ANNEX 2. Fiscal rules in the European Union and Lithuania

Introduction

The recent economic, financial and sovereign debt crisis encouraged the review of the EU economic policy management. The provisions of the Stability and Growth Pact (SGP) were supplemented by the six-pack and the two-pack legal acts, as well as by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (hereinafter — the Treaty). The fiscal governance system was finalised after the introduction of the European Semester — the main calendar of the EU economic policy formation. It is expected that this integrated system will ensure clarity of the rules and create conditions for better coordination of national policies of individual states at the EU level, encourage closer cooperation of Member States and EU institutions and will faster apply sanctions for non-compliance with the rules. It is expected that this will help Member States comply with fiscal obligations and implement structural reforms; therefore, the EMU will become stronger and more resilient to future challenges.

Lithuania was one of 25 Member States that signed the Treaty on 2 March 2012 and committed to transpose its provisions to the national law. The Seimas of the Republic of Lithuania ratified this Treaty on 28 June 2012 and adopted the Republic of Lithuania Constitutional Law on the Implementation of the Fiscal Treaty (CLIFT) on 6 November 2014, in order to implement the Treaty. Amendments to the legal acts related to the CLIFT, including the Republic of Lithuania Law on Fiscal Discipline (LFD) of 2007, were also adopted. Moreover, by adopting the euro in 2015, Lithuania assumed the obligation to also comply with those EU rules that are applicable only to euro area Member States. Taking into account the above-mentioned circumstances, this analysis has two main objectives: first, to discuss the main EU fiscal governance mechanisms and reasons for their creation and development. The second objective is to review the national fiscal rules of Lithuania and to establish a clear summarised scheme of Lithuania's fiscal governance.

Stability and Growth Pact: origins and essential provisions

The fall of the communist regime in Eastern Europe and the reunification of Germany were the main reasons that determined the signing of the Maastricht Treaty in 1992. This Treaty was an essential step of the first stage in the creation of the Economic and Monetary Union (EMU) — it established the EU. When designing the EMU, attention was paid to the concerns of the US and European economists that effective functioning of the EMU needs not only labour mobility, cross-border fiscal transfers, coincidence of business cycles and economic shocks, but also adequate fiscal rules (Jonung, Drea 2009: 28). It was thought that only strong fiscal discipline of national governments will ensure successful functioning of the EMU and help to avoid deficit bias, which emerges as a result of fragmented political process. Therefore, the Maastricht Treaty enshrined some basic principles necessary for the sustainability of the EMU: prohibition of financing of Member State budget deficits by central banks, prohibition of exclusive rights for the public sector to borrow from financial institutions, "no-bailout" principle, requirement for Member States to avoid excessive budget deficit and debt. The Maastricht Treaty also created two important institutional elements: first, it established convergence criteria to be complied with by EU Member States wishing to join the EMU; second, EU Member States agreed to sign the SGP, which would facilitate the practical implementation of the requirement to avoid excessive budget deficits established by the Maastricht Treaty (Schuknecht et al. 2011: 8).

The SGP covers four secondary EU legal acts, which implement fiscal monitoring provisions envisaged by Articles 121 and 126 of the Maastricht Treaty: two Regulations adopted by the EU Council in 1997 (EC 1466/97 and EC 1467/97), Resolution of the EU Council adopted in Amsterdam in 1997 and the Code of Conduct on the Implementation of the SGP. According to the EU Council Regulations establishing the procedure for the implementation of the said articles of the Maastricht Treaty, the SGP is divided into preventive arm and corrective arm.

