VALSTYBĖS KONTROLĖ
BUDGET POLICY MONITORING

To the Seimas of the Republic of Lithuania

ASSESSMENT OF THE STABILITY PROGRAMME OF LITHUANIA FOR 2023

8 May 2023 No BPE-2

Vilnius

IT MAY BE INCREASINGLY DIFFICULT TO ENSURE QUALITY PUBLIC SERVICES WITHOUT MEASURES INCREASING REVENUE OF THE STATE BUDGET

Implementing the functions of the fiscal institution, the National Audit Office (hereinafter - Fiscal Institution in the NAO) submits its assessment of the Stability Programme of Lithuania for 2023 to the Seimas.

Currently, it is difficult to predict the outlook for the general government finances. The post-pandemic economic situation and high inflation have led to an unexpectedly strong performance of public finances in 2022, but it is likely to be a one-off phenomenon. The re-imposition of the fiscal discipline rules, in order to ensure fiscal sustainability, on the whole general government may require additional sources of revenue to cover rising expenditures. Tax changes could contribute to the objective of adequately funding areas of societal importance. The direction of the tax proposals presented is appropriate and has the potential to address some of the problems of the country's tax system. While the recommendations of international institutions are taken into account, they could be addressed in a more ambitious way. The Fiscal Institution in the NAO supports the proposed changes to budget planning. The discretionary decisions foreseen for three years would allow for a more reliable medium-term perspective when forecasting the indicators of the general government sector.

1. **The anticipated amendments in budget planning may help forecast more realistic public finance indicators in the medium-term**
2. **With the economy below its potential level, a moderate stimulus is foreseen in 2023–2024**
3. **Rapid growth in prices increased the revenue of the general government, however, it will lead to higher expenditures in the future**
4. **The changes in the Lithuanian tax system are necessary and the direction of the provided proposals is appropriate, however, the proposals could be more in line with the recommendations made by international institutions**
5. **Better results of public finance in 2022 were caused by a more favourable economic situation than projected**
6. **The fiscal discipline rules which are applicable during the period of exceptional circumstances were complied with in 2022, full application of the rules is expected in 2024**

1. THE ANTICIPATED AMENDMENTS IN BUDGET PLANNING MAY HELP FORECAST MORE REALISTIC PUBLIC FINANCE INDICATORS IN THE MEDIUM-TERM

Taking into account the uncertainty of the collection of revenue and the upward pressure on general government expenditure, compliance with fiscal discipline rules will require specific measures going forward. The general government (GG) indicators submitted in the 2023 Stability Programme meet the aim to comply with the medium-term objective according to the no-policy change scenario. However, the presented scenario of 2024–2026 does not include the rise in expected expenditures due to commitments and other discretionary decisions already made. Concrete measures should be foreseen in the future to achieve this. Besides, according to the Fiscal Institution in the NAO, the actual need for appropriations may be even greater than in the assumptions made by the Fiscal Institution in the NAO accounting for possible discretionary measures. Higher general government revenue is necessary when meeting the real needs, but it is also necessary to keep in mind the ongoing systemic revision of the public spending, which could assist in a more efficient use of resources.

More than half of the discretionary decisions made in 2017–2019 were long-term and their negative impact on the budget amounted to more than 1% of GDP. Revenue-reducing discretionary decisions are usually related to various tax exemptions. The introduction of new or renewal of existing exemptions for personal income tax, corporate income tax, value-added tax and excises resulted in an average annual decrease in revenue of 0.3% of GDP and around 0.1% of GDP for the tax-exempt amount of income between 2019–2022 (Table 1). Expenditure-increasing decisions are usually related to social needs such as the increase in the state-sponsored income level, child benefit, social assistance pensions and basic social benefits. Such decisions have led to an annual increase in expenditures of 0.6% of GDP. The appropriations for salary increases for teachers, officers, healthcare or other public sector workers amounted to around 0.3% of GDP.

Table 1. The average impact of discretionary decisions on government revenue and expenditures

Measure	Average annual change, %. GDP
Tax-exempt amount of income (TEAI)	0.1 (2019–2022)
Social spending	0.6 (2017–2019)
Compensation of the employees	0.3 (2017–2019)

Source: Lithuania’s draft budgets for the respective years, explanatory notes of the budget execution reports, calculations by the Fiscal Institution in the NAO

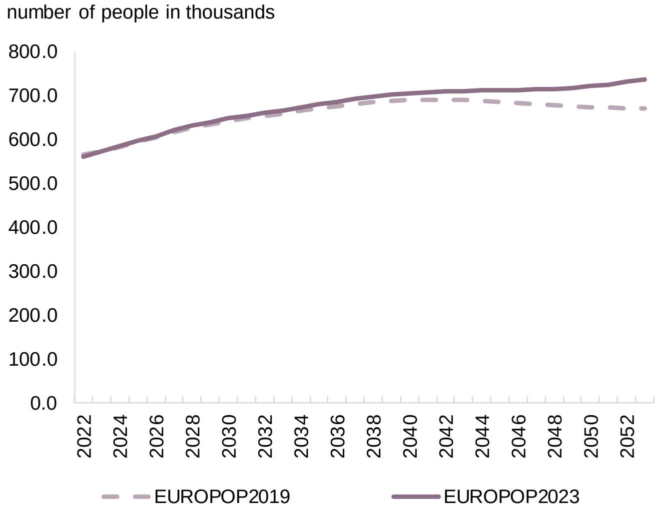
Acknowledging this, the Fiscal Institution in the NAO assumes that at least part of the discretionary decisions, which usually reduce the revenue of the general government and increase the long-term general government expenditures annually, will be made in the medium term. The lower deficit projected by the Fiscal Institution in the NAO for 2023 than in the draft 2023 budget is due to lower potential expenditure on energy price compensation and higher revenues. The Fiscal Institution in the NAO projects a surplus in the local government and social security funds subsectors in the medium term. At the same time, the balance of the central government will remain in deficit. The deficit of the central government will rise to 2.1% of GDP in 2026 from a projected 1.7% deficit in 2023 (Annex 1, Table 1).

Increased revenue level without additional measures may decrease in the medium term. The forecast of the general government revenue is burdened by the last few exceptional years due to COVID-19, high inflation and, based on the assessment of the Fiscal Institution in the NAO, a previously favourable economic cycle. These factors have led to exceptionally high revenue from value-added and corporate taxes which is likely to be one-off in nature. Acknowledging previously mentioned likely discretionary decisions that are usually made and uncertainty related to the revenue collection, the Fiscal Institution in the NAO projects that the tax revenue and social contributions level will decrease from 31.2% in 2023 to 30.7% at the end of GDP medium-term.

The need for expenditures will grow in the medium term due to the commitments made, possible discretionary decisions and aging of the population. Education, healthcare, social protection and defence spending account for around 70% of total general government expenditure. Compensation of employees in the areas of education and healthcare accounts for more than 50% of their expenditures (around 6% of GDP). Taking into account the commitments made to increase salaries for the employees in the areas of healthcare[1] and education[2], and potential additional discretionary decisions, related to the increase of wage growth for the public sector employees, the Fiscal Institution in the NAO projects that the compensation of employees will steadily grow to 10.5% of GDP during the period of 2023–2026 (Annex 1, Table 2). However, the real need may be even higher than projected by the Fiscal Institution in the NAO.

