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REPORT FROM THE COMMISSION

Lithuania

Report prepared in accordance with Article 104(3) of the Treaty

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1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever the deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the “excessive deficit procedure” (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an “excessive deficit” is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Lithuania and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

According to data notified by the authorities in April 2009[2] and subsequently validated by Eurostat[3], the general government deficit in Lithuania reached 3.2% of GDP in 2008, thus exceeding the 3% of GDP reference value, while general government gross debt stood at 15.6% of GDP, well below the 60% of GDP reference value, and the lowest ratio since 1997.

Table 1: General government deficit and debt [a]

	2003	2004	2005	2006	2007	2008	2009	2010
General government balance	-1.3	-1.5	-0.5	-0.4	-1.0	-3.2	-5.4	-8.0
General government gross debt	21.1	19.4	18.4	18.0	17.0	15.6	22.6	31.9

Note:
[a] In percent of GDP.
Source: Eurostat and Commission services' spring 2009 forecasts.

The figure for the 2008 deficit provides *prima facie* evidence on the existence of an excessive deficit in Lithuania in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Lithuania with the adoption of this report. Section 3 of the report examines the deficit criterion. Section 4 deals with public investment and other relevant factors. The report takes into account the Commission services' spring 2009 forecasts, released on 4 May.

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1 OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Lithuania can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

3 Eurostat news release No 56/2009 of 22 April 2009.

3. DEFICIT CRITERION

In 2008, the general government deficit reached 3.2% of GDP.

Although in excess of 3% of GDP, the deficit is close to the Treaty reference value.

The excess over the 3% of GDP reference value cannot be regarded as exceptional. In particular:

- it does not result from an unusual event in the sense of the Treaty and the Stability and Growth Pact. This definition is to be applied narrowly to cover events such as wars or natural disasters.

- it does not result from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. According to official data, GDP growth declined to 3.0% in 2008 from 8.9% in 2007. This annual average growth figure does not allow by itself to qualify the 2008 deficit as exceptional, even though economic activity started to slow from the beginning of 2008 and the economic environment deteriorated sharply in the last quarter of the year.

Table 2: Macroeconomic and budgetary developments [a]

	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP (% change)	10.2	7.4	7.8	7.8	8.9	3.0	-11.0	-4.7
Potential GDP (% change)	5.9	6.4	6.5	6.4	6.2	4.3	2.0	1.4
Output gap (% of potential GDP)	2.6	3.5	4.7	6.1	8.9	7.6	-6.1	-11.7
General government balance	-1.3	-1.5	-0.5	-0.4	-1.0	-3.2	-5.4	-8.0
Primary balance	0.0	-0.6	0.3	0.3	-0.3	-2.6	-4.3	-6.5
One-off and other temporary measures	0.0	0.0	0.0	0.0	-0.6	-0.1	0.5	0.6
Government gross fixed capital formation	3.0	3.4	3.4	4.1	5.2	4.9	5.0	5.8
Cyclically-adjusted balance	-2.0	-2.5	-1.8	-2.1	-3.4	-5.2	-3.8	-4.8
Cyclically-adjusted primary balance	-0.7	-1.5	-1.0	-1.4	-2.7	-4.6	-2.7	-3.3
Structural balance [b]	-2.0	-2.5	-1.8	-2.1	-2.8	-5.2	-4.3	-5.5
Structural primary balance	-0.7	-1.5	-1.0	-1.4	-2.1	-4.5	-3.1	-3.9

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Eurostat and Commission services' spring 2009 forecasts.

The excess over the 3% of GDP reference value is also not temporary in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' spring forecast, the deficit would widen to 5.4% of GDP in 2009 and further to 8.0% of GDP in 2010 on a no-policy change basis. This takes into account measures for the current year in the budget for 2009 and in the supplementary budget adopted by Parliament in May. According to the April 2009 EDP notification, the deficit is targeted to decrease to 2.9% of GDP in 2009. This targeted budget deficit is based on a macroeconomic scenario that assumes output to decrease by 10.5% in 2009, close to the 11.0% GDP contraction projected in the Commission services forecast.

In sum, the deficit is close to the 3% of GDP reference value but the excess over the reference value cannot be regarded as exceptional and it is not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

4. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration. Finally, Article 2(5) of the Regulation provides that the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar should be considered in all assessments in the framework of the excessive deficit procedure. In 2004, Lithuania adopted such a reform, which was fully implemented by 2007.

In view of the above provisions, the following five subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; (4) other factors considered relevant by the Commission; and (5) pension reform as mentioned above.