The preventive arm of the SGP coordinates the budget policy of EU Member States and seeks to ensure sustainable public finances in the medium term. The initial wording (1997) of the preventive arm envisaged that in the medium term general government balances of EU Member States must be close to balance or in surplus. It was thought that such a medium-term objective is sufficient to ensure that the national fiscal policy is capable of stabilising the economy of an particular EU Member State during its cyclical fluctuations without exceeding the limits of 3 per cent and 60 per cent of GDP, respectively for general government deficit and debt. The first wording of the preventive arm also envisaged the budget monitoring mechanisms: an obligation was introduced for EU Member States to submit Stability Programmes (for euro area countries) or Convergence Programmes (for non-euro area countries) to the EC for assessment. Thus, a possibility was created for the EC and the European Council to assess budget plans of EU Member States and their compliance with the medium-term objective. The EC and the European Council were granted the right to warn an EU Member State, if the assessment of its Stability or Convergence Programme ascertained a risk of non-compliance with the medium-term objective during the period under review. If the country does not take the necessary measures to manage the situation and the general government deficit of a certain year exceeds the Maastricht criterion in non-temporary nature in the absence of extraordinary economic circumstances (annual GDP decline of at least 2 per cent), the corrective arm of the SGP is applied. The corrective arm of the SGP implements the excessive deficit procedure (EDP), which describes the steps to be taken by the Member State to reduce its excessive general government deficit. It should be noted that the wording of the corrective arm of 1997 did not provide for the procedure to assess properly whether general government debt of EU Member States complies with the Maastricht criterion, especially whether the

debt to GDP ratio above 60% was sufficiently diminishing and approaching the reference value at a satisfactory pace. Therefore, the debt criterion was essentially in-operational (European Commission 2013a: 7–9).

The Maastricht Treaty and the SGP contributed to the significant progress made by the EU and the euro area states in the last decade of the 20th century in reducing general government budget deficits: the general government deficit of the whole future euro area comprised around 5.5 per cent of GDP in 1993, less than 3 per cent of GDP in 1997 and was close to zero in 2000. Such decline was affected by the preparation of certain EU Member States to introduce the euro in 1999 and the rapid economic growth period after 1997. However, the events in stock markets in 2000 and a slowdown of the economic growth demonstrated that the previous improvement of general government balances was not fully sustainable. Portugal was the first euro area country, whose general government deficit exceeded the 3 per cent threshold in 2001. It was joined by Germany and France in 2002, the Netherlands and Greece in 2003 and Italy's general government deficit exceeded 3 per cent of GDP in 2004. These developments of public finances in the euro area countries revealed that the SGP provisions were applied ineffectively and there is a need for revision (González-Páramo 2005: 6). The SGP reform of 2005 was also triggered by other factors: first, the decision of the European Council to close the EDP for Germany and France, despite the EC assessment. Second, ten Central and Eastern European countries joined the EU in 2004 with their economies significantly different from those of old EU states (European Commission 2013a: 9).

The Stability and Growth Pact reform of 2005

In 2005, the European Council adopted regulations, which supplemented earlier adopted legal acts and created conditions to take into account specific circumstances of the Member States, to assess the macroeconomic situation more accurately together with more flexible application of the SGP provisions. The main changes of the preventive arm of the SGP were the following: first, the previous requirement to have balanced or in surplus nominal general government balance over the medium term was replaced with individual medium-term structural objectives. Structural medium-term objective of each state must take into account the debt level and population ageing and ensure that the general government deficit does not exceed 3 per cent of GDP, with the national fiscal policy performing the macroeconomic stabilisation function. The lowest limit for the medium-term objective was set at the level of 1 per cent of GDP structural deficit for euro area countries and the countries that joined the second exchange rate mechanism (ERM II). Second, the benchmark annual adjustment of 0.5 per cent of GDP, by which a certain country's structural general government balance should approach the medium-term objective over the year, was established. Third, Member States performing structural pension scheme reforms were allowed to temporarily deviate from the selected strategy for reaching the medium-term objectives. Although in the short term such reforms require additional expenditure, in the long term they help ensuring sustainability of public finances. When analysing the amendments to the corrective arm of the SGP, the following changes should be mentioned: first, the list of extraordinary circumstances, which are taken into account when making an assessment whether the general government deficit is non-temporary higher than the Maastricht criterion, was adjusted. The decline of the annual GDP of at least 2 per cent was considered as extraordinary circumstances earlier, whereas the corrective arm reform of 2005 envisaged that a fall in the GDP of any size or a prolonged period of slow economic growth may be considered as extraordinary circumstances. Second, it was established that the structural deficit must improve by at least 0.5 per cent of GDP over one year of excessive deficit correction. Third, the conditional compliance concept was introduced. It provides for the possibility to extend the term of excessive deficit correction, if the country reduces the structural deficit over the year by the value set in the EDP, but the nominal general government balance still exceeds the Maastricht criterion due to unforeseen circumstances (European Commission 2013a: 10–11).

