COUNCIL OF
THE EUROPEAN UNION

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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	COUNCIL RECOMMENDATION with a view to bringing an end to the situation of an excessive government deficit

COUNCIL RECOMMENDATION TO LITHUANIA

of

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the Commission, Whereas:

(1) In accordance with Article 126(1) of the Treaty on the Functioning of the European Union (TFEU), Member States are to 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 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.

(4) On 7 July 2009, the Council decided, in accordance with Article 104(6) of the Treaty establishing European Community (TEC), that an excessive deficit existed in Lithuania and issued recommendations to correct the excessive deficit by 2011 at the latest, in accordance with Article 104(7) TEC and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1]. This implied an average annual fiscal effort of at least 1½ % of GDP over the period 2009-2011. The Council also established a deadline of 7 January 2010 for effective action to be taken.

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1 OJ L 209, 2.8.1997, p. 6.

(5) On 20 October 2009, the Council agreed that, provided that the Commission forecasts continued to indicate that the recovery is strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest, that specificities of country situations should be taken into account, and that a number of countries needed to consolidate before that date.

(6) Regulation (EC) No 1467/97 (which is part of the Stability and Growth Pact) establishes provisions for the implementation of Article 104 TEC (now Article 126 TFEU). Under Article 3(5) of Regulation (EC) No 1467/97, if effective action has been taken in compliance with a recommendation under Article 104(7) TEC (now Article 126(7) TFEU) and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of Regulation (EC) No 1467/97, to adopt a revised recommendation under Article 104(7) TEC (now Article 126(7) TFEU).

(7) The Commission services' spring 2009 forecast projected a contraction in real GDP of 11 % in 2009, following expected growth of 3 % in 2008. However, the output contraction in the first nine months of 2009 was much larger than forecast, at around 16 %. The Commission services' autumn 2009 forecast projects the contraction in economic activity in 2009 as a whole to be 7 p.p. deeper than envisaged in the spring, as a result of a more substantial deterioration in both domestic and external demand. The effect on public finances of the deeper-than-expected contraction is estimated to be substantially more than the standard budget elasticity with respect to the output gap would suggest, reflecting the bursting of the real estate bubble and the ongoing disinflationary process. The Commission services' autumn 2009 forecast revised upward the projected 2009 general government deficit by 4⅓ p.p. to 9,8 % of GDP, despite substantial consolidation measures adopted by the government during the year, mainly due to very negative revenue surprises, with the latter falling significantly beyond what could be expected on the basis of standard elasticities. In view of the above, unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred after adoption of the Council Recommendation under Article 104(7) TEC of 7 July 2009 (hereinafter "the Council Recommendation of 7 July 2009").

(8) In response to the Council's Recommendation of 7 July 2009, the Lithuanian authorities have implemented the fiscal consolidation measures embodied in the original 2009 budget, including a comprehensive tax reform and a wide range of expenditure-saving measures, and the first supplementary budget of May 2009. Furthermore, progress towards the correction of the excessive deficit has been made by adopting a second supplementary budget on 17 July 2009, with additional fiscal consolidation measures of around 0,4 % of GDP. These measures add to the substantial consolidation adopted earlier; the implemented fiscal adjustment totalled around 8 % of GDP. Moreover, in view of the Council Recommendation of 7 July 2009, and in order to support the adoption of the 2010 budget, on 28 October 2009 the government signed a National Accord with the social partners. This defines the main fiscal consolidation and structural measures to be adopted in 2009 and 2010 and spells out structural reforms to be implemented over the medium-term. Main measures in the 2010 budget adopted by parliament in December 2009 are further substantial cuts in expenditure, particularly in government current spending (2,5 % of GDP), including the public sector wage bill, and social benefits (1,5 % of GDP). On the revenue side, changes are limited to a reduction in the corporate income tax rate and some increases in non-tax revenue.

Set against these measures, revenue is expected to decrease further (by around 1 % of GDP), chiefly reflecting the ongoing output contraction, and some other expenditure items, including interest payments, healthcare spending and capital expenditure, are set to increase (+1,4 % of GDP); the net consolidation effect is therefore around 1,5 % of GDP, which is in line with the Council Recommendation of 7 July 2009 in which an average annual fiscal effort of at least 1½ % of GDP was recommended. However, some of the adopted measures are due to expire or be reversed at the end of 2010 or 2011. In the absence of other measures in 2011, the deficit might be around 1,5 % of GDP higher that year. Furthermore, the temporary partial suspension of transfers to second-pillar pension funds will expire by end 2010 (0,6 % of GDP). There is uncertainty about whether public sector wage bill cuts will be carried forward after the crisis. Overall, taking into account economic developments compared to the outlook in the Commission services' spring 2009 forecast, it can be concluded that Lithuania's authorities can be considered to have taken effective action.

(9) Since Lithuania's authorities are considered to have taken effective action in compliance with the Council Recommendation of 7 July 2009 and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in Lithuania, revised recommendations under Article 126(7) TFEU for Lithuania are justified. In spite of the effective action, the weaker overall position of the economy implies a more challenging scale for the consolidation effort needed over the medium-term than that envisaged when the earlier Council recommendation was framed. Starting from the estimated 9,8 % of GDP deficit outcome in 2009 in the Commission services' autumn 2009 forecast, as from 2010 an average annual fiscal effort of above 3 % of GDP would be necessary to bring the deficit below 3 % of GDP reference value by 2011. Moreover, the general government deficit is projected to remain high at above 9 % of GDP in 2010 and to increase further in 2011 in the absence of additional measures. In view of the above, a new deadline for the correction of the excessive deficit in Lithuania by 2012 at the latest is appropriate.