4.1. Medium-term economic position

Cyclical conditions and potential growth. The Lithuanian economy recorded above-potential growth rates over the period 2001-2007 (averaging 8.0%), largely based on domestic demand driven by a massive credit expansion which boosted private consumption and real estate investment. In 2008, the economy started to slow gradually; economic activity declined sharply at the end of the year as domestic cyclical deceleration was reinforced by falling external demand. In the last quarter of the year, real GDP contracted by 1.4% quarter-on-quarter after a more modest contraction of 0.3% in the third quarter, although GDP growth still reached 3.0% for the year as a whole. Going forward, Lithuania is projected to experience a pronounced economic downturn due to sharp deceleration in domestic cyclical conditions and the global financial crisis. The Commission services' spring forecast expects the economy to contract by around 11% in 2009 and further by 4¾ % in 2010, with the external current account balance projected to improve from a deficit of 11.6% of GDP in 2008 to a deficit of 2.0% in 2009 and to turn positive in 2010. Commission services' calculations according to the commonly agreed methodology show a marked deceleration in the rate of potential growth, from an average of 6½% over the period 2005-2007 to 2% in 2009, weakening further in 2010. Estimates of the output gap indicate a very significant cyclical downturn from a strongly positive output gap reaching nearly 9% in 2007 and over 7% in 2008 to a sharply negative output gap reaching over 6% and 11% respectively in 2009 and 2010[4].

Recent structural reforms. Lithuania has made slow progress in implementing structural reforms in the key policy areas of improving macro-financial stability and reducing inflation. Administrative capacity remains relatively weak although recently adopted legal instruments and further plans, if properly implemented, should improve the regulatory environment and

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4 Output gap figures in general must be interpreted with special caution in the case of an economy such as Lithuania's, as potential growth is difficult to determine for an economy subject to rapid structural change.

the efficiency of public administration. A number of measures have been implemented to improve youth employability and provide entrepreneurship training. Recent reforms in this field have had no significant budgetary impact. Structural reform priorities, involving the use of substantial EU funding and budgetary expenditure, include advancing rapidly with higher education, R&D and labour market reforms. As set out in the Council's country-specific recommendations on the implementation of the Lisbon strategy[5], Lithuania is making significant progress as regards the reform of higher education. The goals of the education reform, adopted by Parliament at the end of April 2009, are to intensify competition in the higher education sector; reform governance of higher education institutions (with greater involvement of social partners); increase transparency in funding of research projects and studies; reduce government regulation and raise quality standards. The government plans to establish and develop Integrated Science, Higher Education, and Business Centres (referred to as “Valleys”). The issue of energy dependency is high on the agenda, with the government having passed measures to increase energy efficiency and planning longer term measures to increase availability of energy sources. As regards labour market reforms, programmes exist to improve internal mobility and encourage the return of workers migrated overseas (but there is no evidence of the latter's effectiveness). The government is also considering introducing more flexible work arrangements.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Lithuania has experienced good economic times in recent years as assessed by strong growth and large positive output gaps. However, the economic situation deteriorated in 2008 and Lithuania entered a deep downturn at the beginning of 2009. Lithuania is projected to remain in a recession during the Commission services' spring forecast period. Despite an improvement in the nominal balance, the structural (cyclically-adjusted net of one-off and other temporary measures) balance deteriorated markedly between 2004 and 2008 (from -2.5% to -5.2% of GDP). Windfall revenues were typically spent by adopting supplementary budgets and no reserves were accumulated to prepare for worse times. Lithuania thus did not use good economic times for a more ambitious fiscal consolidation. According to the Commission services' spring forecast, the structural balance is projected to improve in 2009 but worsen further in 2010[6]. This is despite the discretionary measures introduced with the 2009 budget in December 2008 limiting the budget deficit through comprehensive tax changes and expenditure cuts and despite further substantial expenditure cuts included in the supplementary budget adopted in April 2009.

Public investment. General government investment as a share of GDP is high in Lithuania. It increased by 1.5 percentage points between 2004 and 2008, to 4.9% of GDP, but the general government deficit rose somewhat more strongly by 1.7 percentage points over the same period. The increase in the government investment ratio was also less pronounced than the deterioration in the structural balance (from -2.5% to -5.2%). According to the Commission services’ spring forecast, in 2009 and 2010 the general government deficit ratio would exceed the public investment ratio as fiscal consolidation also involves cuts in public investment (with the exception of projects supported by EU funds).

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5 As laid down in the draft report No 6638/09 from the ECOFIN Council to the European Council.

6 Structural balance calculations are dependent on calculated output gaps and thus also subject to particular uncertainty for an economy such as Lithuania's – see footnote 4 above.