Various opinions were expressed when assessing the SGP reform of 2005. There was partial agreement that the amendments made were necessary, since they clarified the economic sense of this pact without changing its nature, improved fiscal monitoring within the EU and ensured higher flexibility in the application of the SGP provisions. However, the European Central Bank (ECB 2005: 59) strongly criticised the SGP reform and stated that the reform reduced clarity and simplicity of the rules. Generally, it was agreed that the essential condition for a more effective functioning of the SGP is a strict and accurate application of the envisaged provisions (González-Páramo 2005: 6). The economic recession that started in 2008 demonstrated that their application in the past wasn't ambitious enough. When the financial crisis turned into the sovereign debt crisis in 2009, debt to GDP ratios of some euro area countries became the main source of concern in financial markets as they significantly exceeded the reference value. It became obvious that the EU and euro area Member States did not use the upturn of their economies during the period of 2005 to 2007 to reduce their debts to sustainable levels. Sovereign crisis also showed was an existing strong contagion effect among euro area countries.[14] This was an additional factor that triggered an additional review of the SGP and EU fiscal monitoring mechanisms.

Changes to the Stability and Growth Pact from 2011 to 2013

In 2011, the European Council adopted five new regulations and one directive — the so-called six-pack. This pack introduced several important new elements in the EU fiscal governance system: first, it created the European semester, which linked previously applied EU fiscal monitoring and management procedures into a single framework and established the chronological order and calendar of their application. Second, it created the macroeconomic imbalance procedure,

[14] Mostly due to the link between the banking sector and sovereign debt. This problem is addressed by creating the Banking Union.

whose main objective is the advance identification of the emergence of macroeconomic imbalances and a timely reduction of the risk imposed by them on fiscal indicators. Third, the minimum requirements to national budgetary frameworks were established and it was agreed that fiscal monitoring at the national level should be performed by independent fiscal councils. The preventive arm of the SGP was supplemented with the expenditure benchmark rule, which envisaged that the annual growth of public expenditure may not exceed the long-term average growth of potential GDP. Expenditure may grow faster than potential GDP only if that difference is covered by additional revenue and the budget deficit does not increase (European Commission 2013b: 29–33). In addition, the preventive arm was supplemented with the possibility to impose a fine of 0.2 per cent of GDP, if the country repeatedly breaches the rules. The corrective arm of the SGP was supplemented with a provision that clearly defines the possibility to start the EDP, if the public debt-to-GDP ratio exceeds 60 per cent of GDP, although the general government deficit complies with the Maastricht criterion. The concept of a "sufficiently diminishing" debt level, though a new debt reduction benchmark, was also defined. It was indicated that the average decline of the debt ratio over three years should account for at least one twentieth of the difference between the actual debt level and the reference value. Same as in the preventive arm, the six-pack tightened the conditions for the application of the corrective arm's sanctions and increased their automatic nature by introducing the reverse qualified majority voting procedure. It specified that in the case of a country's non-compliance with certain EDP requirements, sanctions should be imposed automatically, unless the qualified majority of voting Member States decide against their application.

After the official announcement of the six-pack in November 2011, on 9 December 2011 the European Council agreed to transpose some of the most important provisions to the national law. It was a part of the general strategy for overcoming sovereign debt crisis in the euro area. It was decided to transpose the provisions by signing a new EU Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and naming one of its parts the Fiscal Compact. All EU Member States approved this Treaty, with the exception of the United Kingdom (UK). The UK Prime Minister vetoed the signing of the Fiscal Compact on the grounds that the Treaty did not provide for clear guaranties that the UK financial services sector will not be affected. During further negotiations, the Czech Republic expressed a wish to join the Treaty later. Therefore, other EU Member States decided to sign the Treaty not as an EU Treaty, but as an international intergovernmental agreement (Miller 2012: 1). Three new elements were introduced after signing it on 2 March 2012: first, under the Fiscal Compact, Member States committed to transpose fiscal medium-term objectives and the strategies for reaching them to the national law, preferably, at the constitutional level. Second, Member States committed to create automatic budget correction mechanisms, which would be activated in the case of deviation from the planned strategy for reaching the medium-term objective. Third, the role of independent fiscal councils in the monitoring and control of fiscal indicators was defined. The Member States that signed the agreement committed also to establish fiscal councils and ensure their effective operation, as defined in the common principles on national fiscal correction mechanisms published together with the six-pack (European Commission 2013a: 15, 19).