(10) This correction would represent an average annual fiscal effort of 2¼ % of GDP over the period 2010-2012[1]. The substantial consolidation package proposed by the Lithuanian government for 2010 will limit the deficit only to some extent, as tax revenue is projected to decline further and some expenditures, such as interest payments, are set to increase. Bringing the deficit below 3 % of GDP by 2012 will require significant consolidation efforts, continuing, in 2010 and beyond, the consolidation begun in 2009. For 2010, the envisaged corrective measures need to be implemented rigorously and additional measures taken as appropriate to achieve the necessary fiscal consolidation path. Additional measures may be necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. Furthermore, it will be important to aim for permanent measures, also on the revenue side, and frontload implementation of the planned efficiency-enhancing structural reforms, especially in the areas of public administration, healthcare and the social security system.

[1] In line with the initial recommendations under Article 104(7) TEC issued by the Council on 7 July 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations, the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium-term. In particular, in Lithuania, due consideration was given to the need to correct imbalances and limited borrowing possibilities. In calculating the average annual budgetary adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural budgetary adjustment needed to reach the nominal deficit target of 3 % by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

(11) Although general government debt remains well below the 60 % of the GDP reference value (15,6 % in 2008), according to the Commission services' autumn 2009 forecast it is projected to be on a rapidly growing trend, rising to nearly 30 % of GDP in 2009 and close to 50 % of GDP in 2011 on a no-policy-change basis. These dynamics underline the need for substantial consolidation also in the light of existing risks to long-term sustainability.

(12) In order to further enhance the credibility of the consolidation strategy, it will be crucial to address fragilities in the Lithuanian medium-term budgetary framework. The latter remains weak as regards planning and control of public finances and has not succeeded in preventing expenditure overruns in recent years. As already recommended by the Council in previous opinions on successive convergence programme updates, risks to the adjustment should be limited by enhancing the medium-term budgetary framework, including by strengthening fiscal governance and transparency and reinforcing expenditure discipline through enforceable ceilings, as well as improving monitoring of the budget execution throughout the year. The medium-term budgetary framework needs to be enhanced by introducing necessary forward-looking elements and mechanisms to avoid pro-cyclicality.

(13) The long-term budgetary impact of ageing in Lithuania is somewhat above the EU average, mainly as a result of a relatively high projected increase in pension expenditure over the coming decades. The budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability gap. Improving the primary balance over the medium-term via both an increase in revenues and cuts in expenditure and further reforms to the social security system would help to reduce the risk to the long-term sustainability of public finances as defined by the Commission Communication[1] on 'Long-term sustainability of public finances for a recovering economy' and discussed by the ECOFIN Council[2] on 10 November 2009.

(14) Enhanced surveillance under the excessive deficit procedure (EDP), which seems necessary also in view 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. In this context, a separate chapter in the updates of the Lithuanian convergence programme prepared between 2010 and 2012 could usefully be devoted to this issue.

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1 Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf.

2 Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf.

(15) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, to cope with the permanent changes in the growth prospects, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

(16) In addition, in view of the importance of achieving a medium-term budgetary objective (MTO) to provide an adequate safety margin against cyclical downturns and to ensure convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, Lithuania should ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

(1) Recognising that Lithuania's budgetary position in 2009 resulted from the interplay of the severe recession and significant consolidation efforts, which is an appropriate response to the European Economic Recovery Plan, the Lithuanian authorities should put an end to the present excessive deficit situation by 2012.

(2) Lithuania's authorities should bring the general government deficit below 3 % of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Lithuanian authorities should:

(a) implement rigorously the corrective measures planned in the budget for 2010 and adopt additional measures, if necessary, to achieve the envisaged consolidation;

(b) ensure an average annual fiscal effort of at least 2¼ % of GDP over the period 2010-2012, notably by containing primary current expenditure;

(c) specify and adopt the additional measures necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected; to this end adopt and swiftly implement the planned structural reforms entailing significant budgetary savings.

(3) To limit risks to the adjustment, Lithuania should enhance the medium-term budgetary framework, including by strengthening fiscal governance and transparency and reinforcing expenditure discipline, through enforceable ceilings, as well as improve the monitoring of the budget execution throughout the year. The medium-term budgetary framework needs to be enhanced by introducing necessary forward-looking elements and mechanisms to avoid pro-cyclicality.

(4) The Council establishes the deadline of 16 August 2010 for the Lithuanian government to take effective action to implement the recommended fiscal consolidation in 2010 as planned in the budget for 2010 and to outline the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The Lithuanian authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes prepared between 2010 and 2012.

Furthermore, the Council invites the Lithuanian authorities to implement reforms with a view to raising potential GDP growth and reduce the risks to long-term sustainability of public finances. This includes reforms especially in the areas of public administration, healthcare and the social security system. In addition, Lithuania is invited to foster medium-term growth through productivity-enhancing measures and adequate policies which will help to restore competitiveness.

This Recommendation is addressed to the Republic of Lithuania.

Done at Brussels,

For the Council
The President