Quality of public finances. Although the expenditure ratio rose from around 33% of GDP in 2004 to some 37% in 2008, it still remains one of the lowest in the EU. Besides public investment which was boosted by contributions from EU funds, government consumption, and particularly social benefits and transfers, has been growing very rapidly. Social benefits and transfers more than doubled in nominal terms between 2004 and 2008, with an annual increase of 35% in 2008 alone, following policy decisions adopted during the year. Though compensation of employees increased in line with nominal GDP growth, it nearly doubled in nominal terms over the same period; public sector wages increased more slowly than private sector wages in the period until 2007 but more rapidly in 2008. Both the 2009 budget adopted by the government in December 2008 and the supplementary budget adopted in April 2009 aim at consolidating public finances by reducing current expenditure, including average remuneration in the public sector and investment expenditure. On the other hand, the share of social transfers other than in kind is expected to increase relative to total expenditure, as these have not been affected by fiscal consolidation.

Long-term sustainability of public finances. In its opinion of 10 March 2009 on the most recent convergence programme, the Council assessed the long-term sustainability of Lithuania's public finances as follows. The long-term budgetary impact of ageing is lower than the EU average as a result of the pension reform already enacted. However, the budgetary position in 2008, as estimated in the programme, has worsened considerably compared with the starting position of the previous programme and compounds the budgetary impact of population ageing on the sustainability gap. Achieving primary surpluses over the medium term, as foreseen in the programme, would contribute to reducing the medium risks to the sustainability of public finances. The risk assessment of long-term sustainability has not changed since the adoption of the Council opinion.

4.3. Other factors put forward by the Member State

In a letter of 29 April 2009, the Lithuanian authorities have not proposed relevant factors other than those already specified in Article 2(3) of Council Regulation (EC) No 1467/97.

4.4. Other factors considered relevant by the Commission

Recent public finance developments in Lithuania were also influenced by the following factors in the area of budgetary institutions and procedures. The medium-term budgetary framework has not succeeded in preventing expenditure overruns in recent years. Macroeconomic forecasts underlying budgetary planning have systematically underestimated growth in the upward phase of the cycle. Buoyant revenue growth has facilitated repeated upward revisions of expenditure targets mostly in form of supplementary budgets and no fiscal reserves were accumulated. With a view to strengthening the framework, a Law on Fiscal Discipline was adopted in November 2007, including notably an expenditure rule. However, the law focused on the preparation and execution of the annual budget and did not as such introduce more of the necessary forward-looking medium-term elements. Hence, the current framework as regards medium-term planning and control of public finances remains weak. Transparency of the budgetary process as regards appropriate reporting of revenue and expenditure executions also remains weak, including the comparability of cash- and accrual-based the budgetary indicators.

In its opinion on the most recent update of the convergence programme, the Council considered that in Lithuania for a sustained period wage growth has exceeded productivity growth by far, thus weakening the country's competitiveness and hindering prospects of export-led economic recovery. The planned restrictive fiscal stance from 2009 until 2011 was an appropriate response in the light of existing imbalances. The Council therefore invited Lithuania to (i) implement measures needed to achieve the budgetary target in 2009 by prioritising expenditures and continue targeted fiscal consolidation in the medium-term; (ii) implement public sector wage restraint to facilitate the alignment of whole-economy wages with productivity and to strengthen cost competitiveness; (iii) strengthen fiscal governance and transparency, by enhancing the medium-term budgetary framework and reinforcing expenditure discipline.

Subsequent to the Council invitations, the Lithuanian authorities adopted a supplementary budget in April 2009 which includes further substantial expenditure cuts on top of fiscal consolidation measures already adopted in the initial 2009 budget.

With a view to stabilising the financial sector, in October 2008 the Lithuanian authorities increased the guarantee for deposit insurance from the equivalent of 22 000 EUR to 100 000 EUR. The deposit guarantee ratio was extended to 100%. The latest convergence programme acknowledges a possible risk related to deposit guarantees, where the total amount guaranteed at the end of 2008 was around 30% of GDP.

