APPROVED BY
Resolution No 1230
of 8 December 2006
of the Government of the Republic of Lithuania

CONVERGENCE PROGRAMME OF LITHUANIA OF 2006

I. FINANCIAL POLICY OVERVIEW

1. Lithuania's economic policy serves the goal of ensuring a rapid real convergence, i.e. approximation to the high level of productivity and subsistence within the Economic and Monetary Union. The Convergence Programme of Lithuania of 2006 (hereinafter referred to as this Programme) gives projections of the economic policy outlined in the preliminary budgets currently with the Seimas of the Republic of Lithuania.

2. The entire set of reforms is geared towards the development of measures aimed at achieving the above-mentioned goal over the medium term. These measures include:

2.1. a rapid and sustainable real convergence and a stable macroeconomic environment;

2.2. favourable conditions for business development and a successful implementation of structural reforms;

2.3. a transparent public administration and a political consensus regarding the reforms to be carried out;

2.4. a stable and predictable legal environment; and

2.5. management of the demand pressure on prices.

3. Lithuania has undertaken in this Programme to pursue an economic policy that ensures the stability of prices and general government finances so as to maintain strong confidence in the continuity of the currency board arrangement in Lithuania and to participate successfully in the Exchange Rate Mechanism II (hereinafter referred to as the ERM II).

4. This Programme gives an overview of recent economic developments in Lithuania, a projection of a medium-term economic policy, an assessment of risks and the quality of general government finances, and a description of Lithuania's readiness to overcome the effects of an ageing population, as well as an outline of structural reforms underway which have a significant financial impact.

5. This Programme examines and assesses the preconditions for the achievement of the declared economic policy goals. The economic development projections given are based on the assumption that Lithuania's external economic environment will, in principle, remain stable during the period concerned and that the demand for loans will be met by prudent solutions based on deep knowledge, which will protect the economy from the risk of "overheating" and the consequent correction. Other assumptions used are those made by the European Commission. The commitment to maintain strict fiscal discipline as laid down in

this Programme have been enforced by the Council of the European Union which unanimously tightened, in June 2005, fiscal policy requirements under the Stability and Growth Pact, according to which the states participating in the ERM II have to reduce their structural fiscal deficit by about 0.5% of the Gross Domestic Product (hereinafter referred to as the GDP) a year, until the medium-term fiscal deficit target is reached. EU regulations explicitly require pursuing a tight fiscal policy, thus imposing a legally binding obligation to reduce fiscal deficit. Lithuania is currently discussing the issue of institutionalisation of fiscal discipline provisions of the Stability and Growth Pact, by negotiating for a relevant agreement between parliamentary parties.

6. National currency pegged to the euro under the currency board arrangement ensures that the average multi-annual inflation will remain close to that in the euro area. After the acceleration of inflation in 2006-2007 and with the stabilisation of oil and natural gas prices as well as with the approximation of excises to the EU rates, inflation in Lithuania will, over time, again come close to inflation in the euro area.

7. The growth of exports and investment remains on a fast track in Lithuania, with unemployment going down at the highest pace among the EU states. Over the past five years (from the second quarter of 2001 to the second quarter of 2006), the level of employment has grown by 9.4%. A rapid growth of investment will ensure Lithuania’s competitiveness in the long run and increase the import of investment goods and the current account deficit (hereinafter referred to as the CAD) in the short run.

8. Lithuania will make efforts to join the euro area as soon as possible. According to the available data, the best period for joining the euro area starts in 2010.

9. One of the fiscal policy objectives, to keep the economic impact of fluctuations in the demand under control, laid down in the Convergence Programme of Lithuania of 2004 will be pursued under this Programme, too. In future updates of this Programme, specific additional measures aimed at preventing economic “overheating” and managing fiscal risks will be described.

10. The rapid growth of demand under the conditions of a fixed exchange rate for the litas inspires a rapid growth of imports and Lithuania’s CAD. Thus, to ensure the continuity of foreign capital inflows, the government should further improve the business and investment environment, give maximum support to investment that is promoted by laws, and create particularly favourable conditions for "green field" investment, as well as maintain market confidence in the continuity of the goal of an early integration of the country into the euro area.

Given the need to implement structural reforms securing productivity and the long-term sustainability of government finances, and in the light of the rapid growth of GDP and the current low level of debt, the medium-term objective (hereinafter referred to as the MTO) for 2008 is a structural deficit below 1% of GDP. For later periods, the MTO will be tightened to take note of the Commission’s latest estimates suggesting that general government debt will approach to 77% of GDP in 2050, unless fiscal policy is tightened. The EU

Commission's estimations for 2006 suggest that in order to grant reliable social guarantees to pensioners in the period 2030-2050 despite the problem of an ageing population and to secure the long-term stability of general government finances which is a requisite in the euro area, Lithuania's primary structural surplus should reach about 1.9% of GDP over the medium term. Therefore, once major structural reforms have been completed, the MTO will again be a balanced or a surplus budget, depending on the economic cycle.

11. Currently, Lithuania's capacity to aim at a fiscal deficit below 1% of GDP is prejudiced by temporary budgetary difficulties associated with tax reduction. Thanks to strict fiscal discipline, government current expenditure will remain at the lowest level in the EU. The GDP share of government expenditure will grow slightly due to the implementation of the Public Investment Programme and increasing investment support from the EU. Fiscal discipline will be maintained over the medium term by holding the GDP share of government current expenditure down and by increasing the share of social expenditure, i.e. by keeping it at above 9% of GDP. The successful implementation of the pension reform will pave the way for the reduction of the national debt in the long run and will encourage private persons to save funds to supplement their old-age pension. Tax revenues to be allocated in 2008 for the pension reform will account for about 0.7% of GDP. The reduction of the rate of personal income tax which is expected to ensure a better balance between labour and capital taxation will contribute to the successful implementation of the Lisbon objectives in the labour market, to increase employment and potential GDP, and to mitigate the effects of an ageing population for government finances. Although potential GDP will increase as a result of the tax reform, the fulfilment of the Stability and Growth Pact requirements, namely to prevent negative effects for the fiscal deficit and the economic cycle, will be possible only on the condition that additional tax revenue is collected on a temporary basis.

12. The fiscal policy pursued in compliance with the strict regulations of the Stability and Growth Pact will make it possible to consistently reduce government debt until government finances become capable of ensuring a sustainable implementation of commitments under the Maastricht Treaty, while maintaining reliable social guarantees, regardless of the projected significant growth in the number of pensioners and the decreasing number of employed people in the third decade as a result of the low birth rate and high emigration.

II. ECONOMIC OUTLOOK

Assumptions

13. The projections for Lithuania's economic indicators are based on recent economic development trends and assumptions about economic growth.

Economic projections are based on the assumption that the Seimas of the Republic of Lithuania, when passing legal acts regulating general government expenditures and tax rates, will take into account the principal provisions of the Stability and Growth Pact and approve measures aimed at stabilising inflation at below 3% by the end of 2008. This would be achieved if parliamentary parties reached an agreement on fiscal discipline.

An assumption is made that preliminary conclusions of consultations with the International Monetary Fund (IMF) about neighbouring economies will help them to implement economic policy measures in time, enabling to prevent an economic “overheating” and create favourable external conditions for sustainable development in Lithuania.

The key assumptions about the external economic environment in implementing the EU fiscal monitoring procedure and in seeking to ensure the comparability of economic forecasts correspond to the external environment assumptions published by the European Commission.