Challenges also arise due to more rapid growth of expenditures on social benefits. In the renewed projections of EUROPOP2023, when compared with the baseline scenario of EUROPOP2019 projections, a slower reduction of the working-age population is foreseen, however, the growth of the number of persons that are over 65 years old is projected to be more rapid (Figure 1). The Fiscal Institution in the NAO predicts that expenditures on social benefits will grow up to 15.1% of GDP during the period of 2023-2026 (Annex 1, Table 2).

Figure 1. The updated EUROPOP2023 projections show faster growth in the number of people aged 65+ than in EUROPOP2019



Source: Eurostat

According to the assessment of the Fiscal Institution in the NAO, the general government balance estimate in the medium term may be lower due to the persisting risks. If energy prices rise higher than expected, additional discretionary measures may be necessary. Geopolitical tension in the region could increase the need for additional funding for national defence to at least 2.5% of GDP in the medium term. The European Central Bank's (ECB) interest rate hikes could raise borrowing costs more than expected. Risks, regarding the implementation of European Structural and Investment Funds, as well as of the Economic

[1] Collective agreement of the Lithuanian national health system branch on the salary increases for healthcare institutions in 2022–2024. Internet access https://sam.lrv.lt/uploads/sam/documents/files/%C5%A0akos%20kolektyvin%C4%97%20sutartis.pdf.

[2] Lithuania's collective agreement for education and science foresees a 10% increase in salaries for 2023–2024. Internet access: https://www.svietimoprofsajunga.lt/wp-content/uploads/2021/11/2017-m.-lapkricio-22-d.-Lietuvos-svietimo-ir-mokslo-sakos-kolektyvines-sutarties-pakeitimas.pdf.

Recovery and Resilience Plan and consequently the level of investment, remain. It is foreseen that these expenditures will account for more than 2% of GDP annually in the medium term. However, rising prices and high demand for commodities related to the aim of a greener economy make it challenging to implement projects in such a short time frame. For this reason, the Fiscal Institution in the NAO made an assumption that these expenditures will not exceed on average 2% of the GDP annually. It is also important to note that these financial flows do not affect the general government balance.

The proposed amendments of the Law on Budget Structure[3] including the establishment of medium-term budget planning would contribute to the improvement of the budget system, more accurate and transparent forecasting of public finances, however, the risk of implementation remains. The Fiscal Institution in the NAO believes that the greatest advantage of the submitted draft of the law is that discretionary decisions would be foreseen for three years instead of one. The institutions producing forecasts could plan public finances in a more reliable way, would assess the effect of the adopted decisions on future budgets. The proposal to include the aggregate expenditure limit could assist in changing the established practice when part of expenditures is foreseen from the borrowed budget funds that are not included in the appropriations of the draft budget approved by the State. The foreseen transfer of unused appropriations to the following budget year would allow for a reduction in the usual end-of-year spending. However, there are potential risks that discretionary decisions would be adopted for three years, but at the same level as in the first year, rather than providing concrete increases in the levels.

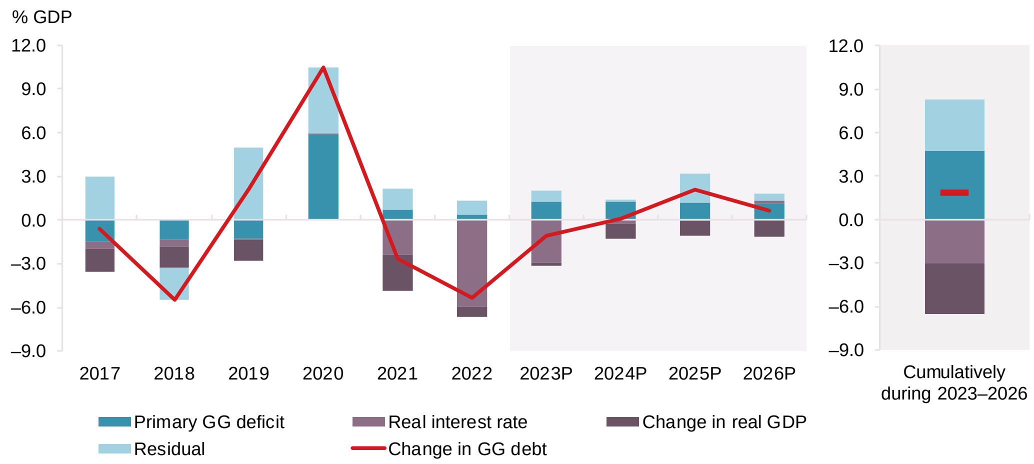
It is projected that the general government debt at the end of the medium term may reach around 40% of GDP. Based on the methodology of the International Monetary Fund (IMF)[4], the Fiscal Institution in the NAO projects that this indicator will reach 37.3% and 37.4% of GDP in 2023–2024 respectively. However, long-term commitments and possible discretionary decisions mean that debt is likely to rise to 40.2% of GDP in 2026 (Annex 1, Table 3). It is projected that the primary GG deficit will increase the debt by 1.3% of GDP in 2023 and by an average of 1.2% annually between 2024 and 2026 (Figure 2). However, favourable automatic debt dynamics[5] will reduce the GG debt by 3.1% of GDP, while this effect is likely to weaken in 2024–2026. This will be affected by the rising real interest rate. It should be noted that early accumulation for the repurchase of the Eurobond issue will contribute to debt growth in 2023.

[3] 12/04/2023 A draft amendment to the Law on Budget Structure. Internet access: https://e-seimas.lrs.lt/portal/legalAct/lt/TAP/64064c81d93211ed9a68f3096fdcecc3.

[4] IMF explanatory note "Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries", 9 May 2013. Internet access: https://www.imf.org/external/np/pp/eng/2013/050913.pdf.

[5] If the projected real interest rate is higher than real GDP growth, automatic debt dynamics are positive and increase debt. Conversely, if the economy is growing faster than the expected real interest rate, this dynamic is negative and reduces debt.

Figure 2. The primary general government deficit will contribute the most to the increase in the general government debt-to-GDP ratio in 2023–2026



Source: State Data Agency, calculations by the Fiscal Institution in the NAO

Public debt management expenditures are likely to increase during the medium term as borrowing becomes more expensive in domestic and foreign markets. Based on the data of 27 April 2023, Lithuania's Government's 10-year bond yield was around 4%. Accordingly, the current low-cost Government issuances of securities may have to be replaced with more expensive ones when refinancing GG debt[6]. The Fiscal Institution in the NAO projects that expenditure on GG debt interest payments in 2023–2024 will amount to EUR 335 million and 453 million respectively (0.5% and 0.6% of GDP). They are likely to increase up to EUR 825 million in 2026 (1.0% of GDP).

