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Recommendation for a

COUNCIL RECOMMENDATION

on the National Reform Programme 2011 of Lithuania

and delivering a Council opinion

on the updated Convergence Programme of Lithuania, 2011-2014

{SEC(2011) 723 final}

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, and in particular Article 9(3) thereof,

Having regard to the recommendation of the European Commission²,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial Committee,

Whereas:

- (1) On 26 March 2010, the European Council agreed to the European Commission's proposal to launch a new strategy for jobs and growth, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.
- (2) On 13 July 2010, the Council adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States³, which together form the "integrated guidelines". Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

¹ OJ L 209, 2.8.1997, p. 1.

² OJ C , p. .

³ Maintained for 2011 by Council Decision 2011/308/EU of 19 May 2011.

- (3) On 12 January 2011, the Commission adopted the first Annual Growth Survey, marking the start of a new cycle of economic governance in the EU and the first European semester of ex-ante and integrated policy coordination, which is anchored in the Europe 2020 strategy.
- (4) On 25 March 2011, the European Council endorsed the priorities for fiscal consolidation and structural reform (in line with the Council's conclusions of 15 February and 7 March 2011 and further to the Commission's Annual Growth Survey). It underscored the need to give priority to restoring sound budgets and fiscal sustainability, reducing unemployment through labour market reforms and making new efforts to enhance growth. It requested Member States to translate these priorities into concrete measures to be included in their Stability or Convergence Programmes and National Reform Programmes.
- (5) On 25 March 2011, the European Council also invited the Member States participating in the Euro Plus Pact to present their commitments in time to be included in their Stability or Convergence Programmes and their National Reform Programmes.
- (6) On 28 April 2011, Lithuania submitted its updated 2011 Convergence Programme covering the period 2011-2014 and its 2011 National Reform Programme. In order to take account of the interlinkages, the two programmes have been assessed at the same time.
- (7) The Lithuanian economy is recovering from a severe economic crisis, during which GDP contracted by 17% from peak to trough as the collapse in domestic demand was amplified by a slump in global trade. The labour market reacted rapidly to the crisis, and unemployment rose to a record high, peaking at 18.3% by mid 2010 from as low as 4.2% at the beginning of 2008. A strong commitment to the currency board arrangement, underpinned by substantial fiscal consolidation alongside adjustment in private sector wages and measures aimed at strengthening financial system stability, helped stabilise the economy. As the global economy recovered, and the economy benefitted from regained competitiveness, exports surged and economic growth resumed in 2010. In 2011, the recovery is gathering pace as domestic demand picks up. However, even though unemployment is expected to decline at a rapid pace, it will remain at double digit level.
- (8) Based on the assessment of the updated convergence programme pursuant to Regulation Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underlying the 2011 Convergence Programme is plausible. While based on somewhat more favourable growth assumptions for 2011, it is broadly in line with the latest Commission forecast for 2012. The programme plans to bring the deficit below the 3% reference value by 2012, the deadline set by the Council, but is not sufficiently underpinned by measures for 2012. The accelerating economic momentum may lead to better 2011 budgetary outcomes than expected in the programme. However, if temporary consolidation measures that will expire at the end of 2011 are not renewed and complemented by sizable permanent measures, the programme's budgetary targets for 2012 risk not being met despite the improving macro-economic outlook. The average annual fiscal effort over the period of 2010-2012 is well below the 2.25% of GDP recommended by the Council under the excessive deficit procedure (EDP) adopted on 16 February 2010. As economic growth and tax revenues are substantially stronger than expected at the time of the Council

EDP Recommendation, implementation of the required fiscal effort should allow for faster deficit reduction and progress towards the medium term objective (MTO). The medium-term objective of a structural surplus of 0.5% of GDP is not foreseen to be achieved within the programme period.

- (9) In view of the sizable adjustment required to meet the 2012 EDP target and make progress towards the MTO, and the need to secure the necessary co-financing in order to frontload the absorption of EU structural funds and increase productive investment in the economy, identifying further consolidation measures will be a challenge. Improvements in public sector efficiency could create additional room for expenditure adjustments without compromising the quality of public services. In the absence of further reform, age-related expenditure will increase at a rate above the EU average over the next few decades. In June 2010, the government approved the broad outline of a comprehensive social security and pension system reform. The proposal included significant increases in the pensionable age, changes to the way pensions are calculated and the integration of state pensions into the general scheme of social insurance. The approval and successful implementation of all aspects of these proposals will be critical for long term fiscal sustainability and could help increase the labour supply by providing stronger incentives to work for older workers while ensuring the adequacy of pensions. Moreover, long-term fiscal sustainability would also require a stronger fiscal framework. In particular, in the run-up to the crisis, the fiscal framework did not prevent recurrent sizeable revisions of expenditure targets and pro-cyclical expenditure growth financed by revenue windfalls. Excessive expenditure growth financed by boom-related revenues was at the origin of the large fiscal imbalances that emerged during the crisis. They also contributed to overheating the economy.
- (10) The unemployment rate in Lithuania is one of the highest in the EU. The immediate concern is to ensure that this rapid increase does not become structural. Very strict labour regulations and disincentives to work within the social assistance system are compromising the functioning of the labour market. When combined with sufficiently funded active labour market policies, measures taken in these domains, would help reduce the risk of high unemployment becoming structural, and reduce the sizeable shadow economy.
- (11) Lithuanian State-Owned Enterprises represent about 18% of GDP. They remain prone to inefficiencies with unsatisfactory financial returns. The successful reform of state-owned enterprises would also enhance competition and improve the business environment. In 2010 Lithuania began a reform in five major sectors. The reform set out transparency guidelines for state-owned enterprises, providing a basis for government accountability. The Government's Resolution on Improvement of Efficiency in December 2010 provided a further credible framework for the reform. Nevertheless these remain only frameworks and guidelines, and the Resolution lacks a number of key measures initially proposed, and which would have ensured the separation of regulatory and ownership functions.
- (12) The energy intensity of the Lithuanian economy is one of the highest in the EU. This is to a large extent related to household heating where poorly maintained multi-apartment buildings account for the bulk of the problem. Despite the introduction of a strategy to address this dating back to 2004, few investments have been made. Moreover, levels of car ownership have increased rapidly, whilst revenues from