Table 1. Key assumptions

Indicator	2005	2006	2007	2008	2009
Short-term interest rates	2.3	3.7	3.7	3.3	3.5
Long-term interest rates	3.6	4.1	4.1	4.2	4.2
USD/EUR exchange rate (euro area and ERM II countries)	1.24	1.25	1.27	1.27	1.27
Nominal effective exchange rate	-0.8	0.0	0.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	N.A.	N.A.	N.A.	N.A.	N.A.
World (excluding EU-25) GDP growth	5.1	5.7	5.2	5.2	5.2
EU-25 GDP growth	1.7	2.8	2.4	2.4	2.4
Growth of key export markets	1.7	2.8	2.4	2.4	2.4
World import volumes, excluding EU	8.8	9.1	8.3	7.9	7.9
Oil prices (Brent, USD/barrel)	55.2	65.6	66.3	68.0	68.0

Sources: Ministry of Finance, European Commission

GDP growth projections are particularly dependent on frequently and radically changing credit increase projections made by commercial banks. Credit increase assumptions correspond to those made by commercial banks. Credit increase in 2006 will be 2-3 percentage points of GDP higher than in 2005, to be followed by a corresponding drop in 2007. Changes in credit increase assumptions accelerated the GDP growth of 2006, whereas the 2007 growth will hardly exceed the potential growth, given the additional stimulus for growth to be provided by a likely decent harvest in agriculture. A higher deceleration of credit increase is assumed to start in 2008-2009, marking the start of a natural cyclical slow-down of GDP growth and a growth of the nominal fiscal deficit.

Globalisation-driven competition and a possible changes in real estate prices will have no effect on real production volumes only if labour force is flexible enough and manage to shift among different sectors of the economy. Labour market flexibility may be achieved at the expense of wages: in the medium term, competition intensified by globalisation and a varying credit change cycle in certain sectors may prompt not only a slow-down of the growth of wages but also their reduction. The assumption about labour market flexibility ensures that the rapid growth of average wages is balanced with potential development divergences among sectors of the economy of Lithuania. If the assumption of labour force flexibility proves false, employment will be lower and real GDP growth will be slower.

A rapid medium-term growth is particularly dependant on the assumption that business community will manage to meet financial markets expectations for a rapid and sustainable approximation of Lithuania's productivity to the EU-average and to generate profits even with a rapid growth of wages.

If credit increase of 2006 exceeds 15% of GDP, assumptions about the level of absorption of EU support will become peripheral. In the period 2006-2009, absorption of the EU structural funds and other financial assistance from the EU will have a smaller effect on the growth of GDP than changes in credit increase volumes. A different-than-planned absorption of EU support would only slightly affect the growth of GDP in the corresponding year.

In the medium term, Lithuania will maintain rapid economic development: GDP growth may reach 7.8% in 2006 and 6.3% in 2007. Growth in 2006-2007 will in principle have no effect on the inflationary GDP gap. It is assumed that a timely implementation of demand management measures will cause the inflationary GDP gap to start falling rapidly in 2008. If this is the case, GDP growth will account for 5.3% in 2008 and 4.5% in 2009. An early and manageable correction of GDP growth rates would ensure a rapid and sustainable average growth of 6% in later years.

If these assumptions prove false as the economy develops, economic projections or the outlook of projections for 2006-2009 will be changed accordingly. Economic projections are likely to change if commercial banks decide to change their lending plans.

Monetary and exchange rate policy

14. The application of the fixed exchange rate mechanism under the currency board arrangement has played an important role in achieving stable macroeconomic development, which has stabilised inflationary expectations of market players, lowered country and currency risk premiums, boosted confidence in the economic policy of the country, and accelerated nominal and real convergence. Openness of the economy, exchange rate stability important for the price level, and relative flexibility of prices and wages are those features of Lithuania's economy that contribute to the successful application of the fixed litas exchange rate strategy.

Lithuania has been participating in the ERM II since 28 June 2004, by implementing a unilateral commitment to maintain a fixed exchange rate regime and a fixed national currency exchange rate vis-à-vis the euro.

15. One of the economic policy goals for Lithuania is as early introduction of the euro as possible.

Therefore, Lithuania's monetary and exchange rate policy goals remain unchanged. Lithuania participates in the ERM II, by maintaining a strictly fixed litas exchange rate vis-à-vis the euro, and seeks to join the euro area as soon as economic convergence criteria are met.

Table 2. Interest rates, 1996-2006 (%)

Indicator	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Aug 2006**
Average interest on bank loans in litas	21.3	13.9	12	13	11.9	9.3	6.6	5.8	5.7	5.2	5.0
Average interest on litas deposits with banks *	13.8	8.2	6.7	7.7	7.3	5.3	3.2	2.5	2.3	2.5	2.7

Source: Bank of Lithuania

* Average interest on deposits with maturity of over 1 month
** Interest rates according to the new methodology adopted by MFI

Table 3. Interpolated yield of euro-denominated euro-bonds of the Republic of Lithuania and the difference between the latter and the basic euro yield* (as of the end of period)

	Time before redemption									
	1 year		2 years		3 years		5 years		10 years	
	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference
Dec 2001	–	–	5	+1.3	5.3	+1.4	5.6	+1.2	–	–
Dec 2002	2.9	+0.3	3.2	+0.5	3.5	+0.6	4.2	+0.8	5.1	+0.9
Dec 2003	2.5	+0.3	2.9	+0.3	3.2	+0.4	3.9	+0.3	4.8	+0.5
Dec 2004	2.2	-0.1	2.5	+0.0	2.8	+0.1	3.2	+0.1	4.0	+0.3
Dec 2005	2.8	+0.1	2.9	+0.0	3.0	+0.0	3.2	+0.1	3.5	+0.2
Jun 2006	3.6	+0.2	3.7	+0.1	3.8	+0.1	4.0	+0.1	4.4	+0.3

Sources: Bank of Lithuania, news agency "Bloomberg"

*The yield (%) is expressed as the average of buying and selling prices quoted in the secondary market, and the differences in the yield are expressed in percentage points. The yield of euro-bonds of the Republic of Lithuania has been calculated according to actual yield curves.

Table 4. Yield of government securities (GS) of the Republic of Lithuania and the difference between the latter and the interpolated yield of euro-denominated euro-bonds of the Republic of Lithuania* (as of the end of period)

	Time before redemption									
	1 year		2 years		3 years		5 years		10 years	
	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference
Dec 2001	4.8	–	5.4	+0.4	5.7	+0.4	6	+0.3	–	–
Dec 2002	3.2	+0.2	3.8	+0.6	4	+0.5	4.7	+0.5	5.2	+0.1
Dec 2003	2.3	-0.2	3.4	+0.5	3.7	+0.5	4.1	+0.3	4.9	+0.1
Dec 2004	2.3	+0.1	2.4	-0.1	2.7	-0.1	3.2	-0.0	4.2	+0.2
Dec 2005	2.7	-0.1	2.9	-0.0	3.0	+0.0	3.2	+0.1	3.5	+0.1
Jun 2006	3.3	-0.3	3.6	-0.1	3.8	+0.0	4.0	-0.0	4.4	+0.0

Sources: Bank of Lithuania, news agency "Bloomberg"

*The yield (%) is expressed as the average of buying and selling prices quoted in the secondary market, and the differences in the yield are expressed in percentage points. The yield of euro-bonds of the Republic of Lithuania has been calculated according to actual yield curves.