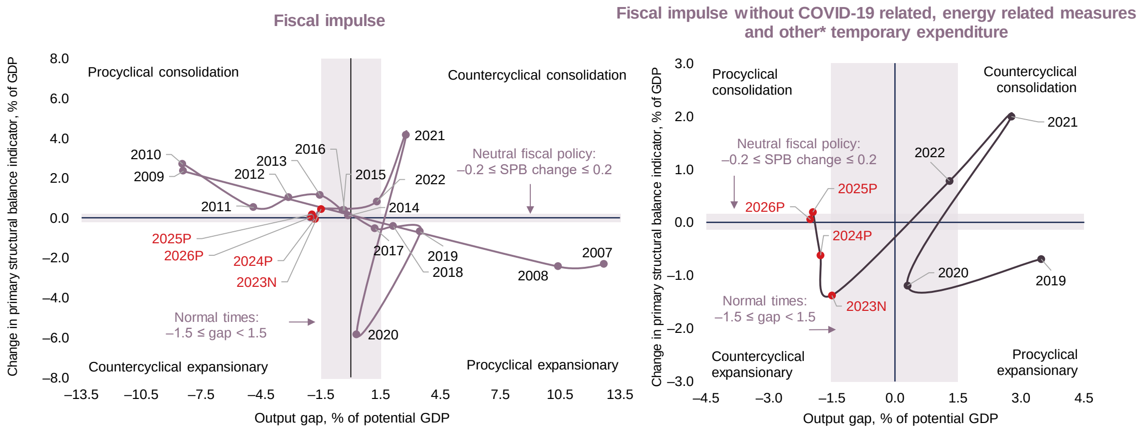
2. WITH THE ECONOMY BELOW ITS POTENTIAL LEVEL, A MODERATE STIMULUS IS FORESEEN IN 2023–2024

Excluding the impact of energy price mitigation and other one-off measures, fiscal policy will stimulate the economy in 2023–2024. While the Fiscal Institution in the NAO estimates that the output gap will be negative, an annual change of 0.4% of GDP in the structural primary balance (SPB) of the GG in 2023 is projected (Annex 2). This means that the fiscal policy is in a pro-cyclical consolidation area. Meanwhile, the projected change in SPB is close to 0% of GDP in 2024. It falls within the broadly neutral fiscal policy interval (+/-0,2% of GDP) set by the European Commission (EC)[7]. On the other hand, the fiscal impulse for 2023–2024 is stimulating the economy, as the rise of energy prices mitigation and other temporary measures are counted as one-off factors (Figure 3). With the economy below its potential level, moderate stimulus is appropriate. However, the current uncertainty about economic development makes the assessment of the economic cycle more difficult.

[6] The issue of EUR 700 million Eurobonds with a coupon of 3.375% is expected to be repurchased in 2024. Meanwhile, the issues of EUR 970 million and EUR 750 million are planned to be redeemed in 2025, with coupons amounting to 0.25% and 1.25% respectively, an issue of EUR 1085 million (coupon of 2.125%) for 2026.

[7] An overview of the stability and convergence programmes of the European Commission (EC) for 2019. Internet access: https://ec.europa.eu/info/sites/default/files/economy-finance/ip110_en.pdf.

Figure 3. The fiscal impulse for 2023–2024 not including temporary factors stimulates the economy



* Other one-off measures: assistance to Ukrainian people fleeing Russian military actions, installation of physical barriers and safety systems at the Lithuania-Belarus border, maintenance of Lithuanian railway infrastructure.

Source: State Data Agency, Ministry of Finance, the calculations by the Fiscal Institution in the NAO

3. RAPID GROWTH IN PRICES INCREASED THE REVENUE OF THE GENERAL GOVERNMENT, HOWEVER, IT WILL LEAD TO HIGHER EXPENDITURES IN THE FUTURE

According to the European Central Bank[8], higher inflation is generally expected to improve public finances by raising more revenue for the State budget. At the same time, general government expenditure becomes higher later due to rapid price increases. This is influenced by the fact that expenditures do not increase as quickly, mainly due to previously approved budgets and agreed public procurement. Indexation of expenditures[9], if it is applied, also lags behind by around a year. Thus, the ECB's analysis of euro area countries shows that inflation has a positive impact on government revenues, but only in the short term. In 2022, higher collection of revenue and only a partial increase in expenditures led to a neutral net impact on the euro area budget balance for 2022. However, in later years, the pressure on the growth of expenditure intensifies and is no longer offset by the increased revenue, hence, according to the ECB assessment, the budget balance for 2024 in the euro area could deteriorate by almost 0.5% of GDP.

In 2022, general government VAT revenue increased by more than a fifth in one year. In 2022, when compared to 2019, this revenue-to-GDP ratio increased from 7.9% to 8.4% of GDP. This was influenced by especially sharp increase in prices. In 2022, due to the energy prices shock, inflation in Lithuania was among the highest in the EU and reached 18.9%. Only Estonia experienced faster price growth.

[8] 13/02/2023 ECB Fiscal policy and high inflation. Internet access: https://www.ecb.europa.eu/pub/economic-bulletin/articles/2023/html/ecb.ebart202302_01~2bd46eff8f.en.html.

[9] Indexation is frequently applied on pensions, other social benefits, salaries of public sector employees.

Box. Methodology for assessing the impact of inflation on the collection of VAT revenue

The change in VAT revenue can be broken down into several factors of change. García-Miralles and Martínez Pagés (2023) highlight real and price components, discretionary revenue measures and the residual, which shows the difference between estimated and actual revenue growth. In the assessment for the case of Lithuania, the impact of the discretionary revenue measures is included in the residual. According to Kremer et al. (2006), the change in VAT revenue (EUR million) in the current year is assessed by the equation:

$$\Delta R_t = \underbrace{\varepsilon^r g_t^r R_{t-1}}_{\text{Real component}} + \underbrace{\varepsilon^p g_t^p R_{t-1}}_{\text{Price component}} + \nu_t \qquad (1)$$

Here: ΔR_t – change in revenue in year *t* (EUR million);
R_{t-1} – level in revenue in year *t-1* (EUR million);
ε^r – revenue elasticity with regard to real economic indicator;
ε^p – revenue elasticity with regard to price indicator;
g_t^r – growth of real economic indicator in year *t*;
g_t^p – growth of price indicator in year *t*;
ν_t –residual, which also includes the impact of discretionary revenue measures, in the year *t* (EUR million).