4.5. Systemic pension reforms

In 2004, an extensive pension system reform was implemented in Lithuania introducing a three-tier pension system. The transfer of social security contributions to the second-pillar pension funds increased from 2.5% in 2004 to 3.5% in 2005, 4.5% in 2006 and 5.5% as of 2007. The system was voluntarily adopted by 69% of the population. As of 1 January 2009, with the aim to balance the budget of the Social Security Fund, the second-pillar contribution rate was lowered to 3%. Furthermore, the revised budget adopted in April by the government and currently discussed in the Parliament includes a proposal to decrease the second-pillar contribution rate to 2%. According to the previous updates of the Lithuanian convergence programme[7], the budgetary impact of the pension reform was estimated to increase from 0.3% of GDP in 2004 to 0.4% in 2005, 0.65% in 2006, 0.9% in 2007 and to 1.0% of GDP in 2008. Due to the temporary reduction of contributions to 3%, the level of expenditure on the reform is estimated to fall close to 0.6% for 2009 and 2010, increasing to 1.1% of GDP in 2011. For 2008, therefore, taking into account the net cost of the reform would produce an adjusted deficit of below 3% of GDP.

[7] http://ec.europa.eu/economy_finance/publications/publication13879_en.pdf

<u>Table 3</u>: Illustration of the impact of the net cost of systemic pension reform in Lithuania

	2005	2006	2007	2008	2009	2010	2011
Government balance*	0.4	-0.4	-1.0	-3.2	-5.4	-8.0	N.A.
Cost of pension reform (total)**	0.4	0.7	0.9	1.0	0.6	0.6	1.1
Cost (stage 1)	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Cost (stage 2)		0.3	0.3	0.3	0.2	0.2	0.3
Cost (stage 3)			0.2	0.2	0.0	0.0	0.2
Cost (stage 4)				0.1	0.0	0.0	0.1
Cost (stage 5)							0.1
Degressive scale (stage 1)	100%	80%	60%	40%	20%	0%	0%
Degressive scale (stage 2)		100%	80%	60%	40%	20%	0%
Degressive scale (stage 3)			100%	80%	60%	40%	20%
Degressive scale (stage 4)				100%	80%	60%	40%
Degressive scale (stage 5)							100%
Cost to be considered (stage 1)	0.4	0.3	0.2	0.2	0.1	0.0	0.0
Cost to be considered (stage 2)		0.3	0.2	0.2	0.1	0.0	0.0
Cost to be considered (stage 3)			0.2	0.2	0.0	0.0	0.0
Cost to be considered (stage 4)				0.1	0.0	0.0	0.0
Cost to be considered (stage 5)							0.1
Cost to be considered (total)	0.4	0.6	0.7	0.6	0.2	0.0	0.2
Adjusted government balance***	0.8	0.22	-0.32	-2.6	-5.28	-7.92	N.A.

* according to Commission services' spring 2009 forecast
** estimates by the Member State
*** government balance adjusted for the pension reform costs to be considered
<u>Source</u>: Commission services

5. CONCLUSIONS

The general government deficit in Lithuania reached 3.2% of GDP in 2008, above, but close to the 3% of GDP reference value. The excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. The deterioration of the fiscal position in 2008 was mainly due to expansionary fiscal policy and only partly due to lower-than-budgeted tax revenue, reflecting the slowdown of the economy in the second half of the year. Since the deficit is above but close to the reference value, according to the Stability and Growth Pact due consideration should be given to the impact on the deficit of Lithuania's implementation of its pension reform. For 2008 taking into account the net cost of the reform would produce an adjusted deficit of below 3% of GDP. However, given the deficits projected in the Commission services' spring forecast for 2009 and 2010, the excess in 2008 over the 3% of GDP reference value cannot be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact.

From 2009 onwards, in line with the EERP, Lithuania, which is facing significant external and internal imbalances, has adopted a budgetary policy which clearly aims at correcting such imbalances. Taking into account the need to correct economic imbalances and the difficulty in securing new financing at acceptable conditions due to market risk aversion, the government adopted a comprehensive tax reform and a wide range of expenditure-saving measures in December 2008, including reductions in public wages in 2009. In view of a sharper than expected deterioration in the macroeconomic outlook at the beginning of 2009 and worse than planned revenue collection, the government adopted a restrictive supplementary budget in April 2009. Nevertheless, despite these consolidation measures, the general government deficit in Lithuania is still projected in the Commission services' spring forecast to increase to above 5% and to around 8% of GDP in 2009 and 2010 respectively, well above and not close to the 3% of GDP reference value. This suggests that the deficit criterion in the Treaty is not fulfilled.

In line with the Treaty, this report has also examined “relevant factors”. Given that the deficit in 2008 does not satisfy the double condition of closeness and temporariness, these factors cannot according to the Stability and Growth Pact be taken into account in the steps leading to the decision on the existence of an excessive deficit. Considered on their own merit, the relevant factors in the current case present on balance a mixed picture.

The existence of a severe economic downturn, with potential public finance implications, increases the need to undertake enhanced surveillance under the EDP.