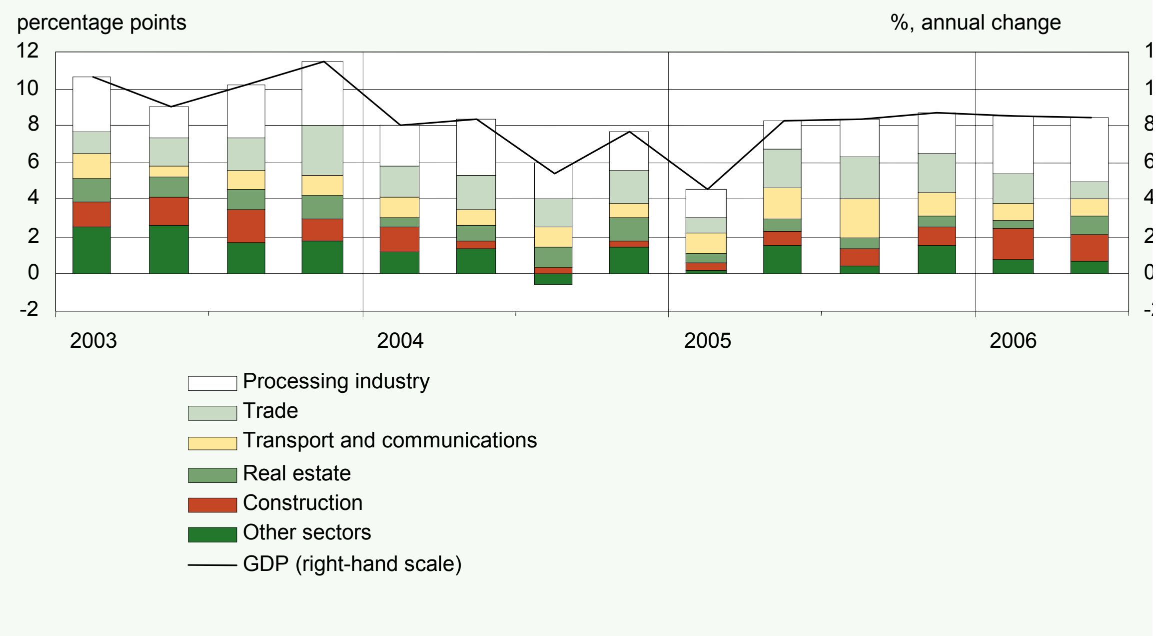
Economic cycle and a medium-term macroeconomic scenario

Goods and services markets

16. In recent years, Lithuania's economy has been growing at a very high pace. Over 2005, real GDP has grown by 7.6%, followed by a growth of as much as over 8% in the first half of 2006. Domestic demand remains the main driver of economic development, promoted by active borrowing and rapidly growing nominal income, while quite positive changes in net exports testify a fairly good external competitiveness of domestic producers. Despite a moderate growth of interest rates and a growing shortage of labour force, economic growth has not decelerated in recent years. A positive gap between the actual and potential GDP raises certain concerns related to a growing tension in the labour market and an increasingly high impact of domestic demand on prices and the CAD. It is expected, however, that a very rapid growth of domestic demand will slow down as the rate of growth of bank loans (which seems to be quite inert) become more responsive to the continued tightening of monetary policies by the European Central Bank (ECB) and to higher real estate prices in Lithuania.

GDP growth was driven mainly by the growth of household consumption expenditure. The situation was particularly favourable for this growth: wages grew rapidly (and will grow further despite the reduction of the rate of personal income tax) coupled by a modest growth of employment; consumption loans gained popularity; and consumers cherished particularly optimistic expectations. As the Government of the Republic of Lithuania pursued a more balanced expenditure policy and the number of people employed in the public sector decreased, general government real consumption expenditure grew moderately.

Fig 1. Factors of change in real GDP (by expenditure approach)



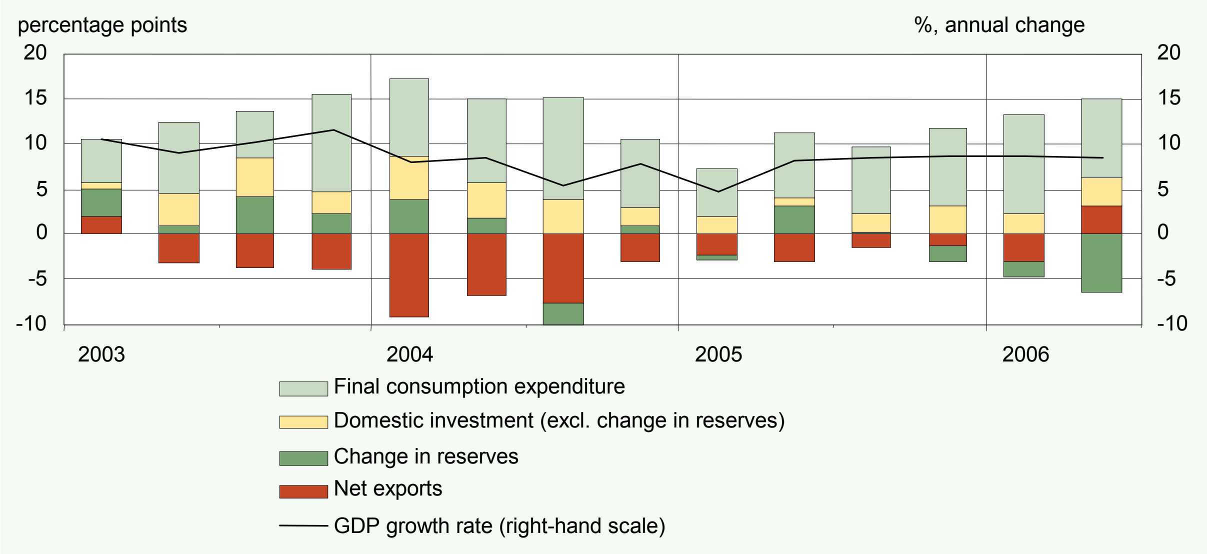
Sources: Statistics Department under the Government of the Republic of Lithuania (hereinafter referred to as Statistics Lithuania) and estimates by the Bank of Lithuania

Due to still very low interest rates and an increasing total corporate profitability in the country, investment in gross fixed capital continued to grow rapidly, although the growth rates were lower than several years ago (mainly due to the basis of comparison effect). In the environment of high domestic demand and shortage of labour force, investments play a particularly important role in promoting sustainable economic growth: they are expected to ensure a growth of the economic potential and to avert the danger of economic "overheating". It must be pointed out, however, that recently investment in buildings and constructions dominated over investment in equipment and other capital goods. Effective investments will be promoted by allocating EU structural funds support.

Foreign trade volumes continued to grow rapidly, driven by favourable external environment and high domestic demand. After a long break, the impact of real net exports on real GDP growth became positive in the second quarter of 2006. A rapid growth of nominal exports shows that competitiveness of Lithuanian producers has not dropped despite the growth of prices of raw materials and a higher demand for labour force in the market. On the other hand, a potential drop of competitiveness is partially offset by EU grants for exports outside the EU.

Economic growth is quite well balanced, i.e. activity improves in all main sectors of the economy, which is welcomed. Almost all types of economic activity in the private sector continued to be developed in the environment of an exceptionally high domestic demand. Favourable external conditions also contribute to the rapid growth of exporting sectors of the economy. Large budgetary inflows stimulated by an overall economic upswing facilitated the improvement of activity in sectors financed with government funds. Manufacturing industry remained the largest contributor to the economic growth, followed by the chemical industry, production of fertilisers, furniture and food industries, which demonstrated a rapid growth of real sales. In contrast, producers of electric and optic equipment, the textile and extracting industries and agriculture faced difficulties or quite large uncertainties regarding future prospects. Real activity in the construction sector grew at a particularly high pace (cf. real annual growth of value added was 19.1% in the first quarter of 2006). A rapid growth of real activity was also observed in real estate and financial intermediation sectors. Market services and public sector economic activities demonstrated moderate yet robust growth, except for maybe education where real value added was 7% lower in the second quarter of 2006 than in the corresponding period of 2005.

