limiting expenditure growth set in the CL without a legal basis. There are other cases[12]

[9] The International Monetary Fund's Fiscal Transparency Evaluation on the Republic of Lithuania. Internet access: https://www.imf.org/en/Publications/CR/Issues/2019/05/03/Republic-of-Lithuania-Fiscal-Transparency-Evaluation-46865, p. 44.

[10] Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union. Internet access: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:174:0001:0727:LT:PDF.

[11] The national rules on expenditure limitation (CL and FDL) are activated if the average government balance over the previous five years is negative, but do not apply if Lithuanian GDP at current prices calculated on the basis of four last quarters of the year grows at a slower pace than the multi-annual growth of the GDP of the European Union at current prices increased by 2 percentage points, and the projected adjustment to the balance indicator is positive and at least 1.0% of GDP, and the output is negative. In the case of the FDL, the latter does not apply if the harmonised consumer price index exceeds 3.0%.

[12] Flexibility measures for municipalities included: short-term loans treated as revenue for the purpose of assessing compliance with the rules; adjustment of current year revenue by adding the unused part of the revenue; and additional borrowing opportunities for municipalities for projects selected by the Central Project Management Agency.

where subordinate legislation expands and amends the Lithuania's fiscal discipline framework. This practice cannot be allowed to continue and the fiscal framework needs to be revised in depth. Without a revision, it is difficult to ensure the benefits to citizens of compliance with the rules of fiscal discipline, in terms of reducing the impact of business cycles on the economy and controlling inflation.

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 13/04/2022 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.

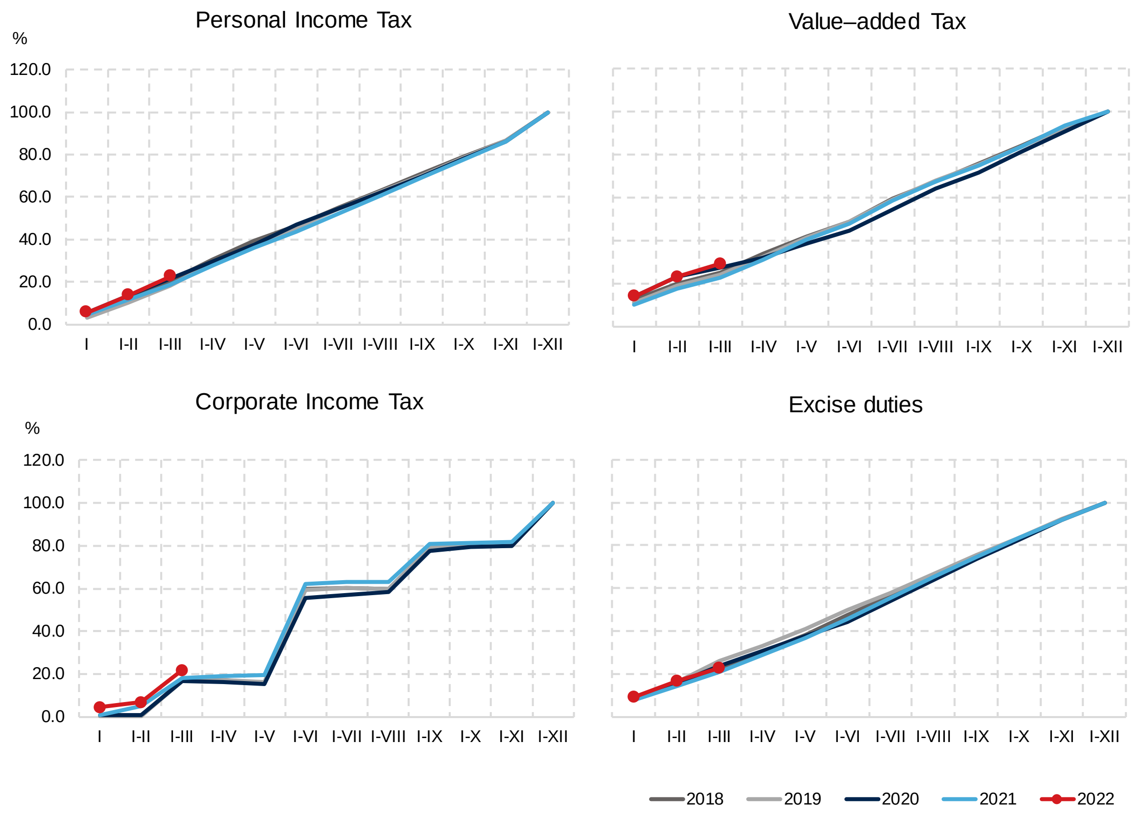
Head of Budget Monitoring Department — Saulė Skripkauskienė