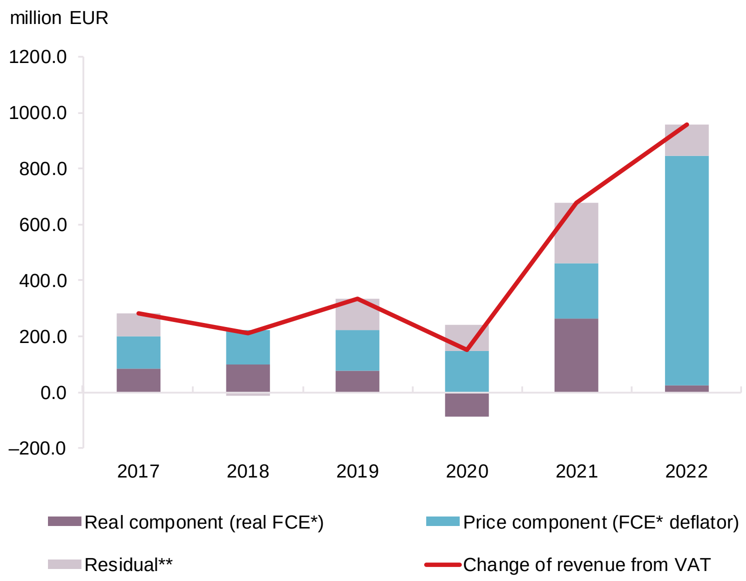
Final consumption expenditure of national accounts statistics is used to define the tax base of VAT revenue[10]. Accordingly, real final consumption expenditure (1) in the equation is defined as the real economic indicator (*r*), whereas the deflator of the final consumption expenditure – the price indicator (*p*). Revenue elasticity with regard to a certain economic indicator shows how much the revenue will increase if the given indicator will rise by 1%. According to Mourre et al. (2019), the VAT elasticity for Lithuania, like for other countries of the EU, is considered to be 1, as the dynamics of the revenue from this tax remain proportional to its base. In other words, unitary elasticity applied to indirect taxes shows that the changes in revenue of these taxes closely respond to economic fluctuations. Acknowledging the mentioned proportionality, an assumption is made that the elasticities of VAT revenue with regard to the real economy and price indicators (ε^r and ε^p) remain equal to 1.

We are grateful to the specialists of Spain's Independent Authority for Fiscal Responsibility (AIReF) for sharing good practices in evaluating the impact of inflation on public finances.

In 2022, more than 80% of the VAT revenue growth was due to the growth in prices. In 2021–2022, VAT revenue grew at double-digit rates (16.9% and 20.4% respectively). In comparison, during the 2015–2020 period, it grew by 6.4% annually. Based on the methodology provided in the Box, rapid economic recovery after the shock of the pandemic led to real final consumption expenditure being the main driver of the VAT revenue growth in 2021 (Figure 4). The effect of prices on revenue collection started to grow when inflation started to rise rapidly in the second half of that year. In 2022, VAT revenue collections were EUR 956.2 million higher than in 2021. Based on the assessment of the Fiscal Institution in the NAO, around 85.5% (EUR 817 million) of this growth could be attributed to the high inflation. Considering the slowing growth in prices foreseen in the Economic Development Scenario of March 2023, it would be difficult to expect such rapid growth in VAT revenue in 2023–2026. It should be noted that the potential revisions of the National Accounts Statistics could have an influence on the results of the assessment.

[10] While analysing the impact of the inflation on VAT revenue, the data of the national accounts, updated on 01/04/2023, was taken into account.

Figure 4. The rise of VAT revenue in 2022 was mostly driven by the growth in prices



* Final consumption expenditure ** Residual includes the impact of revenue discretionary measures

Change of VAT revenue on accrual principle

Source: State Data Agency, calculations by the Fiscal Institution in the NAO

4. THE CHANGES IN THE LITHUANIAN TAX SYSTEM ARE NECESSARY AND THE DIRECTION OF THE PROVIDED PROPOSALS IS APPROPRIATE, HOWEVER, THE PROPOSALS COULD BE MORE IN LINE WITH THE RECOMMENDATIONS MADE BY INTERNATIONAL INSTITUTIONS

The direction of the proposed tax amendments is appropriate – their approval would likely contribute to the creation of a simpler and more neutral tax system. Some of the proposals are based on the recommendations of international institutions, however, they could be addressed even more ambitiously. Simplicity and neutrality[11] are some of the key principles of tax policy[12]. International organisations have proposed recommendations for the Lithuanian tax system in line with these principles. The Fiscal Institution in the NAO performed the analysis of the package of tax proposals[13] to assess whether these recommendations of 2021–2022 are addressed (Table 2). A more detailed tax amendments analysis is presented in Annex 3 of the assessment.

Table 2. The package of tax proposals partially meets the recommendations of the international institutions

Taxes mentioned in the package of tax proposals	Do the proposals comply with the recommendations?	Reason for non-compliance
Personal income tax	Partially	The taxation of income by form of activity and type of income remains (WB). The application of presumptive costs is not abolished (OECD).
Corporate tax	No	The threshold for the application of the reduced tax rate is not adjusted (WB). The corporate tax rate is not unified for all companies (WB).

[11] The principle of neutrality means that forms of business activities or types of revenue should be taxed equally, so that the resources would be allocated effectively and the tax system would not create incentives to seek more favourable taxation.

[12] Internet access: https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy/fundamental-principles-of-taxation_9789264218789-5-en.

[13] Internet access: https://finmin.lrv.lt/en/news/minister-of-finance-the-highlights-of-the-package-of-tax-proposals-are-convenience-economic-growth-and-fairness.

Taxes mentioned in the package of tax proposals	Do the proposals comply with the recommendations?	Reason for non-compliance
Value-added tax	No	The VAT registration threshold remains too high (OECD).
Real estate tax	Partially	The structure of the tax does not adhere to the main principles of taxation.

International institutions that made recommendations: Organisation for Economic Co-operation and Development, 2022 (OECD), World Bank, 2022 (WB).

Source: Ministry of Finance, analysis by the Fiscal Institution in the NAO

The proposals to amend the personal income tax meet some of the recommendations of the international organisations, however, they lack decisive action towards a more neutral tax system. The tax proposals package takes into account the recommendation to align the income tax rates between standard employment contracts and the individual activity scheme, increase the number of income tax brackets, etc., (Annex 3), however the recommendation[14] of the World Bank to move away from taxation based on the form of activity and the type of income has been addressed partially. This means that income will continue to be treated in an unequal manner and the different rates of taxation of income will remain.

The proposed amendments to corporate tax are not in line with the recommendation to solve the corporate "bunching" problem. The mentioned World Bank recommendations state that small and medium-sized enterprises are concentrating at the current threshold of reduced tax application, which is EUR 300 thousand of revenue. This bunching is considered to be a result of tax optimisation which is harmful to the growth of the economy and discourages the development of these companies. One of the main reasons behind "bunching" is a rapid rise in tax rates by crossing the threshold of preferential tax treatment; therefore, it is recommended to apply a uniform corporate tax rate for all companies. This proposal has not been taken into account.

International institutions have recommended to lower the threshold, from which an individual becomes liable for value-added tax, whereas it is being raised in the proposals. At the moment, the law foresees that an individual becomes a VAT payer, when the overall remuneration (during the last 12 months) of his/her for the sold goods and (or) provided services in performing the economic activity in the country's territory exceeds EUR 45 thousand. The OECD recommendations for Lithuania[15] state that at the moment, the mentioned threshold is too high, which could lead to lower transparency in the collection of taxes. It is worth noting that the package proposes to raise this threshold up to EUR 55 thousand, which could contribute to a lower collection of value-added tax.

