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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2009
SEC(2009) 860 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Lithuania

EXPLANATORY MEMORANDUM

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 timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. It also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon strategy. 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 initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. 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, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

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)

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[1] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on 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/other_pages/other_pages12638_en.htm.

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".

On the basis of the data notified by the Lithuanian authorities in April 2009[2] and subsequently validated by Eurostat[3] and taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) for Lithuania on 13 May 2009[4].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 28 May 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to the April 2009 EDP notification, the general government deficit in Lithuania reached 3.2% of GDP in 2008, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the deficit was close to the 3% of GDP reference value but that the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it did not result from a severe economic downturn in 2008, when 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. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' spring 2009 forecast, taking into account measures for the current year in the budget for 2009 and in the supplementary budget adopted by Parliament in May, the deficit would widen to 5.4% of GDP in 2009, and on a no-policy-change basis worsen further to 8.0% of GDP in 2010. Therefore, the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60% of GDP reference value and stood at 15.6% of GDP in 2008. It is nevertheless, according to the Commission services' spring 2009 forecast, projected to rise rapidly to 22.6% of GDP in 2009 and to 31.9% in 2010 mainly due to expected high primary deficits.

In line with the provisions in the Stability and Growth Pact, the Commission in its report gave due consideration to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Lithuanian authorities, the net costs of this reform amount to 1.0% of GDP in 2008 and, due to the temporary reduction of

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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.

4 All EDP-related documents for Lithuania can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

contributions from 5.5% to 2%, 0.5% in 2009 and 0.4% in 2010. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value. For 2008 (which is the only year in which the deficit can be considered close to the reference value), taking into account the net cost of the reform would produce an adjusted deficit of 2.6% of GDP. For 2009 and 2010, on the other hand, the deficit forecast by the Commission services is no longer close to the reference value and therefore the cost of the pension reform cannot be taken into account.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Lithuania, the double condition is not met. Considered on their own merit, the relevant factors in the current case present on balance a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Lithuania. This opinion, adopted by the Commission on 24 June 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Lithuania with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Lithuania, special circumstances are considered to exist. The general government deficit was close to 3% in 2008 but is expected to widen further in 2009 despite the government's substantial consolidation efforts due to the impact of the severe downturn on revenue, reinforced by the global financial and economic crisis. Lithuania entered a severe recession at the beginning of 2009, with a cumulative loss of real output of around 16% over 2009-2010 according to the Commission services' 2009 spring forecasts and a possible slight recovery at the end of 2010 but to growth rates well below those observed in the years preceding the recession.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework. Based on the Commission services' spring 2009 deficit forecast for 2009 and 2010, and given the special circumstances, Lithuania is recommended to correct the excessive deficit by 2011 at the latest, starting consolidation in 2009. This would imply an average annual structural fiscal effort of at least 1½% of GDP over the period 2009-2011.

In line with the EERP agreed in December by the European Council, given that Lithuania is a country facing significant external and internal imbalances and taking into account the difficulty in securing new financing due to market risk aversion, the new government, formed in December, adopted a budget with substantial fiscal consolidation measures, which was approved by parliament on 22 December 2008. A comprehensive tax reform and a wide range of expenditure saving measures, including reduction in public wages, have been taken. In view of a sharper–than-expected deterioration in the macroeconomic outlook at the beginning of 2009 and weaker–than-planned revenue collection despite revenue increasing measures, a supplementary budget was approved by Parliament on 7 May 2009, with additional fiscal consolidation measures of around 3% of GDP, targeting a general government deficit of 2.9% of GDP. However, taking into account substantial downside risks to the macroeconomic outlook, adopted fiscal consolidation measures are likely to be insufficient to bring the deficit below the reference value in 2009 as planned. In light of its particular vulnerabilities linked to financial market conditions, Lithuania should implement the fiscal measures included in the 2009 budget and in the supplementary 2009 budget as planned, so as to limit the deterioration of public finances. Further measures should be considered to limit the deterioration of public finances in 2009. For 2010, new consolidation measures will need to be articulated and implemented to correct the excessive deficit in 2011.

