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Recommendation for a

COUNCIL RECOMMENDATION TO LITHUANIA

of 27.1.2010

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

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 on the Functioning of the European Union. 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 in 2008/09. 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 2008. The Plan explicated that the stimulus should be timely, targeted and temporary and 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 have impacted 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 126 of the Treaty on the Functioning of the European Union (TFEU) 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 126(2) TFEU 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" (Code of Conduct), endorsed by the ECOFIN Council of 10 November 2009, 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 126(3) TFEU (ex 104(3) of the Treaty establishing the European Community (TEC)) 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 taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) TEC for Lithuania on 13 May 2009.

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

On 24 June 2009 the Commission, having taken into account its report under Article 104(3) TEC and the opinion of the Economic and Financial Committee under Article 104(4) TEC, addressed to the Council, in accordance with Article 104(5) TEC, its opinion that an excessive deficit existed in Lithuania.

Subsequently, acting upon a recommendation by the Commission, the Council decided on 7 July 2009 that an excessive deficit existed in Lithuania in accordance with Article 104(6) TEC, and, also on a recommendation by the Commission, it addressed recommendations to Lithuania in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive government deficit by 2011. In its recommendations, the Council established a deadline of 7 January 2010 for effective action to be taken.

Regulation (EC) No 1467/97, Article 3(5), states that if effective action has been taken in compliance with a recommendation under 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, to adopt a revised recommendation under Article 126(7) TFEU. To this end, the Commission has assessed recent macro-economic and budgetary developments as well as effective action taken by Lithuania.

3. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

According to Article 3(5) of Council Regulation (EC) No 1467/97, the occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the initial Council recommendation, adopted on 7 July 2009.

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2 According to Council Regulation (EC) No 479/2009, 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/portal/government_finance_statistics/procedure/edp_notification_tables.

The Council recommendations of 7 July were based on the macroeconomic and fiscal projections in the Commission services' spring 2009 forecast. This forecast took into account that the economy, after several years of above-potential growth, had gradually started to slow in 2008, but with activity declining more sharply at the end of the year as domestic cyclical deceleration was reinforced by rapidly falling external demand in the context of the international crisis. While real GDP growth still reached 2.8% for 2008 as a whole, going forward, Lithuania was projected to experience a pronounced economic downturn due to a sharp deceleration in domestic cyclical conditions and the global financial crisis. The Commission services' spring forecast expected the economy to contract by around 11% in 2009 and by a further 4¾% in 2010. The expected contraction was driven mainly by falling domestic demand, with investment set to decline substantially due to tight credit conditions and the bursting of the real estate bubble.

Based on the latest available information, real GDP declined year-on-year by around 16% in the first nine months of 2009, one of the largest declines in the EU and a drop not seen in 17-years. Investment collapsed by more than 40% y-o-y, while the decline in private consumption was nearly 20%. The fall in output is much larger than forecast in spring, and led to a sharp drop in tax revenue, which contracted at a much faster pace than experienced at the end of 2008.

According to the Commission services' autumn 2009 forecast the contraction in economic activity in 2009 as a whole would be 7 pp. deeper than envisaged in the spring forecast. Moreover, the autumn forecast projects an even stronger nominal GDP decline due to sharper than expected price disinflation. The strongest price decline is expected for investment, due to the real estate price correction and falling production costs.

		2008	**2009**	**2010**	**2011**
Real GDP (% change)	COM spring forecast	3.0	-11.0	-4.7	n.a.
	COM autumn forecast	2.8	-18.1	-3.9	2.5
Nominal GDP (% change)	COM spring forecast	13.6	-8.9	-5.9	n.a.
	COM autumn forecast	12.7	-19.2	-5.3	2.9
General government balance (% of GDP)	COM spring forecast	-3.2	-5.4	-8.0	n.a.
	COM autumn forecast	-3.2	-9.8	-9.2	-9.7

The general government deficit was expected in the spring to widen from 3.2% of GDP in 2008 to 5.4% in 2009 and 8.0% in 2010. However, according to the Commission services' autumn 2009 forecast, the general government deficit projected for 2009 is now 9.8% of GDP or 4⅓ pp. higher than expected in spring, in spite of the consolidation impact of the second supplementary budget adopted by the government in June and approved by parliament in July 2009. The measures in the second supplementary budget, including an increase in the standard VAT rate by 2 pp. and substantial cuts in public sector wages, contributed to contain the deficit by around 0.4 pp. of GDP in 2009, with a positive effect also on the 2010 deficit.

The effects of the economic situation on the budget are stronger than in a normal cycle. A standard budgetary elasticity for Lithuania with respect to output growth would have suggested an increase in the deficit ratio by 4.2% of GDP as a result of the downward revision of real and nominal GDP growth. However, the actual impact of the substantially deeper-than-expected contraction in 2009 is estimated to be significantly more: tax elasticities have turned very unfavourable during the sharp recession and revenues, previously boosted by the real estate boom and inflation, have been severely hit. The very negative revenue surprise (tax revenue decreased by around 32% y-o-y in the first nine months of 2009), despite significant discretionary tax increases during the year, has been only partly offset by reductions in planned expenditure.