The proposed amendments to the real estate tax seek to expand the tax base, however, they deviate from the main principles of taxation. IMF recommendations for Lithuania stress that the country's tax system should be more oriented towards the taxation of capital and wealth[16]. The proposed amendments of this tax that are related to the determination of taxation of the main residential dwelling according to the real estate median would include a higher share of the population, which would likely increase the share of the collection of revenue from this tax. It is expected that real estate tax could create an additional sustainable

[14] The World Bank. A microsimulation analysis of the scale and impact of tax optimisation and corporate "gorges". Report and recommendations. December 2022.

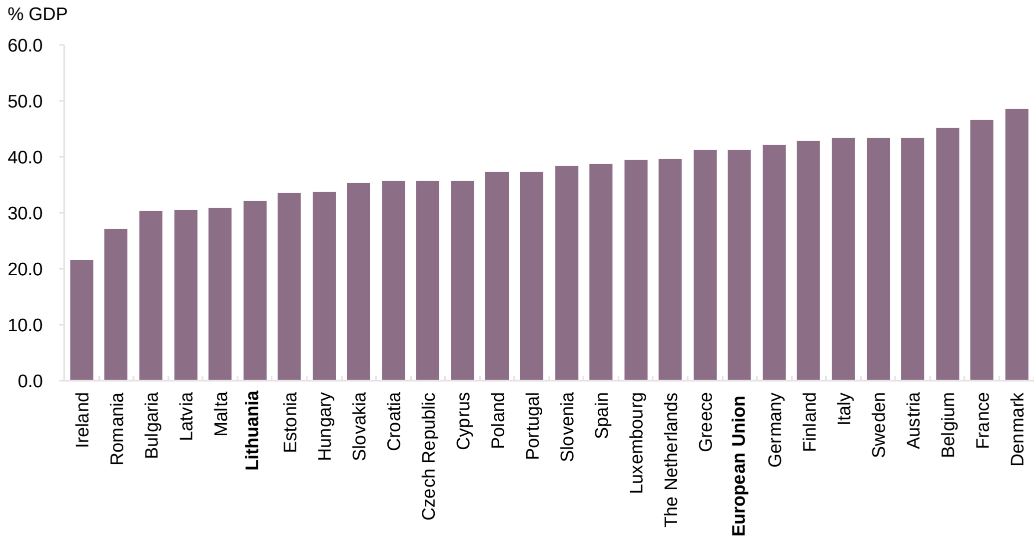
[15] Internet access: https://www.oecd-ilibrary.org/sites/53952224-en/1/3/2/index.html?itemId=/content/publication/53952224-en&_csp_=72dafb47de9557cdbb7ac64eb53a37e0&itemIGO=oecd&itemContentType=book.

[16] Internet access: https://www.imf.org/en/Publications/CR/Issues/2021/08/30/Republic-of-Lithuania-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-464874.

source of revenue for municipal budgets. The Bank of Lithuania[17] has noticed that the proposed tax structure has significant deficiencies. It does not ensure the universality of the tax, horizontal and vertical equity. Although international organizations have not submitted concrete recommendations on the real estate tax structure in Lithuania, they rely on these principles when submitting their comments on the tax system. Based on the assessment of the Fiscal Institution in the NAO, the proposed taxation model does not comply with them.

Implementation of the tax proposals package in the future could allow to increase the revenue-to-GDP ratio, which is one of the lowest in the European Union. In 2021, the GG tax revenue in Lithuania accounted for 32.2% of GDP (Figure 5). However, in the European Union, they accounted for 41.4% of GDP. It is notable that due to the applied exemptions for personal income tax, corporate income tax, value-added tax and excises state budget revenue was lower by 2.6% of GDP in 2015 and by 5% of GDP in 2022. The National Audit Office[18] has recommended performing the monitoring of tax exemptions to acknowledge their objectives, impact on society and business, duration, and influence on the budget revenue. If no time limit is set for the application of the tax exemptions, they may distort the market in the long run, since they were adopted under different economic conditions. Reduction of tax exemptions could contribute to increased collection of revenue to the State budget.

Figure 5. In 2021, the tax revenue collected in Lithuania* amounted to 32.2% of GDP, which is one of the lowest figures in the European Union**.



* Total receipts from taxes and social contributions (including imputed social contributions) after deduction of amounts assessed but unlikely to be collected.

** Ireland's data was not included due to the impact of international companies to the GDP of this country.

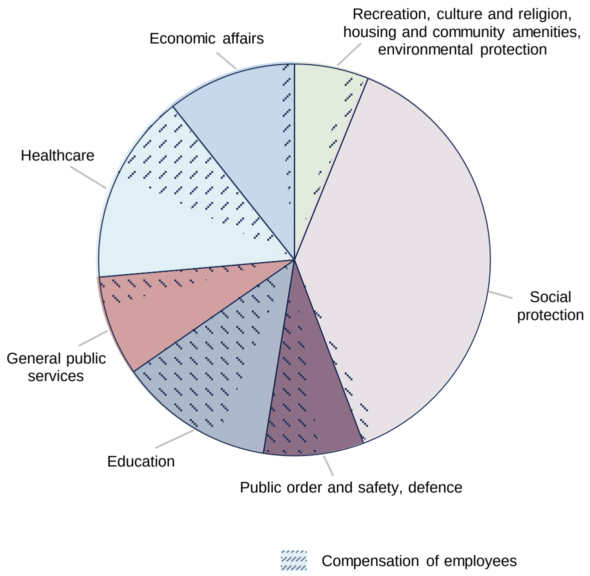
Source: Eurostat

Adjustments to the tax system are necessary to achieve balanced public finances at a time when the need for spending on areas of societal importance constantly grows. An analysis of the general government expenditure by function in 2021 shows that the largest share (25% of GDP) is allocated to public welfare-oriented areas, such as social protection, healthcare, and education (Figure 6). The largest share of healthcare and education expenditures is allocated to salaries (6.1% of GDP). Social benefits and pensions of the social security function account for 15% of GDP (0.7% of GDP for salaries).

[17] Internet access: https://www.lb.lt/lt/naujienos/lietuvos-banko-pozicija-del-mokesciu-istatymu-projektu.

[18] 07/06/2013 Public Audit Report No VA-P-60-3-7. Internet access: https://www.valstybeskontrole.lt/EN/Product/23097/tax-incentives.