ANNEXES

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
Annex 1

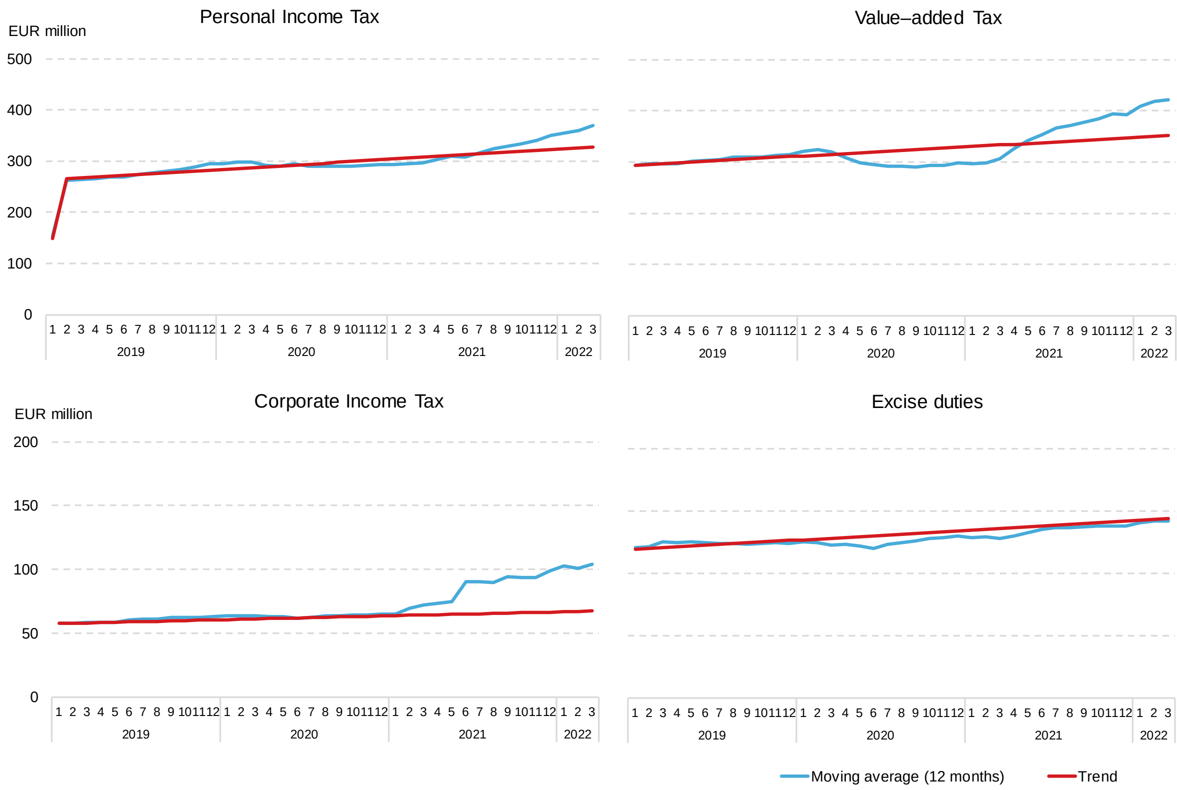
Trends in 2018–2022 revenue collection

Firgure 1. Trends of 2018–2022 in the implementation of the plan revenue



Source: data of Form 1–VP Statement of Taxes and Other Contributions to Budgets, calculations of the Fiscal Institution in the NAO

Firgure 2. Trends in monthly revenue collection performance of 2018–2022



Source: data of Form 1–VP Statement of Taxes and Other Contributions to Budgets, calculations of the Fiscal Institution in the NAO