The financial crisis of 2008 demonstrated that fiscal policy coordination in the euro area has shortcomings and the contagion effect is strong. Therefore, in the beginning of 2012, when the text of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union was still negotiated, the EC proposed two additional legal acts to strengthen fiscal policy coordination among euro area countries. These two legal acts, known as the two-pack, became effective in May 2013. The first regulation on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area envisaged that Member States must present to the EC and the Eurogroup their draft budgets for the coming year no later than by 15 October. The drafts must comply with the general EU economic policy coordination framework, the common guidelines prepared by the EC and the European Council in the beginning of the annual surveillance cycle — the European Semester, the EC recommendations to each country and the macroeconomic imbalance procedure. The EC has to present assessments of these draft budgets by 30 November and, if significant violations of the SGP provisions are identified, it may request the revision of the draft budget. The second regulation on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area envisaged stricter monitoring and responsibility of the countries experiencing financial or fiscal difficulties. It is expected that it will help to timely identify deviations from the adopted EDP or macroeconomic imbalance correction programme and to take necessary measures.

Fiscal rules of Lithuania: Law on the Fiscal Discipline of 2007

Preconditions for the strengthening of fiscal governance in Lithuania were formed by several factors: first, after Lithuania joined the EU in 2004, it committed to comply with the SGP provisions applicable to EU Member States. Second, after the adoption of the National Euro Changeover Plan by the Resolution of the Government of the Republic of Lithuania in 2005 (LRV 2005), the objective was raised to join the euro area in 2007 and thus complete the process of Lithuania's integration in the EMU. Third, during the period of particularly strong economic growth from 2005 to 2007, the general government balance of Lithuania remained in deficit, therefore, international institutions expressed growing concerns about sustainability of Lithuania's public finances: in May 2007, the credit rating agency *Standard and Poor's* reduced Lithuania's credit outlook to negative and based such decision on the fact that the legal acts did not ensure confidence of financial markets in compliance with fiscal discipline, as interest risk premia increased strongly in recent months (Hawkesworth et al. 2009: 9, 11). In its Article IV assessment of 2007, the International Monetary Fund also

encouraged Lithuania to pursue stricter fiscal policy and introduce the expenditure restriction rule by a legal act (IMF 2007: 11). Due to these factors, the Seimas of the Republic of Lithuania passed the LFD on 8 November 2007. The main objective of this Law is to manage government finances in such a manner that ensures general government balance being in surplus or close to balance in the medium term (Article 3.1). For this purpose, the rule restricting expenditure from the state budget (excluding EU funds), which comprises the largest part of the general government expenditure, was established. It may be formalised as follows:

$$\frac{\Delta(SB\ expenditure)_{t+1}}{(SB\ expenditure)_t} \leq 0{,}5 \cdot \left(\sqrt[5]{\prod \frac{(SB\ revenue)_{t-j+1}}{(SB\ revenue)_{t-j}}} - 1\right);\ j = 1, 2, 3, 4,$$

where: SB expenditure — state budget appropriations, excluding EU financial assistance funds, SB revenue — state budget revenue, excluding EU financial assistance funds. The main objective of the expenditure restricting rule was to ensure that state budget expenditure does not grow faster over the planned year than a half of the average annual increase of state budget revenue over the last five ended years, if no exceptions envisaged in the LFD are applicable. Expenditure limiting rule covered the period of five years, since it was thought that this is the average duration of a business cycle in Lithuania (LRFM 2007). If the annual increase of state budget revenue of a certain year, calculated in times (ratio), is lower than one, it is considered to be zero according to this rule.