Figure 6. In 2021, the largest share of expenditure was allocated to healthcare, social protection, and education (in total 25% of GDP), of which 6.8% of GDP was to salaries



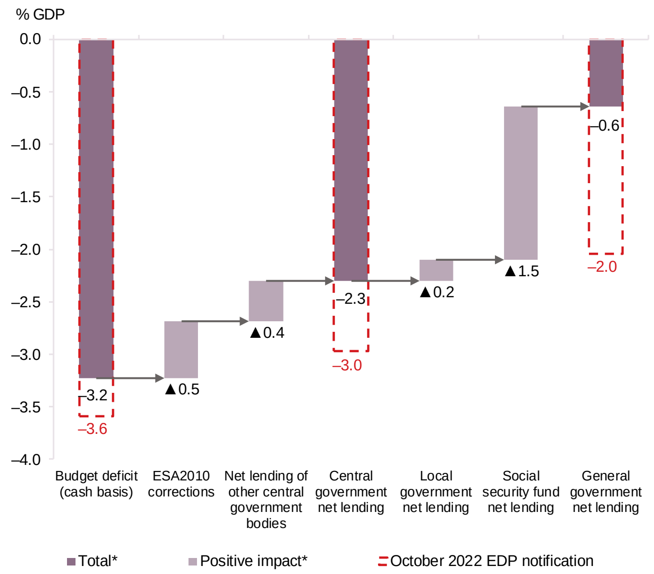
General government expenditures by function in 2021 (COFOG)

Source: State Data Agency, calculations by the Fiscal Institution in the NAO

5. BETTER RESULTS OF PUBLIC FINANCE IN 2022 WERE CAUSED BY A MORE FAVOURABLE ECONOMIC SITUATION THAN PROJECTED

The actual deficit of 1.0% of GDP in 2022 was the consequence of more favourable results of all subsectors of the general government. The state budget deficit on a cash basis amounted to 3.2% of GDP (Figure 7). The general government deficit on accrual principle amounted to 0.6% of GDP[19] which is 1.4 p.p. lower than projected in October 2022. This outcome was mostly influenced by the surplus of social security funds and the 0.8% of GDP lower expenditure for the acquisitions of weapons, military equipment and military inventories.

Figure 7. Based on the EDP notification of April 2023, the actual deficit of 0.6% of GDP in 2022 was the consequence of more favourable results of all subsectors of the general government



* Based on the EDP certificate of April 2023

Source: EDP notification of October 2022, April 2023, calculations by the Fiscal Institution in the NAO

[19] Based on the data published by State Data Agency on 20/04/2023. Internet access: https://osp.stat.gov.lt/valdzios-sektoriaus-finansai.

All balances of the GG subsectors, except the central government, were in surplus on the accrual basis. The balance of the social security subsector was two times higher than projected reaching 1.5% of GDP instead of 0.7%. Strong wage growth led to higher contributions to the funds of State Social Insurance (SSIF) and Compulsory Health Insurance (CHIF); therefore, revenue was EUR 500 million greater than approved in the respective laws. Expenditures were EUR 150 million lower than planned. These funds[20] have also contributed to higher fiscal reserves[21] than planned in the budget law for 2022[22]. In 2022, reserves increased to EUR 3.14 million or 4.7%. of GDP. In comparison, fiscal reserves averaged 1.3% of GDP during the period of 2015–2021.

The smaller deficit of the central government subsector is mainly due to higher revenue than planned in the Budget Law for 2022. Compared to the approved revenue plan, in 2022, almost EUR 1 billion more was collected to the state budget on a cash basis (excluding EU and other international financial assistance). Greater than planned revenue collection was due to several main factors: taxpayers' COVID-19 arrears repayments, better macroeconomic indicators and higher corporate profits.

State budget appropriations (excluding EU and other international financial assistance) on a cash basis were more than EUR 800 million greater than the plan approved in the Budget Law. EUR 1.32 billion increase in appropriations, which were not included in the approved plan, but were foreseen from borrowed funds, as a result of the resolutions of the Government of the Republic of Lithuania[23]. More than EUR 650 million of it was foreseen for the expenditures, related to the compensation of a share of the price of electricity to household and non-household consumers. Taking into account the revisions allowed by the decrees and needs that arose, around EUR 600 million of funds available for borrowing were unused. The full amount available for borrowing during the preparation of the budget was included in the calculation of the potential general government deficit in 2022, so the unused part contributed to the lower deficit.

The general government sector debt-to-GDP ratio decreased from 43.7% to 38.4% when comparing 2021 to 2022. Debt on a nominal basis during this period increased by EUR 1.14 billion, hence such dynamics were mainly driven by the nominal GDP that grew by 19.1%. The general government sector debt was EUR 0.4 billion lower than projected in the Government Borrowing Programme as a result of the lower deficit [24].

6. THE FISCAL DISCIPLINE RULES WHICH ARE APPLICABLE DURING THE PERIOD OF EXCEPTIONAL CIRCUMSTANCES WERE COMPLIED WITH IN 2022, FULL APPLICATION OF THE RULES IS EXPECTED IN 2024

With exceptional uncertainty prevailing, the application of fiscal discipline rules is temporarily narrowed. In Lithuania, exceptional circumstances were first announced in March 2020, following the outbreak of the COVID-19 pandemic. After the impact on public finances of the

[20] At the end of 2022, the amount of funds accumulated in the SSIF reserves was 34% and CHIF 20.1% greater than planned in the Budget Law for 2022.

[21] The fiscal reserves include the Reserve (Stabilisation) Fund, the SSIF, the CHIF, the Guarantee Fund and the Long-Term Employment Benefit Funds.

[22] Law No XIV-745 of 17/05/2021 of the Republic of Lithuania on the Approval of Financial Indicators of the State Budget and Municipal Budgets for 2021, amending the preamble, Articles 1, 2, 6, 7, 9, 10, 11, 14, 15, 21, and Annexes 1, 2, 3, 4, 5, 6, 7, 11.

[23] The Fiscal Institution in the NAO has previously recommended that all planned expenditures should be presented in the state budget appropriations, instead of applying the practice where a share of the state budget expenditures are planned from borrowed budget funds on behalf of the state.

[24] Internet access: https://finmin.lrv.lt/uploads/finmin/documents/files/2022%20metu%20Vyriausybes%20skolinimosi%20programa.pdf.

pandemic diminished in 2022, the geopolitical situation[25] became the basis for the exceptional circumstances. The EC fiscal policy guidance for 2024[26] indicates that the general escape clause of the Stability and Growth Pact will likely be deactivated at the end of 2023, consequently, it is expected that all of the rules will be applied once again in Lithuania from 2024.

Taking into account the narrowed application of the fiscal discipline rules, the general government budgets for 2022 complied with the requirements set out in the Constitutional Law (Table 3[27]). The surplus GG and GG expenditure growth rules do not apply during the period of exceptional circumstances. The structural budget balance of the SSIF in 2022, estimated by the Fiscal Institution in the NAO, accounted for 1% of GDP. As the structural balance was positive, SSIF budged complied with the requirements of Article 4(3) of the constitutional law (CL). The estimated structural budget balance of the CHIF in 2023 accounted for 0.3% of GDP. The budget of this fund complied with the requirements of Article 4(2) of the CL, as it was in surplus according to the structural balance indicator. The compliance of municipal budgets with fiscal discipline rules will be assessed in the first half of 2023.