Fig. 2. Factors of change in real GDP (by production approach)



Sources: Statistics Lithuania, estimates by the Bank of Lithuania

Future capacity of producers to satisfy the high domestic demand will largely depend on sufficiency of labour force as one of the most important factors of production. In the past quarters, labour market has been very dynamic, with the overall situation in the market being very tense. Due to the shortage of skilled labour force and emigration, wages grow faster than labour productivity (in the second quarter of 2006, the average monthly gross wages were 14.1% higher, whereas real labour productivity was only 6.3% higher than a year ago). Unemployment has been decreasing very rapidly recently. In the second quarter of 2006, the level of unemployment dropped to its record lows (5.6% compared to 8.5% a year ago). Labour market also underwent certain structural changes, such as an active shift of labour force from less productive sectors of the economy to those which are currently very active yet affected by larger cyclical fluctuations (e.g. construction, real estate, trade).

Economic growth can be said to be more or less balanced, i.e. different sectors of the economy grow evenly, although the likelihood of a slowdown is growing. This can be judged from the increasing tension in the labour market, growing CAD, excessive consumption financed, for a considerable part, with future income, high uncertainty in the real estate market, etc. There are certain changes in financial and property markets, namely a continuous tightening of the ECB monetary policy position and changes in real estate prices that will affect real economic activity. The relaxation of tension in the oil market has slightly reduced the risk that changes in oil prices can undermine economic growth in the medium term. Factors injecting optimism about future economic development include the recent recovery of exports which shows domestic producers are quite competitive, also the gradually accelerating absorption of EU structural funds, the increasing business transparency, the decreasing disbalance in the tax system attributable to a tax reform, and the favourable external environment.

In the period 2006-2009 and later, domestic demand will continue to be a strong driver of economic growth, and Lithuania's export performance will remain on a positive track. The growth of nominal exports will be stimulated by the recovery in the EU market. However, both the need to modernise production of export goods and the growing personal income will promote the development of imports, which will mean a negative balance of goods and services in the reference period.

Domestic lending opportunities and EU financial assistance will create conditions for more active investments. With stronger investor confidence in the stability of the economy, investments will account for an increasingly large share of GDP. At the end of the reference period, the share of gross fixed capital formation will account for over 23% of GDP.

A positive impetus to consumption in the reference period will be provided by the accelerating growth of wages, decreasing unemployment and labour taxation, the opening of EU labour markets, transfer of earnings to Lithuania, and by particularly positive consumer expectations about economic development. The nominal value of final consumption expenditure is projected to grow at about 10.4% on average in the period 2006-2009. A larger part of population will have to spend a large share of their additional income on heating the cost of which is expected to more than double as a result of higher prices of imported gas. But the continued active consumption will facilitate growth of wholesale and retail trade; however, with the "cooling" of the economy projected for the end of the reference period growth in this sector will come close to growth in other sectors.

Export-intensive industries will remain the key contributor to sustainability of economic growth.

Table 5. Macroeconomic prospects

	ESA* code	Level in 2005	rate of change, %				
			2005	2006	2007	2008	2009
Real GDP	B1*g	66315.4	7.6	7.8	6.3	5.3	4.5
Nominal GDP	B1*g	71200.1	13.8	14.4	10.0	8.1	7.0
Components of real GDP							

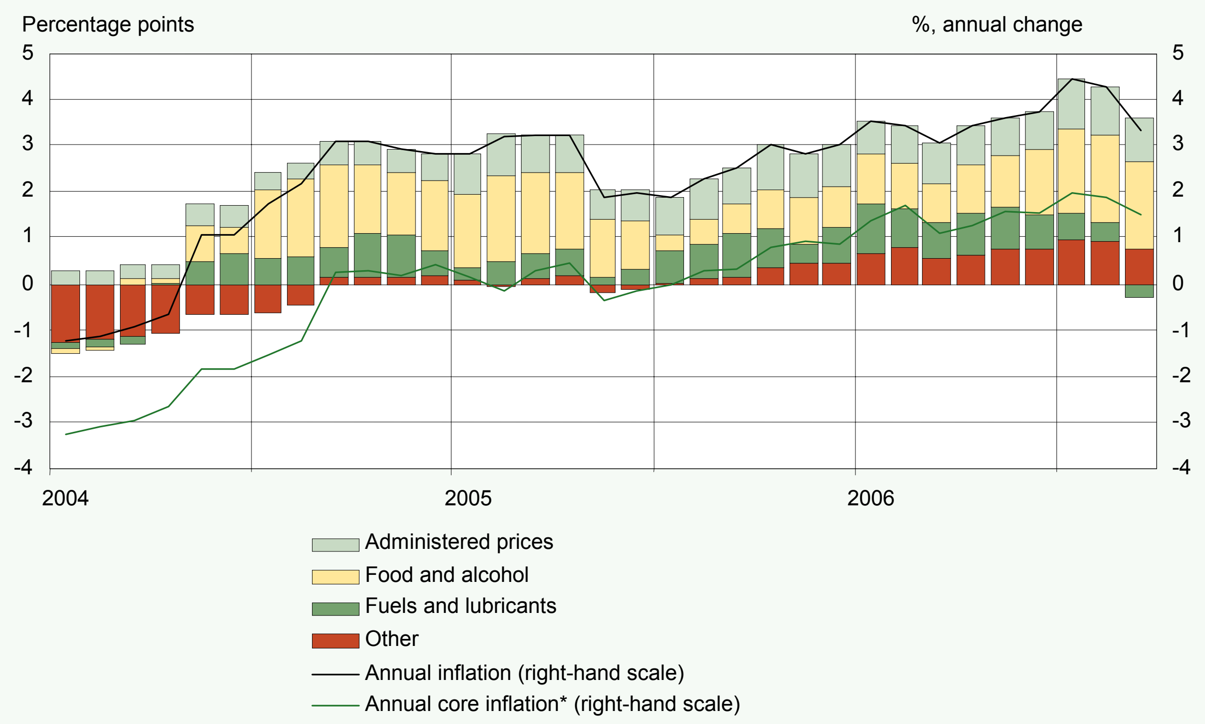
Household consumption expenditure + NPISHs	P.3	44367.6	9.8	10.5	7.0	6.6	6.3
General government consumption expenditure	P.3	11927.5	4.9	6.2	2.5	2.5	2.5
Gross fixed capital formation	P.51	15517.8	9.2	15.0	6.5	5.7	6.9
Changes in inventories and net acquisition of valuables (% of GDP)	P.52+P.53	11.6	3.9	4.9	4.8	4.4	4.2
Exports of goods and services	P.6	37850.5	14.5	13.2	6.8	7.8	7.6
Imports of goods and services	P.7	47530.0	16.0	14.9	6.5	7.3	8.7
Contributions to real GDP growth							
Final domestic demand		–	10.2	11.0	7.1	6.3	6.6
Changes in inventories and net acquisition of valuables	P.52+P.53	–	3.6	-0.7	0.3	-0.2	0.0
Balance of goods and services	B.11	–	-6.8	-3.2	-0.9	-0.9	-2.1

Sources: Statistics Lithuania, Ministry of Finance
*European System of Accounts.

Stability of prices

17. After a short increase in July and August 2006 when inflation measured by the Harmonised Index of Consumer Prices (HICP) reached 4.4-4.3%, annual inflation dropped to 3.3% in September 2006. In the first half of 2006, annual inflation fluctuated at about 3.4-3.7% (except in March when inflation dropped to 3.1% due to the "base effect"). From the beginning of the year, changes in prices of most inflationary goods and services, i.e. prices of food products, fuels and administered prices, were accountable for 2.9 percentage points of annual inflation on average, whereas price changes of the remaining goods and services were accountable for 0.8 percentage points only.