Transposition of the Fiscal Compact to the Lithuanian law

When the President of the Republic of Lithuania signed the EU intergovernmental Treaty, Lithuania assumed an obligation to comply with the Fiscal Compact requirements and to transpose its essential provisions to the national law. However, from 2015, when Lithuania became the euro area member, it also has to comply with the two-pack provisions applicable only to euro area countries. Due to these circumstances, the Seimas adopted the CLIFT and amendments to the legal acts related to it, including the LFD, in November 2014.

In order to implement the EC recommendations, the fiscal rules envisaged in the Fiscal Compact were transposed to the national legislation of Lithuania as a constitutional law, which may be changed only through the majority voting of at least three fifths of all members of the Seimas. The main objectives of the CLIFT are essentially similar to those of the LFD: to ensure sustainability of general government sector finances and a stable development of the economy and to implement the Treaty (Article 1 of the CLIFT). However, contrary to the LFD, the CLIFT seeks to do it by managing the structural general government balance (instead of the nominal one) and this is the main difference between the CLIFT and the LFD. The CLIFT envisages that the medium-term objective will be pursued in a purposeful way, i.e. by establishing each year the annual step towards the medium-term objective — the structural impetus target. The Seimas establishes it for the current year and for the coming year by 30 June of the current year or no later than by the date of adopting the law on amending the current year budget, if other conditions listed in Article 6 of the CLIFT are not applicable. According to the legal act adopted by the Seimas, the medium-term objective will also be established for the three-year period, however, it may not be higher than the limit envisaged in the Fiscal Compact — the structural deficit of 0.5 per cent of GDP.[15]

Compared to the first wording of the LFD, the CLIFT introduced the fiscal rule applicable to the whole general government sector (not only to the state budget). The rule may be divided into three parts. The first part envisages that each year, with the exception of the years when extraordinary circumstances defined in Article 2.2 of the CLIFT emerge, at least one of these four conditions should be satisfied:

1) in year *t*, the structural general government balance (GGB^S) is in surplus: $GGB_t^S > 0$;
2) in year *t*, the absolute value of the structural general government balance is lower than the absolute value of the medium-term objective (*MTO*) and is declining, if in year *t* the output-gap (*OG*) is not negative: $|GGB_t^S| < |MTO|, \text{and } \Delta|GGB_t^S| < 0, \text{when } OG_t \geq 0$;
3) in year *t*, the absolute value of the structural general government balance is lower than the absolute value of the MTO, if in year *t* the output-gap is negative: $|GGB_t^S| < |MTO|, \text{when } OG_t < 0$;
4) the actual structural impetus towards the medium-term objective in certain year *t* is not lower than that year's structural impetus target (*SIT*): $\Delta GGB_t^S \geq \text{SIT}_t$.

The validity of at least one of these conditions is ensured by planning (or changing) a certain year's *t* + 1 budgets of general government sub-sectors with appropriations higher than 3 per cent of GDP, i.e. by managing the state budget (SB), Compulsory Health Insurance Fund (*CHIF*) budget and State Social Insurance Fund (*SSIF*) budget appropriations as a whole, with the exclusion of the EU financial assistance funds. This is the second part of the fiscal rule of the CLIFT, which envisages expenditure restriction, similarly to the LFD. It may be expressed as follows:

[15] Or no higher than 1 per cent of GDP, if the general government debt-to-GDP ratio is lower than 60 per cent and the risk to long-term sustainability of general government finances of Lithuania is low.