energy and transport taxes have fallen relative to GDP and to taxes on labour (considerably above the EU average). Addressing low energy tax rates, including those for the registration and ownership of transport vehicles, would support fiscal consolidation in the short-term, whilst also incentivising more efficient energy use.

- (13) While Lithuania has a business regulatory framework that is favourable overall, it scores relatively poorly on start-up conditions, the time and cost involved in issuing construction permits, and the protection of investors. Improvements to regulations in these areas would help stimulate job creation and growth. Competition policy reform would further improve the environment, but progress is slow, especially in the energy and food retail sectors. The completion of the revised national energy independence strategy will help address concerns over security of supply and support greater competition in electricity generation. The implementation of the Third Package of EU electricity and gas market legislation would improve retail energy market competition. Within the food retail sector, Lithuanian passed a law in 2009 on the prohibition of unfair operations of retail trade undertakings. However, the food retail sector continues to show an insufficient level of competition, due partly to its structure and inefficiencies in market regulation. Concentration in the food retail chains has been on an upward trend, with the share of the four largest retailers reaching 72% of the total sales in 2008.
- (14) Lithuania has made a number of commitments under the Euro Plus Pact⁴. To strengthen fiscal sustainability, Lithuania will adopt laws to facilitate the accumulation of funds in the State Treasury reserve for difficult economic periods and promote a responsible anti-inflationary budgetary policy. A number of important measures to reform the pension and social security system have also been announced. Employment measures focus on fostering employment, combating illegal and undeclared work, and promoting flexible employment agreements. To improve the business environment a number of commitments have been made to strengthen business inspectorates, increase transparency and reduce the administrative burden on business. These commitments relate to all four areas of the pact. Overall, they reflect the reform agenda outlined in the Convergence Programme and the National Reform Programme. The range of measures in the employment domain would, if implemented, provide a welcome contribution to generating demand for labour. These commitments have been assessed and taken into account in the recommendations.
- (15) The Commission has assessed the Convergence Programme and National Reform Programme, including the Euro Plus Pact commitments⁵. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Lithuania but also their conformity with EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU level input into future national decisions. In this light, the Commission considers that measures to ensure compliance with the budgetary targets for 2012 will need to be specified. Further steps should be also taken to reform the pension system in order to improve fiscal sustainability and to encourage longer working lives, improve the functioning of the labour market, implement the state-owned-enterprises reform package, improve

⁴ More details on the commitments made under the Euro Plus Pact can be found in SEC(2011) 723.

⁵ SEC(2011) 723.

energy efficiency and address low taxes on energy, and strengthen competition in certain sectors.

- (16) In light of this assessment, also taking into account the Council Recommendation under Article 126(7) Treaty on the Functioning of the European Union of 2 June 2010, the Council has examined the 2011 update of the Convergence Programme of Lithuania and its opinion⁶ is reflected in particular in its recommendation under (1) and (2) set out below. Taking into account the European Council conclusions of 25 March 2011, the Council has examined the National Reform Programme of Lithuania,

HEREBY RECOMMENDS that Lithuania should take action within the period 2011-2012 to:

- (1) Adopt additional fiscal measures of a permanent nature by the time of the 2012 budget to correct the excessive deficit. Reinforce tax compliance and take full advantage of the economic recovery to further accelerate deficit reduction and ensure progress towards the Medium Term Objective by at least 0.5% of GDP annually. Strengthen the fiscal framework, in particular by introducing enforceable and binding expenditure ceilings in the medium-term budgetary framework.
- (2) Adopt the proposed implementing legislation on Pension System Reform. In order to enhance participation in the labour market, remove fiscal disincentives to work for people at or approaching pensionable age.
- (3) Enhance labour market flexibility by amending the Labour Code to make it more flexible and to allow better use of fixed-term contracts. Amend the relevant legislation, in particular the Law on Cash Social Assistance, to ensure that the social assistance system does not contain disincentives to work.
- (4) Implement all aspects of the State-Owned Enterprise reform package by the end of 2011, ensuring a separation of ownership and regulatory functions, clear enterprise objectives, enhanced transparency and a separation of commercial and non-commercial activities.
- (5) Improve the energy efficiency of buildings through a rapid implementation of the Holding Fund and take steps to shift taxation towards energy use, starting with taxes on registration and ownership of passenger transport vehicles.
- (6) Take steps to improve start-up conditions, the delivery of construction permits, and to strengthen competition in the energy and retail sectors.

Done at Brussels,

*For the Council
The President*

⁶ Foreseen in Article 9(3) of Council Regulation (EC) No 1466/97.