Fig 3. Factors of change in the annual inflation by HICP



Sources: Statistics Lithuania, estimates by the Bank of Lithuania
** HICP, excl. food, fuel and lubricants, and administered prices*

The accelerating rise of food prices was offset by a slower growth of fuel prices which even fell in September. Since the beginning of the year, the inflationary impact of food prices has almost doubled, to reach 1.9 percentage points in September and account for over 50% of annual inflation. Particularly unfavourable weather conditions in summer 2006 limited food supply both in and outside Lithuania. However, it should be noted that the particularly rapid growth of domestic demand and the growing tension in the labour market (which is a very painful problem for the retail trade) create extremely favourable conditions to raise prices.

The decreasing impact of fuel prices is directly associated with oil prices that have been going down for some time (down by about 13.8 USD/barrel in August and September).

As administered prices account for quite larger share of the HICP, administrative decisions have a fairly large inflationary impact. (Prices of goods and services which are sensitive to administrative decisions accounted for 17.8% of the consumer goods and services basket in 2005. This includes prices of water supply (0.42%), sanitary and sewage services (0.76%), electricity (2.76%), natural gas (0.6%), heating (3.62%), medical and pharmaceutical goods (3.1%) and services (0.3%), passenger transportation by railways and roads (1.99%), postal services (0.02%), and education services (0.5%)).

In the first three quarters of 2006, the impact of administered prices on annual inflation was more or less stable (about 0.9 percentage points), but it is projected to grow in the end of the year. Three important factors played a role in 2006: higher prices of gas, heating and medical services. From 1 January and from 1 July 2006, the Russian company *Gazprom* raised prices of natural gas sold to Lithuania. Decisions taken by the National Control Commission for Prices and Energy authorising domestic enterprises to raise natural gas prices accordingly has increased annual inflation by 0.4 percentage points in January-September 2006.

Seeking to raise wages for medical staff, rates of fees for medical services were further increased in January and May 2006. For this reason, prices of medical services were about 11.7% higher in the first half of 2006 compared to the previous year. The higher prices of medical services were accountable for 0.08 percentage points of annual inflation of January-June 2006.

With the growth of natural gas prices in the fourth quarter of 2006, the inflationary impact of administered prices will grow significantly, mainly due to growing heating prices. Pursuant to the decisions already adopted by the National Control Commission for Prices and Energy, heating prices will grow in the second half of 2006 in Vilnius (16.3%), Druskininkai (33%), Akmenė (39.3%), Ukmergė (34.4%), Mažeikiai (18.8%), Šakiai (11.5%), and Panevėžys (11% for private users). These decisions are projected to have the largest impact in the beginning of the heating period. As gas and heating prices account for a fairly large share of the consumer prices basket, they will have quite a large impact on the HICP growth rate (about 0.6-0.7 percentage points).

Growing prices of energy resources (prices of imported gas are projected to more than double in the next two years), Lithuania's commitments to raise excises, solution of the issue of compensations for personal deposits and real estate, upward trends of wages will all accelerate inflation in the medium term. For a large part, inflation grows for objective international reasons, not government decisions. Inflation caused by higher natural gas prices alone will be about 0.9 percentage points in 2006 and 1.7 percentage points in 2007 (of which 1.3 percentage points will be owing to higher heating prices and 0.4 to higher household gas prices).

Table 6. Price developments

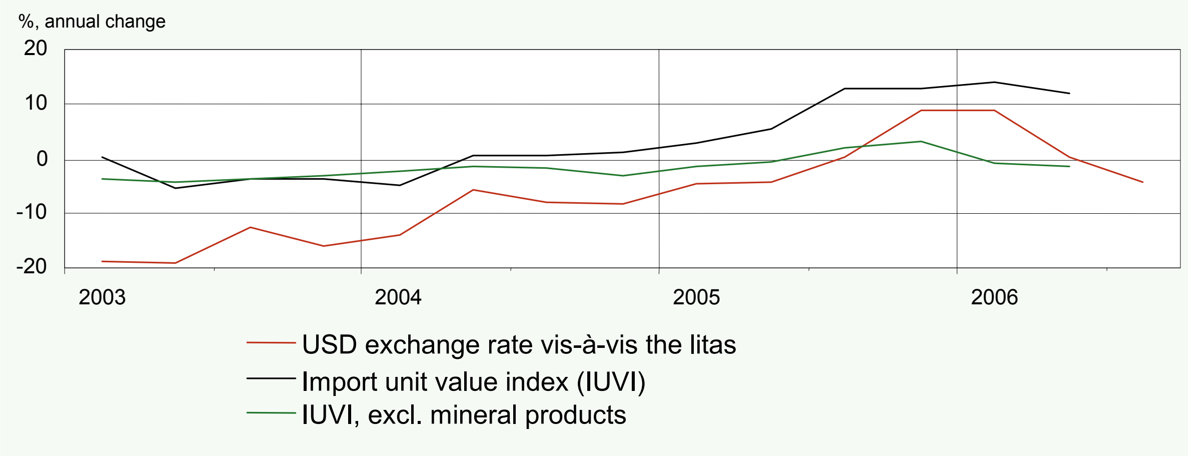
Indicator	ESA code	Level in 2005	rate of change, %				
			2005	2006	2007	2008	2009
1. GDP deflator		107.4	5.8	6.0	3.5	2.6	2.5
2. Private consumption deflator		104.8	3.7	4.0	3.8	3.0	2.7
3. HICP (average annual change)		100.0	2.7	3.9	4.7	3.4	3.1
4. General government consumption deflator		99.6	1.0	4.0	3.8	3.0	2.7
5. Investment deflator		92.4	8.9	15.4	6.7	1.0	1.1
6. Export price deflator (goods and services)		109.6	11.0	10.2	4.0	2.5	2.5
7. Import price deflator (goods and services)		97.8	8.1	11.2	5.5	2.5	2.5

Sources: Statistics Lithuania, Ministry of Finance

Annual core inflation (annual inflation according to the HICP, excluding the effect of food, administered and fuel prices) has been gradually growing since mid-2005 yet without exceeding 2% and has eventually stabilised in the past months. The largest impact on core inflation was caused by higher prices of market services. This could in part be associated with wages that grew faster than labour productivity in the environment of high domestic demand. On the other hand, growth of unit labour costs varied greatly from sector to sector, with the largest growth recorded in those sectors where goods and services do not form part of consumer basket or have a very low comparative weight (e.g. construction, real estate, education, health-care). For this reason, core inflation is influenced only by indirect growth of unit labour costs with slow and insignificant effect.

In 2006, growth of inflation was limited by decreasing prices of many imported goods. Excluding the impact of prices of oil products, import prices were about 1% lower in the second quarter of 2006 than a year ago. Compared to the average price level of the previous year, the largest decrease of prices was recorded for imported clothes, radio and television equipment, and computers. The largest growth of prices (excluding oil products) was recorded for imported agricultural products, tobacco products, and motor vehicles.