$$\frac{\Delta(SB+CHIF+SSIF)\ expenditure_{t+1}}{(SB+CHIF+SSIF)\ expenditure_t} \leq 0.5 \cdot \left(\sqrt[10]{\prod_{j=-7}^{2} \frac{GDP_{t+j+1}^{Pot}}{GDP_{t+j}^{Pot}}} \cdot \sqrt[2]{\prod_{k=1}^{2} \frac{\frac{nGDP_{t+1,k}^{P}}{rGDP_{t+1,k}^{P}}}{\frac{nGDP_{t,k}^{P}}{rGDP_{t,k}^{P}}}} - 1 \right), \quad (1)$$

where: GDP^{Pot} is potential GDP at constant prices. The long-term average growth of potential GDP at current prices in year $t + 1$ is calculated by multiplying the average change of potential GDP at constant prices over 10 years by the annual change of the forecasted GDP deflator in year $t + 1$. The latter is calculated as the geometric average of the two (therefore $k = (1, 2)$) latest GDP deflator change forecasts made by the Ministry of Finance of the Republic of Lithuania for year $t + 1$. Each GDP deflator change forecast is calculated as a ration of the forecasted nominal GDP ($nGDP^P$) over the forecasted real GDP ($rGDP^P$). This rule is primarily used to ensure that general government expenditure is increasing only by a half of potential GDP growth rate when the economic activity is above its potential level. Such restriction ensures that the structural general government balance does not deteriorate due to excessively fast growth of general government expenditure, compared to the expected growth of general government revenue. This rule is not applied, when at least one of the five conditions below is satisfied:

1) the annual nominal GDP growth in Lithuania in the last four quarters is lower than the long-term EU nominal GDP change calculated as a geometric average of the EU nominal GDP change of the last five ended calendar years and increased by 2 percentage points:

$$\frac{\Delta GDP_t^{LT}}{GDP_{t-1}^{LT}} \cdot 100\ \% < \left(\sqrt[5]{\prod_{j=-6}^{-2} \frac{GDP_{t+j+1}^{EU}}{GDP_{t+j}^{EU}}} - 1 \right) \cdot 100\ \% + 2\ \text{p.p.}$$

2) the expected improvement of the nominal general government balance, expressed in percentages of GDP, is at least 1 percentage point: $\Delta GGB_{t+1} \geq 1$;

3) the arithmetic average of the general government balance, expressed in percentages of GDP, of no less than five consecutive years is no lower than the surplus of 0.1:

$$\frac{\sum_{j=1}^{5} GGB_{t-j}}{5} \geq 0.1;$$

4) the output-gap (OG) in the planned year $t + 1$, calculated according to the economic forecast scenario published by the Government of the Republic of Lithuania or its authorised institution, with regard to the adoption of which the budget policy control institution (BPCI) presented its conclusion, is negative: $OG_{t+1} < 0$;
5) when changing revenue or expenditure of any current year budget attributed to the general government, the changed general government balance (GGB_{t^*}) will not deteriorate, compared to the balance before the change (GGB_t): $GGB_{t^*} \geq GGB_t$.

It should be noted that the monitoring of compliance with the rules envisaged by the CLIFT and implementation of annual structural impetus targets will be performed by the BPCI, whose functions were assigned to the State Audit Office of the Republic of Lithuania. According to the Law of the Republic of Lithuania on the State Audit Office, within 20 business days from the date of submitting the draft national budget to the Seimas, the BPCI shall present to the Seimas its conclusion regarding the structural impetus target formed by the draft national budget and additional measures required for reaching this target. At the end of a certain year, the BPCI must present to the Seimas its conclusion on the implementation of the structural impetus target for that year. It shall present it within 30 business days from the date when the Government presented to the Seimas its conclusion on the satisfaction of at least one of the previously mentioned four conditions (Article 3 of the CLIFT, Article 4 of the Law on the State Audit Office). If the report submitted to the Seimas states that the structural impetus target was not met in the previous year, the correction mechanism is activated (Articles 8 and 13). The latter envisages that the Government has to submit to the Seimas and the BPCI the report on the reasons why the structural impetus target was missed and the measures to achieve structural impetus target in the coming year. This information is also provided to the Seimas in an oral presentation. After that, the BPCI presents to the Seimas the conclusion on validity of the reasons, which were indicated by the Government, why the structural impetus target was not met and suitability of measures for its implementation. The final step of the correction mechanism is the final conclusion of the Government on the reasons why the structural impetus target was missed and the measures to achieve structural impetus target in the coming year. These conclusions need to be taken into account by the Government, when it submits to the Seimas the draft national budget for the next year.