The deterioration in the government deficit is forecast to lead to a more rapid increase in the government debt ratio to nearly 30% of GDP in 2009, up from 23% of GDP expected in the spring 2009 forecast.

Overall, it can be concluded that, assessed against the economic forecast underlying the initial Council recommendation, adopted on 7 July 2009, unexpected adverse economic events with major unfavourable effects for government finances have occurred in Lithuania.

4. ASSESSMENT OF EFFECTIVE ACTION TAKEN

According to Regulation (EC) No 1467/97 and the Code of Conduct a Member State should be considered to have taken effective action if it has acted in compliance with the Article 126(7) TFEU recommendation. The Code of Conduct states that the assessment of effective action should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall should be made. In case of a multi-annual adjustment, the Code of Conduct specifies that the assessment should mainly focus on the measures taken in order to ensure an adequate fiscal adjustment in the year following the identification of the excessive deficit.

The Council recommendations under Art. 104(7) TEC of 7 July 2009 established a deadline of 7 January 2010 for the Lithuanian government to take effective action to implement the adopted fiscal consolidation in 2009, to progress towards the correction of the excessive deficit, against the background of the economic outlook in the Commission services' spring 2009 forecast. The Council recommended the Lithuanian authorities to implement the fiscal measures included in the 2009 budget and in the supplementary 2009 budget approved by Parliament in May 2009 and consider further measures to limit the deterioration of public finances in 2009; ensure an average annual fiscal effort of at least 1½% of GDP over the period 2009-2011 in order to bring the deficit below 3% of GDP by 2011 and devise additional consolidation measures for 2010 necessary to achieve this consolidation path and to implement them rigorously.

The fiscal adjustment implemented during the year totalled around 8% of GDP. The Lithuanian authorities implemented the fiscal consolidation measures embodied in the original 2009 budget and the first supplementary budget of May, including a comprehensive tax reform and a wide range of expenditure saving measures. On the revenue side, indirect taxes and corporate income tax have been raised, while personal income tax was cut. Transfers to the second pillar pension funds have been temporarily reduced. Expenditure cuts have mainly aimed at reducing current expenditure, including public sector wages, which had risen strongly during the boom years. In response to a further marked deterioration in the economic outlook and revenue collection, the authorities revised markedly their macroeconomic projections and adopted additional measures in the second supplementary budget to limit the deterioration of public finances in 2009, both raising revenue and limiting spending. These measures include an increase in the standard VAT rate by 2 pp. and further substantial cuts in public sector wages. The government also announced efficiency-enhancing structural reforms in the healthcare sector and the social security system to be proposed during 2010[3].

Overall, the general government deficit is expected to reach 9.8% of GDP in 2009 according to the Commission services' autumn 2009 forecast (in their October 2009 EDP notification the Lithuanian authorities projected a deficit of 9.5% of GDP), in excess of the 5.4% of GDP deficit projected in the Commission services' spring 2009 forecast which was the benchmark for the recommendation under Article 104(7) TEC. However, as mentioned above, the worsening of the deficit in 2009 is exclusively due to a much worse than anticipated downturn and revenue falling significantly beyond what could be expected on the basis of standard elasticities, in spite of significant consolidation measures.

Moreover, in view of the Council recommendations adopted in July and to support the adoption of the 2010 budget, the government signed a National Accord with social partners on 28 October 2009. 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. In line with the National Accord, main measures in the 2010 budget adopted by parliament on 10 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 - both public sector wages and social benefits were substantially raised in recent years). On the revenue side changes are limited to a reduction in the corporate income tax rate and some increases in non-tax revenues. 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 original recommendation in the Art 104(7) TEC of the average annual fiscal effort of at least 1½% of GDP. However, some of the adopted measures are currently set 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.

On 28 October 2009 the Lithuanian authorities submitted a voluntary notification of the effective action taken in response to the Council recommendation of July 2009. The notification referred to the measures adopted during 2009 and foreseen for 2010 totalling almost 12% of GDP and ensuring an annual average fiscal effort of at least 1.5% of GDP over 2009-2011 as specified in the Council recommendation.

Overall, taking into account economic developments compared to the outlook in the Commission services' spring 2009 forecast, it can be concluded that Lithuania has taken effective action as required by the Council recommendation of 7 July 2009.

[3] On 29 October 2009 the Lithuanian authorities submitted a voluntary notification on the effective action taken in response to the Council recommendation of July 2009. The notification referred to the measures taken during 2009 and the measures included in the budget proposals for 2010.

5. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 126(7) TFEU has to establish a deadline of six months at most for effective action to be taken by the Member State concerned 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".