Fig. 4. Dynamics of imports prices and USD exchange rate



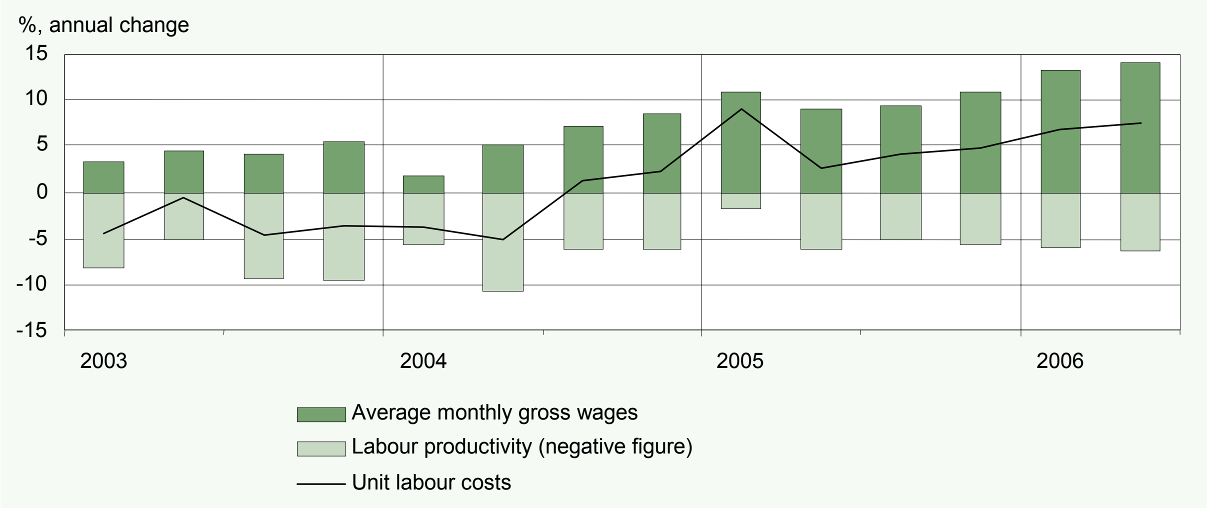
Note: IUVI, excl. mineral products, data for the period from the first quarter of 2006 is not absolutely comparable with the data for the period before 2006

Sources: Statistics Lithuania, estimates by the Bank of Lithuania, news agency "Bloomberg"

The growth of producer prices of industrial production sold in the domestic market (hereinafter referred to as domestic producer prices) has slowed down in the past months, to account for 7.4% in August. As in the previous periods, changes in producer prices were caused by changes in oil product prices. However, decreasing oil prices reduced this impact in 2006. Excluding the impact of oil products, annual inflation of domestic producer prices was more or less stable in the first half of 2006 (about 4.3-4.8%), followed by a jump to over 5% in July and August. This jump was mainly owing to higher prices of gas supply from 1 July and more expensive heating services in Vilnius.

Tension in the labour market coupled with other factors (such as administrative decisions and the presumed decrease of illegal wages) has inspired a further rapid growth of average wages. In the second quarter of 2006, annual growth of wages was 14.1% (cf. 9% in the same period a year ago).

Fig. 5. Wages, labour productivity, and unit labour costs



Sources: Statistics Lithuania, estimates by the Bank of Lithuania

Growth of wages has been surpassing growth of labour productivity for eight quarters in turn. In the second quarter of 2006, annual growth of unit labour costs was 7.4%. Growth of unit labour costs was caused by the growth gap between wages and productivity in the construction and real estate sectors and in branches of market services: trade, hotels and restaurants. The particularly rapid growth of unit labour costs might start exerting a higher pressure on consumer prices. It should be noted that the growth of wages would also be inspired by a presumed reduction of “envelope wages”.

In future periods, a rise of prices of services will have a crucial impact on underlying inflation, because an increasingly expensive labour will account for an increasingly large share of the cost of services, and the global competition and rapid advancement of production will force prices of clothes, footwear and household appliances down. The nature of the current inflation differs in principle from that of the ninth decade. The current inflation may not be prevented by accumulating a reserve, as the value of long-term consumption goods will continue to be subject to international competition. The only way to maintain the current purchasing power of income is to make more prudent investment in productive sectors or in factors of production.

Labour market

18. Confidence in macroeconomic stability has promoted private investment and consumption; therefore, over the period from the second quarter of 2001 to the second quarter of 2006, the number of the employed has grown by 9.4%: 12.2% in urban areas and only 3% in rural areas. Over the reference period, unemployment has shrunk by 11.2 percentage points. 68% of this decline is associated with the growth of employment; growth of employment in urban areas alone accounted for 60% of the overall decline of unemployment in the country. 32% of the decline of unemployment is attributable to shrinkage of labour force. Labour force has shrunk by 3.6%; to a certain extent, this shrinkage was probably caused by emigration. In

rural areas, labour force shrank twice as fast as in urban areas: by 2.8% in urban areas and by 5.6% in rural areas.

Lithuania's labour market increasingly integrates into the EU single market, which makes it possible to expect positive developments for employees.

Table 7. Labour market developments

Indicator	ESA code	Level in 2005	Rate of change, %				
			2005	2006	2007	2008	2009
1. Employment, persons (thou)		1473.9	2.6	3.2	0.5	0.3	0.3
2. Employment, hours worked		2750419	5.4	–	–	–	–
3. Unemployment rate (%)		8.3	-3.1	5.3	4.9	4.9	4.9
4. Productivity (real GDP per person employed)		43231.6	7.1	8.0	6.3	5.3	4.4
5. Labour productivity (real GDP per hour worked), LTL		35.92	3.4	–	–	–	–
6. Compensation of employees, m LTL	D.1	28616.2	13.4	14.7	14.9	12.1	6.9

Sources: Statistics Lithuania, Ministry of Finance

It is assumed that emigration will not retard the growth of the number of people employed and will continue to improve the current account of the balance of payments in Lithuania. Growing demand for labour force, increasing productivity, growing minimal monthly wages, improving market expectations and price convergence after accession to the EU will bring changes in wages. Trends that started in 2004 are projected to continue, meaning a further growth of average monthly gross wages from LTL 1276.2 in 2005 to LTL 1991.5 in 2009. Growth of wages will make it possible to reward gradually the employed population for the high labour productivity achieved in previous periods. It is projected that labour productivity and wages will grow at similar rates, by about 100%, from 1999 to 2009. In other words, both indicators will double.

Re-training and re-allocation of labour force from low productivity sectors to higher productivity sectors will become an important GDP growth factor capable of preventing a shortfall of labour force in the medium term.

Owing to a growing demand for labour force, unemployment is projected to shrink from 8.3% in 2005 (according to the data of an unemployment survey) to 4.9% in 2009.

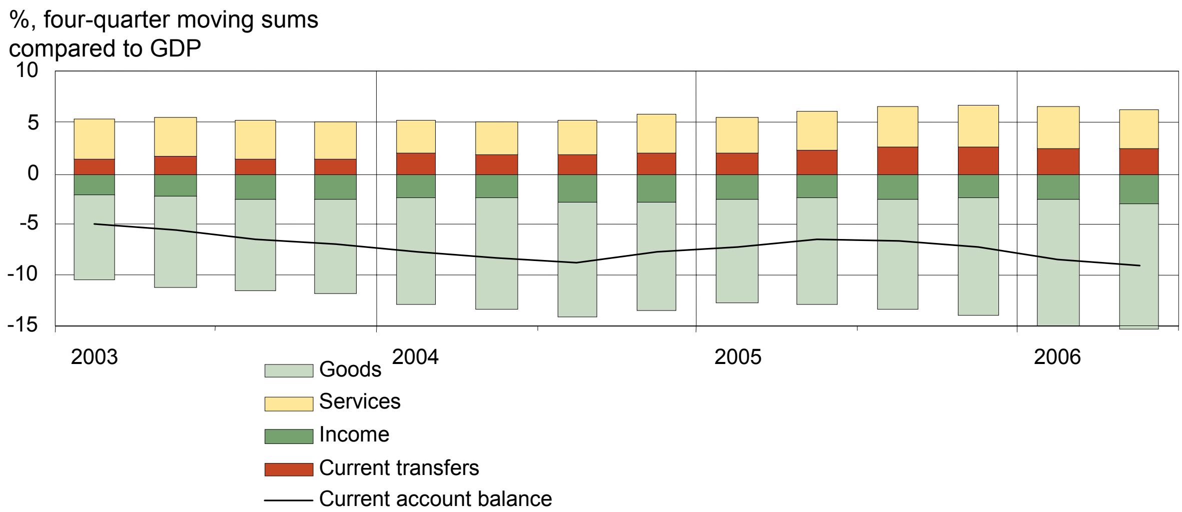
Balance of payments

19. In the first half of 2006, current account deficit (CAD) of Lithuania's balance of payments accounted for 10.3% of GDP. In the same period of the previous year, CAD accounted for 6.5% of GDP. The current account balance was negatively affected by dynamics of all its key components. Because nominal import of goods grew faster than export, foreign trade deficit has grown by 1.6% of GDP over a year, to reach 12.4% of GDP in the first half of 2006. Deficit of the balance of income grew by 1.3% of GDP, mainly due