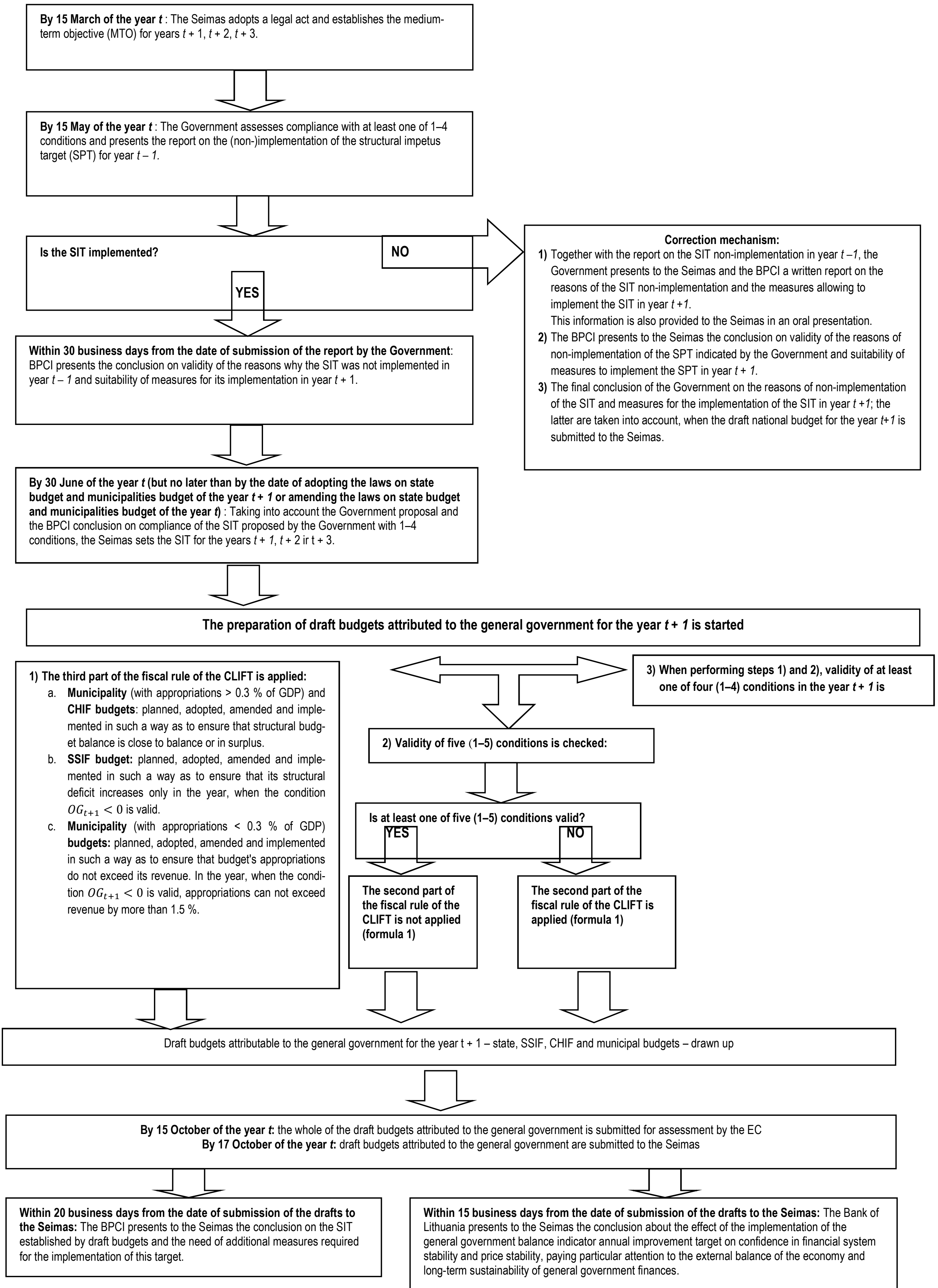
The third part of the fiscal rule envisaged in the CLIFT covers three rules of the budgets attributed to the general government (Articles 4 and 13): first, each budget attributed to the general government (excluding the state budget, the State Social Insurance Fund budget and budgets with planned appropriations not exceeding 0.3 per cent of nominal GDP) should be planned, adopted, changed and implemented in such a way as to ensure the structural budget balance being balanced or in surplus. Taking into account the restrictions, this rule is applicable to the Compulsory Health Insurance Fund budget and budgets of the largest municipalities; however, it will come into effect only from 2018. Second, the State Social Insurance Fund budget should be planned, adopted, changed and implemented in such a way as to ensure its structural deficit increases only in the year, when output-gap is negative ($OG_{t+1} < 0$). This rule will be applied from 1 January 2016. Third, the budget attributed to the general government with appropriations not exceeding 0.3 per cent of the nominal GDP should be planned, adopted, changed and implemented in such a way as to ensure this budget's appropriations do not exceed its revenue, with the exception of the year, when the same condition of negative output-gap