In order to further enhance the credibility of the medium-term consolidation strategy, it will be crucial to address the weaknesses of the Lithuanian budgetary framework. In particular, in the upswing of the cycle buoyant revenue growth facilitated repeated upward revisions of expenditure targets through the adoption of mid-year supplementary budgets. The current medium-term budgetary framework did not succeed to prevent these expenditure overruns in recent years and remains rather weak as regards medium-term planning and control of public finances. Transparency of the whole budgetary process including appropriate reporting of revenue inflows and expenditure execution remains weak, including as regards comparability of the budgetary indicators on cash and accrual bases. Therefore, as already mentioned in the March 2009 Council opinion on the convergence programme update, risks to the adjustment should be limited by strengthening fiscal governance and transparency, by enhancing the medium-term budgetary framework and reinforcing expenditure discipline as well as improving the monitoring of the budget execution throughout the year.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Lithuanian convergence programme which will be prepared between 2009 and 2011 could usefully be devoted to this issue.

Key macroeconomic and budgetary projections

	2007	2008	2009	2010	2011
Real GDP (% change)	**8.9**	**3.0**	**-11.0**	**-4.7**	n.a.
Output gap[1] (% of potential GDP)	**8.9**	**7.6**	**-6.1**	**-11.7**	n.a.
General government balance (% of GDP)	**-1.0**	**-3.2**	**-5.4**	**-8.0**	n.a.
Primary balance (% of GDP)	**-0.3**	**-2.6**	**-4.3**	**-6.5**	n.a.
Cyclically-adjusted balance[1] (% of GDP)	**-3.4**	**-5.2**	**-3.8**	**-4.8**	n.a.
Structural balance[2] (% of GDP)	**-2.8**	**-5.2**	**-4.3**	**-5.5**	n.a.
Government gross debt (% of GDP)	**17.0**	**15.6**	**22.6**	**31.9**	n.a.

Notes:

[1] Based on estimated potential growth of 6.2%, 4.3%, 2.0% and 1.4% respectively in the period 2007-2010.

[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.6% of GDP in 2007 and 0.1% in 2008 (all deficit-increasing), 0.5% in 2009 and 0.6% in 2010 (all deficit-reducing), according to the Commission services' spring 2009 forecast.

Source:

Commission services' spring 2009 forecasts (COM); Commission services' calculations.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Lithuania,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[5] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 3605/93[6] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. 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.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in

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[5] OJ L 209, 2.8.1997, p. 6.
[6] OJ L 332, 31.12.1993, p. 7.

accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Lithuania. The Commission therefore addressed such an opinion to the Council in respect of Lithuania on 24 June 2009[7].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Lithuania, this overall assessment leads to the following conclusions.

(7) According to EDP notification, the general government deficit in Lithuania reached 3.2% of GDP in 2008, thus exceeding the 3% of GDP reference value. The deficit was close to the 3% of GDP reference value but the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it did not result from a severe economic downturn in 2008, when 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. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services’ spring 2009 forecast, taking into account measures for the current year in the budget for 2009 and in the supplementary budget adopted by Parliament in May, the deficit would widen to 5.4% of GDP in 2009, and on a no-policy-change basis worsen further to 8.0% of GDP in 2010. Therefore, the deficit criterion in the Treaty is not fulfilled.

(8) General government gross debt remains well below the 60% of GDP reference value and stood at 15.6% of GDP in 2008. It is nevertheless, according to the Commission services' spring 2009 forecast, projected to rise rapidly to 22.6% of GDP in 2009 and to 31.9% in 2010 mainly due to expected high primary deficits.

(9) In line with the provisions in the Stability and Growth Pact, due consideration should be given to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Lithuanian authorities, the net costs of this reform amount to 1.0% of GDP in 2008, and due to the temporary reduction of contributions from 5.5% to 2.0%, 0.5% in 2009 and 0.4% in 2010. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value. For 2008 (which is the only year in which the deficit can be considered close to the reference value), taking into account the net cost of the reform would produce an adjusted deficit of 2.6% of GDP. For 2009 and 2010, on the other hand, the deficit forecast by the Commission services is no longer close to the reference value and therefore the cost of the pension reform cannot be taken into account.

(10) According to Article 2(4) of Council Regulation (EC) No 1467/97, “relevant factors” can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over

[7] All EDP-related documents for Lithuania can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

the reference value is temporary - is fully met. In the case of Lithuania, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Lithuania.

Article 2

This decision is addressed to the Republic of Lithuania.

Done at Brussels,

For the Council
The President