to higher re-investments by non-residents. The fact that foreign entities opt to re-invest their profits (rather than paying dividends) shows that foreign entities are content with investment returns in Lithuania. In the first half of 2006, the GDP-relative surplus of the balance of services fell by 0.6% of GDP, for several reasons. First, volumes of cargo transportation by railways decreased. Second, higher wages of cargo drivers and a larger shortage of drivers have reduced competitiveness of the Lithuanian carriers, resulting in lower growth rates export of services. Third, a fairly rapid growth of the purchasing power has increased Lithuanians' spending on travelling abroad. As for the export of services, the main growth factor was export of merchanting and trade-related services associated with penetration of Lithuania's sales networks into foreign markets. In the first half of 2006, the flow of current transfers fell by 0.3% of GDP, mainly due to lower transfers by natural and legal persons.

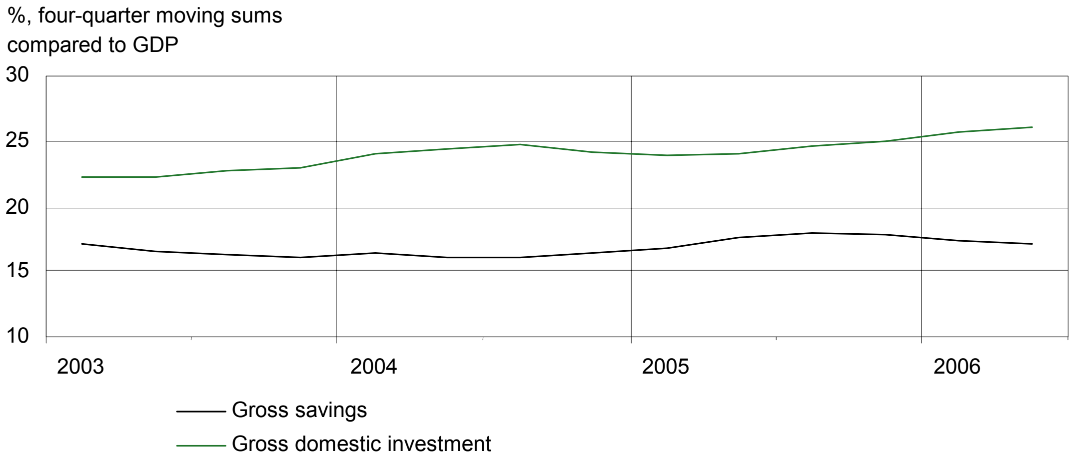
In the second quarter of 2006, the four-quarter moving sum of the CAD equalled 9% of GDP. The key factors of growth of the four-quarter moving sum of the CAD include the growth of foreign trade deficit and the growth of deficit of income on equity (mainly re-investments).

Fig. 6. Components of the current account balance



Sources: Statistics Lithuania, Bank of Lithuania, estimates by the Bank of Lithuania

Fig. 7. Structural factors of the current account deficit

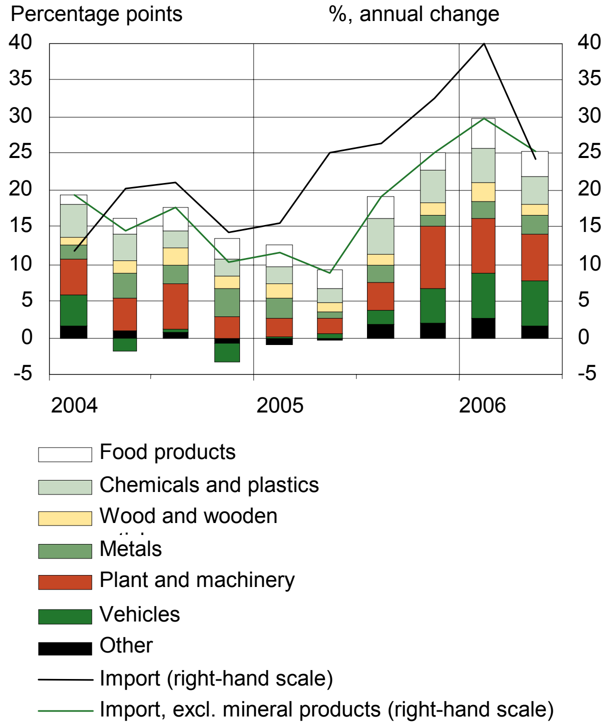


Sources: Statistics Lithuania, Bank of Lithuania, estimates by the Bank of Lithuania

Analysis of factors influencing the balance of savings and investments reveals that the growth of the CAD and GDP ratio is determined by decreasing gross savings and increasing gross domestic investments.

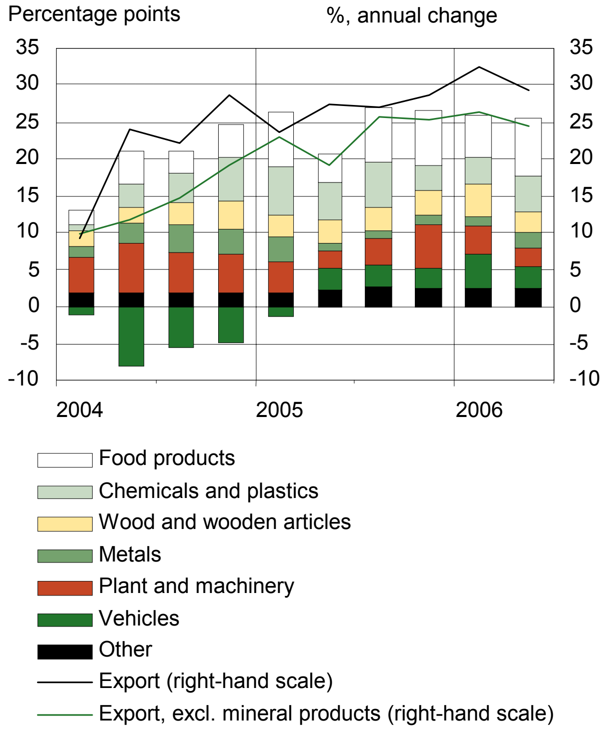
In the first half of 2006, nominal imports grew at the rate of 31.2% year on year, or 27.4% if mineral products are excluded. With the slowdown of import of mineral products in the second quarter of 2006, imports exclusive of mineral products grew faster than total imports, i.e. 25% and 24% year on year, respectively. In the second quarter of 2006, all imports, excluding mineral products, were equally increased by import of vehicles and equipment (6.1 and 6.2 percentage points, respectively). The key factor causing changes in the import of vehicles was a still growing demand for cars both domestically and in the neighbouring states. In foreign trade statistics, this is reflected as re-exports. The dynamics of import of machinery was caused by growing consumption expenditure and investment. This has contributed to the growth of import of electric devices from Poland and China and industrial equipment from Germany. Import of the above-mentioned goods makes it possible to increase the production potential and competitiveness in the short and medium term.