is valid. In the latter case, appropriations may not exceed revenue by more than 1.5 per cent. Taking into account the restrictions, this rule is applicable to budgets of smaller municipalities and will come into effect in 2016.

Amendments to the Law on Fiscal Discipline

In addition to the CLIFT, the Seimas also amended the LFD adopted in 2007. The state budget expenditure restriction rule envisaged in it was expanded and adapted to the general government, thus, the newest wording of this rule in the LFD is the same as the first formula (1) above. Only two exceptions of the application of the rule envisaged in the LFD are slightly different. The exception indicated in the CLIFT $\Delta GGB_{t+1} \geq 1$ is stricter in the LFD: $\Delta GGB_{t+1} \geq 1, \text{when } \Delta GGB_t^P - \Delta GGB_t^E \leq 0.5$ p.p. It means that the exception $\Delta GGB_{t+1} \geq 1$ is not applied, if in year $t + 1$ the planned improvement of the nominal general government balance indicator (*GGB*), expressed in percentages of GDP, comprises at least 1 p.p., where-whereas the expected improvement of the current year *t* general government balance indicator (GSB^E) is lower than the improvement of the general government balance indicator (GSB^P) planned for year *t* by no more than 0.5 percentage point. In addition, the wording of the exception $OG_{t+1} < 0$ was supplemented in the LFD and envisages the possibility of non-application of the main rule (1) for the planned year t +1, when the expected production gap is negative, whereas the expected average annual HICP inflation for the year t + 1 does not exceed 3 per cent ($OG_{t+1} < 0 \; and \; \pi_{t+1} \leq 3\ \%$). The available information shows that stricter definitions of exceptions will be applied when preparing draft budgets attributed to the general government and applying the provisions of the CLIFT and the LFD. The fiscal governance mechanism of Lithuania envisaged in the CLIFT and the LFD is shown in Chart 1.

Chart 1: Fiscal governance mechanism and fiscal rules of Lithuania



Summary

After signing the Treaty in March 2012 and Lithuania becoming a euro area member in 2015, suitable circumstances formed to strengthen national fiscal governance and improve fiscal rules. By adopting the CLIFT and respectively amending the LFD, Lithuania transposed the essential requirements and provisions of the Fiscal Compact to the national law. Following the EC recommendations, the provisions of the Fiscal Compact were transposed to the national legislation of Lithuania at the constitutional level (a constitutional law), therefore, they will not be easily changed. The main objective of the CLIFT is to ensure sustainability of general government finances and a stable development of the economy by managing the structural general government balance (instead of the nominal one, as in the first wording of the LFD). This is an essential improvement of the fiscal governance mechanism. Moreover, the two-pack provisions that came into effect in Lithuania after the adoption of the euro in 2015 should also increase fiscal discipline in Lithuania, since stricter EC control will be applied. These provisions will also help to identify emerging macroeconomic imbalances as early as possible and take measures to reduce them. Nevertheless, effectiveness of the new fiscal governance mechanisms will largely depend on the capacity of Lithuanian and European institutions to implement those provisions. Strict and accurate implementation of the envisaged provisions will be the key factor determining more effective fiscal governance.

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