Table 3. Compliance with fiscal discipline rules in 2022

Fiscal discipline rules	Opinion
Surplus GG rule	not applicable
GG rule for limiting expenditures growth	not applicable
Rules for GG budgets, which include the ones of:	
State Social Insurance Fund	✓
Compulsory Health Insurance Fund	✓
Local Government subsector	not assessed

✓ – the rule is complied with, × – the rule is not complied with

Source: the Fiscal Institution in the NAO

In April 2023, the European Commission published a legislative proposal on the reform of fiscal governance, which may influence the fiscal discipline rules in Lithuania. The proposal published by the European Commission[28] foresees that the fiscal policy supervision on the EU level would be implemented by moving away from the structural balance rule, which depends on an observable variable, i.e. the output gap. Fiscal discipline would rely more on the expenditure growth rule and debt sustainability analysis. The EC would propose fiscal adjustment plans for medium and high-debt-risk countries, which would rely on limiting expenditure growth. When publishing fiscal policy guidance for 2024, the EC noted that the budgets should be set up in such a way that they would meet proposals on economic governance guidance. Based on the reform proposed by the EC, for Lithuania, as a low-debt-risk country, the EC would not propose a fiscal adjustment plan. Nevertheless, the EC has drawn attention to the rapidly growing current expenditures and the need for investments financed with national resources[29]. In recent years, net[30] expenditure growth in Lithuania has exceeded the multi-year growth rate of potential GDP at prices of the time (Figure 8). To reduce the structural deficit of the GG, this expenditure should grow slower than the multi-

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[25] On 20 September 2022, the Fiscal Institution in the NAO issued an opinion on the compliance of the unusual event with the definition of exceptional circumstances No BPE-8. Internet access: https://www.valstybeskontrole.lt/EN/Product/24132/opinion-on-the-endorsement-of-the-economic-development-scenario.

[26] Internet access: https://economy-finance.ec.europa.eu/system/files/2023-03/COM_2023_141_1_EN_ACT_part1_v4.pdf.

[27] A detailed assessment of compliance can be found on the web page in the MS Excel workbook accompanying this opinion. Internet access: https://www.valstybeskontrole.lt/EN/BudgetPolicyMonitoring.

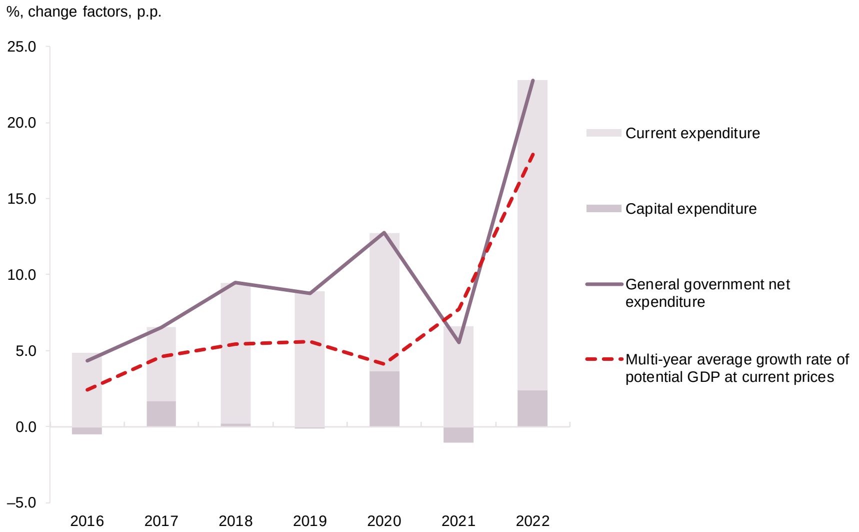
[28] Internet access: https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2393.

[29] Internet access: https://economy-finance.ec.europa.eu/system/files/2022-11/c_2022_9513_1_lt.pdf.

[30] GG net expenditure is the total expenditure after eliminating interest payments on public debt, unemployment benefits, EU and other international financial assistance, and COVID-19 related expenditures.

year growth rate of potential GDP at current prices or could grow more rapidly, if it was financed by additional revenue measures.

Figure 8. In recent years, the growth of net expenditure usually exceeded the sustainable growth rate of the multi-year growth rate of potential GDP at prices of the time



Source: State Data Agency, Ministry of Finance, the calculations by the Fiscal Institution in the NAO

The National Audit Office of the Republic of Lithuania, implementing its functions of a budget policy monitoring institution (fiscal institution) set out in the Constitutional Law on the Implementation of the Fiscal Treaty of the Republic of Lithuania, has carried out an assessment and issued an opinion on the Stability Programme of Lithuania for 2023 prepared by the Ministry of Finance of the Republic of Lithuania and published on 26 April 2023. The assessment must be submitted to the Seimas within 7 working days of the Stability Programme being made public. Pursuant to Article 8(7) of the Law on National Audit Office, the National Audit Office submits its assessment to the Seimas of the Republic of Lithuania.

Head of Budget Monitoring Department | Jurga Rukšėnaitė

ANNEXES

Assessment
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Annex 1

RESULTS OF CALCULATIONS BY THE FISCAL INSTITUTION IN THE NAO

Table 1. The estimates of the general government sector and its subsectors balance

No	Indicator, % GDP	2022	2023N	2024P	2025P	2026P
1.	Central government subsector	−2.3	−2.3	−2.3	−2.2	−2.4
2.	Social Insurance Funds’ subsector	1.5	0.6	0.3	0.3	0.3
3.	Local government subsector	0.2	0.0	0.1	0.1	0.1
4.	General government	−0.6	−1.7	−1.8	−1.9	−2.1

N – Expected, P – Forecast

* Data may not match due to rounding

Source: State Data Agency, calculations by the Fiscal Institution in the NAO

Table 2. Revenue and expenditures of the general government in the year 2022–2026 according to ESA 2010

Indicator, % GDP	ESA 2010 code	2022	2023N	2024P	2025P	2026P
Total revenue	OTR	35.8	36.3	36.1	35.7	35.7
Tax revenue		21.6	21.3	20.9	20.8	20.8
Revenue from indirect taxes	D.2	11.5	11.2	11.3	11.2	11.0
Revenue from direct taxes	D.5	10.1	10.0	9.6	9.6	9.9
Net social contributions	D.61	10.3	9.9	9.8	9.9	9.9
Other revenue, of which:		3.9	5.1	5.4	5.0	4.9
Revenue from property	D.4	0.4	0.3	0.3	0.3	0.3
Total expenditures	OTE	36.4	38.0	37.9	37.7	37.7
Compensation of employees	D.1	10.1	10.1	10.2	10.4	10.5
Intermediate consumption	P.2	4.3	4.9	4.8	4.7	4.6
Subsidies	D.3	1.7	0.8	0.4	0.4	0.4
Interest expenditures	D.41	0.4	0.5	0.6	0.7	1.0
Social benefits	D.6M	14.1	14.6	14.9	15.1	15.1
Other expenditures, of which:		5.8	7.1	6.9	6.4	6.1
Gross fixed capital formation	P.5L	3.0	3.8	3.8	3.5	3.1
Capital transfers	D.9	0.7	0.7	0.7	0.7	0.6
Net lending (+) / net borrowing (–)	B9	−0.6	−1.7	−1.8	−1.9	−2.1