Since Lithuania's authorities are considered to have taken effective action in compliance with the Council recommendations of 7 July 2009 under Article 104(7) TEC and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in Lithuania, a revised recommendation for Lithuania is justified. The substantial deterioration in the budgetary position in 2009, despite sizable consolidation efforts already made, and the weaker overall position of the economy imply that tax revenue is projected to decline further and some expenditure, such as interest payments, are set to increase going forward. In the Commission services' autumn 2009 forecast the general government deficit is projected to remain high at above 9% of GDP in 2010 and to increase further in 2011 if no additional measures are taken. This implies a more challenging scale for the consolidation effort that will be needed over the medium term than that envisaged when the earlier Council recommendation was framed. Consequently, a new deadline for correction of the excessive deficit in Lithuania by 2012 at the latest is appropriate. Based on the autumn forecast, which includes the 2010 budget proposals, the average annual fiscal effort implied by the higher starting point and the revised deadline herein proposed (2012) is 2¼% of GDP[4] over 2010-2012. The projected net impact of budgetary measures of around 1.5% of GDP already adopted for 2010 is thus less than the new required average annual effort. To this end, bringing the deficit below 3% of GDP by 2012 will require significant consolidation efforts, and it seems appropriate that the Lithuanian authorities continue in 2010 and beyond the consolidation begun in 2009. For 2010, the envisaged corrective measures should be implemented rigorously and additional measures detailed to achieve the necessary fiscal consolidation path. Lithuania's authorities should adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2012 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 the implementation of the planned structural reforms, especially in the areas of public administration, healthcare and the social security system.

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4 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.

Although general government debt remains well below the 60% of GDP reference value (15.6% in 2008), according to the Commission services' autumn 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 very unfavourable dynamics underline the need for substantial consolidation.

In order to further enhance the credibility of the consolidation strategy, it seems important 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 could 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 strengthened by introducing necessary forward-looking elements and mechanisms, also aiming to avoid pro-cyclicality. In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

Enhanced surveillance under the 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 to ensure the correction of the excessive deficit. 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.

Key macroeconomic and budgetary projections

	2007	**2008**	**2009**	**2010**	**2011**
Real GDP (% change)	**9.8**	**2.8**	**-18.1**	**-3.9**	**2.5**
Output gap[1] (% of potential GDP)	**11.9**	**11.5**	**-8.2**	**-10.8**	**-8.2**
General government balance (% of GDP)	**-1.0**	**-3.2**	**-9.8**	**-9.2**	**-9.7**
Primary balance (% of GDP)	**-0.3**	**-2.6**	**-8.4**	**-7.0**	**-7.1**
Cyclically-adjusted balance[1] (% of GDP)	**-4.2**	**-6.3**	**-7.6**	**-6.3**	**-7.5**
Structural balance[2] (% of GDP)	**-3.6**	**-6.3**	**-8.0**	**-7.0**	**-7.5**
Government gross debt (% of GDP)	**16.9**	**15.6**	**29.9**	**40.7**	**49.3**

Notes:

[1] Based on estimated potential growth of 3.2%, 2.6%, 2.1%, 2.1% and 2.3% respectively in the period 2007-2011.

[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2007 and 0.1% in 2008 (all deficit-increasing), 0.4% in 2009 and 0.7% in 2010 (all deficit-reducing), according to the Commission services' autumn 2009 forecast.

Source:
Commission services' autumn 2009 forecasts.

Recommendation for a

COUNCIL RECOMMENDATION TO LITHUANIA

of 27.1.2010

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) According to 126(1) of the Treaty on the Functioning of the European Union (TFEU) 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 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 exists 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[5]. 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.

(5) The Council agreed on 20 October 2009 that, provided that the Commission forecasts continue 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

[5] OJ L 209, 2.8.1997, p. 6.

specificities of country situations should be taken into account, and that a number of countries need to consolidate before that.

(6) Regulation (EC) No 1467/97 (which is part of the Stability and Growth Pact) establishes provisions for the implementation of Article 126 TFEU. According to Article 3(5) of Council Regulation (EC) No 1467/97, if effective action has been taken 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 126(7) TFEU.

(7) The Commission services' spring 2009 forecast projected a contraction in real GDP of 11.0% in 2009, following expected growth of 3.0% 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 pp. 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 pp. 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 recommendation under Article 104(7) TEC.

(8) In response to the Council's recommendations under Art. 104(7) TEC 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. 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 recommendations adopted in July and 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 original recommendation in the Art 104(7) TEC of the average annual fiscal effort of at least 1½% of GDP. 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 by 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 recommendations of 7 July 2009 under Article 104(7) TEC 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 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 of 2010-2012[6]. The substantial consolidation package proposed by the 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

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6 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.

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.

(11) Although general government debt remains well below the 60% of GDP reference value (15.6% in 2008), according to the Commission services' autumn 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[7] on 'Long-term sustainability of public finances for a recovering economy' and discussed by the ECOFIN Council[8] on 10 November 2009.

(14) Enhanced surveillance under the 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.

(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.

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

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

(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 also 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 [19 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, 27.1.2010

For the Council
The President