N – Expected, P – Forecast

Source: State Data Agency, calculations by the Fiscal Institution in the NAO

Table 3. Dynamics of general government debt and its evolutionary factors

No	Indicator, % GDP	2022	2023N	2024P	2025P	2026P
1.	GG debt	38.4	37.3	37.4	39.5	40.2
2.	GG debt change (3+4+7)	−5.3	−1.1	0.1	2.1	0.7
3.	Primary GG deficit	0.4	1.3	1.2	1.2	1.1
4.	Automatic debt dynamics (5+6)	−6.7	−3.1	−1.3	−1.1	−0.9
5.	Real interest rate	−6.0	−3.0	−0.2	−0.0	0.2
6.	Change in real GDP	−0.7	−0.2	−1.1	−1.1	−1.1
7.	Residual*	1.0	0.8	0.2	2.0	0.5

N – Expected, P – Forecast

* Balance of borrowed funds included into the residual, early accumulation for the redemption of Eurobonds issuance for 2023–2026

Source: State Data Agency, calculations by the Fiscal Institution in the NAO

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THE CYCLICAL SITUATION OF THE LITHUANIAN ECONOMY AND STRUCTURAL GENERAL GOVERNMENT BALANCE, 2020–2026

No	Indicator, % GDP	2020	2021	2022	2023N	2024P	2025P	2026P
1.	General government net lending (+) / borrowing (–)	–6.5	–1.2	–0.6	–1.7	–1.8	–1.9	–2.1
2.	One–off and other temporary measures*	0.0	0.0	0.2	–0.1	0.0	0.0	0.0
3.	One–off and other temporary measures, including COVID-19 related measures, mitigating the impact of energy price increases and other** measures	–4.6	–2.5	–2.2	–0.7	0.0	0.0	0.0
4.	Output gap from potential, p.p. GDP	0.3	2.8	1.3	–1.5	–1.8	–2.0	–2.0
5.	Cyclical budget component (0.399 × 4 line)	0.1	1.1	0.5	–0.6	–0.7	–0.8	–0.8
6.	Structural GG balance (1 – 2 – 5)	–6.6	–2.2	–1.3	–1.0	–1.1	–1.1	–1.3
7.	Structural GG balance, excluding COVID-19 related mitigation of energy price increases and other one–off measures (1 – 3 – 5)	–2.0	0.2	1.1	–0.4	–1.1	–1.1	–1.3
8.	Interest	0.7	0.4	0.4	0.5	0.6	0.7	1.0
9.	Structural GG primary balance (6 + 8)	–6.0	–1.8	–1.0	–0.5	–0.6	–0.4	–0.3
10.	Structural GG primary balance excluding COVID-19 related mitigation of energy price increases and other one–off measures (7 + 8)	–1.3	0.7	1.4	0.1	–0.6	–0.4	–0.3
11.	Change in the structural GG primary balance	–5.8	4.2	0.8	0.4	0.0	0.2	0.1
12.	Change in the structural GG primary balance excluding COVID-19 related mitigation of energy price increases and other one–off measures	–1.2	2.0	0.8	–1.4	–0.6	0.2	0.1

N – Expected, P – Forecast

* Other one–off measures: assistance to Ukrainian people fleeing Russian military actions, installation of physical barriers and safety systems at the Lithuania–Belarus border, maintenance of Lithuanian railway infrastructure.

Source:– Ministry of Finance, State Data Agency, calculations by the Fiscal Institution in the NAO

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COMPARISON OF TAX PROPOSALS PACKAGE WITH THE RECOMMENDATIONS OF THE INTERNATIONAL INSTITUTIONS

Current regulation	Recommendations of the international institutions	Tax proposals
The proposals to amend the personal income tax		
Income is taxed based on its type and form of activity.	To abandon the personal income tax system based on taxation by forms of activity and type of income (WB).	Different taxation by the type of income and activity remains, but the tax rates are being made more equal.
Income from different activities of an individual are being taxed by applying different tax rates.	Apply a general tax on the whole revenue (WB).	Total taxable income sum includes revenue from self–employment, dividends, employment–related, sale and lease of property.
A tax rate of 20% is applied to all employment–related income up to 60 times the average wage (AW), and 32% for those that exceed 60 of AW.	Introduce a more progressive rate system, which means increasing the number of income tax brackets (WB).	Increase the number of tax brackets: up to 60 of AW apply the rate of 20%, from 60 to 120 of AW add an additional 5%, from 120% of AW add an additional 7%.
Individual activity income is taxed at a nominal tax rate of 15%.	Apply a single income tax rate to employment contracts and individual activity scheme (OECD).	Apply a nominal tax rate of 20% to income gained from individual activity starting from 2026.
A credit of 10% p.p. is applied to taxable income up to EUR 20 thousand and gradually reduced to 0% of EUR 20 thousand of the mentioned income.	To reduce the size of the tax credit of the threshold for its application (OECD).	From 2026, apply a credit of 15% p.p. for the taxable income up to EUR 10 thousand and reduce it gradually to 0% in the threshold of the mentioned range from EUR 10 thousand to EUR 35 thousand.
The size of presumptive costs is 30%.	To abolish the application of presumptive costs (OECD).	To reduce the share of presumptive costs to 20% and no longer apply this principle from the revenue exceeding the VAT payer registration threshold.
Proposals for amending corporate tax		
A reduced tax rate of 5% is applied to companies with revenue not exceeding EUR 300 thousand and meeting the number of employees criterion, while a tax rate of 15% is applied if the revenue exceeds the threshold of EUR 300 thousand.	It is recommended to apply a unified rate of 15% to all legal entities, i.e. to discard the double rate system (WB).	–
The proposals to amend the value–added tax		
At the moment, an individual becomes a value–added tax payer, when the overall remuneration (per year) of his/her for the sold goods and (or) provided services in performing the economic activity in the country's territory exceeds EUR 45 thousand.	To lower the threshold for VAT payer registration (OECD).	To raise the threshold from which an individual becomes a VAT payer up to EUR 55 thousand.
The proposals to amend the real estate tax		
The total value of non–commercial real estate up to EUR 150 thousand is tax–free, a tax rate of 0.5% is applied for the share of the value between EUR 150 thousand and EUR 300 thousand, a tax rate of 1% is applied for the share of the value between EUR 300 thousand and EUR 500 thousand, and for the share of the real estate value exceeding EUR 500 thousand, a tax rate of 2% is applied. All other assets of legal and natural persons are taxed at a rate of 0.5–3%.	The tax system should be more oriented towards the taxation of wealth and capital, thereby broadening the tax base (IMF).	To discard the taxation of non–commercial real estate on the basis of the total sum of their values and replace it on the basis of the median of the real estate objects' values (for the main residential dwelling). Other non–commercial assets should be taxed at a rate of 0.1–3% and between 0.5–3% when the asset is transferred to the legal entity.

International institutions that made recommendations: Organisation for Economic Co-operation and Development (OECD), the World Bank (WB), the International Monetary Fund (IMF).

Source: Ministry of Finance, analysis by the Fiscal Institution in the NAO

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LITERATURE OF THE INSERT

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