Fig. 8. Factors of change in the annual import growth



Sources: Statistics Lithuania, estimates by the Bank of Lithuania

Fig. 9. Factors of change in the annual export growth

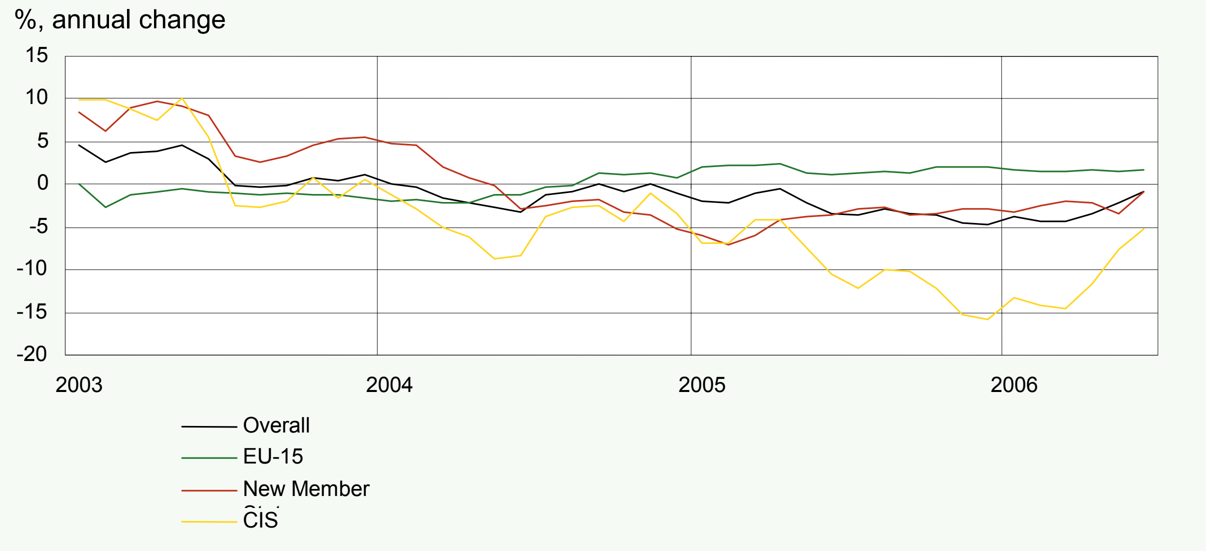


Sources: Statistics Lithuania, estimates by the Bank of Lithuania

In the first half of 2006, nominal exports grew at the rate of 30.9% year on year, or 25.2% exclusive of mineral products. In the second quarter of 2006, the annual growth rate of exports was a bit slower than in the first quarter and stood at 29.3%, or 24.3% exclusive of mineral products. In April-June 2006, Lithuania's export growth was driven by changes in external demand and internal supply. External demand was positively stimulated by the demand for used cars in Russia and the expanding food market. The export boom for cars (in Lithuania, the annual growth rate of export of surface vehicles was 56.6%) was also contributed to by the increased demand for cars in Kazakhstan. In total, export of vehicles has added 2.9 percentage points to the total exports (exclusive of oil). The main factor that has increased internal supply and stimulated export dynamics was a sale of more cattle by farmers (due to bad weather conditions). This has increased export of animal products to Russia and some EU countries. In total, export of food products has added 7.8 percentage points to Lithuania's total exports (exclusive of oil). In the second quarter of 2006, Lithuania's producers of plastics were particularly competitive: a historically high annual growth rate of exports grew further to 70.1%, while export of plastic products to Poland, one of the largest producers of plastics in Europe, almost tripled. Growth of export of plastic products was mainly driven by activities of producers operating in Klaipėda free economic zone (FEZ). In the second quarter of 2006, export of chemicals and plastic products added 4.7 percentage points to the total exports exclusive of mineral products.

In the first half of 2006, the real effective litas exchange rate vis-à-vis all foreign trade partners fell by 3.2%. Because inflation in Lithuania was larger than in the EU-15, the real effective litas exchange rate vis-à-vis the EU-15 grew by 1.6% year on year. In contrast, the real effective litas exchange rate vis-à-vis the new EU Member States fell by 2.4%, as inflation in Lithuania was lower than in these states. In the first half of 2006, the real effective litas exchange rate vis-à-vis the CIS countries fell by 11.1%. In June 2006, the annual decline of this indicator was only 5.4%, mainly due to the depreciation of the U.S. dollar exchange rate vis-à-vis the euro.

Fig. 10. Real effective exchange rates index of the litas, by country group

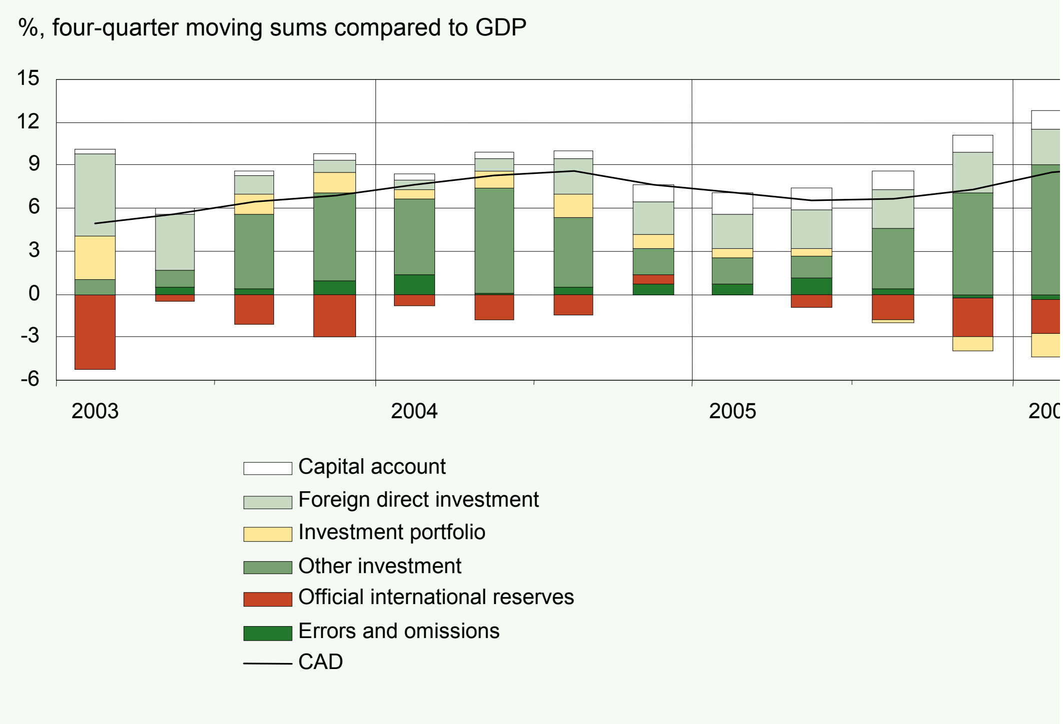


Source: Bank of Lithuania

In the first half of 2006, other investments dominated by long-term liabilities of commercial banks to the leading banks were traditionally the main source of CAD financing. Foreign-debt-neutral capital flows, i.e. foreign direct investment (FDI) and capital account, financed 27.5% of the CAD, compared to 77.2% a year ago.

Analysis of four-quarter moving sums reveals several tendencies. A fairly stable GDP ratio of capital account is mainly ensured by a generally stable flow of non-repayable transfers of capital from EU support funds. Decreasing GDP share of FDI flows is a result of lower FDI flows to Lithuania and higher investments by Lithuanian entities in foreign countries (mainly in the form of loans to secondary companies). In the first half of 2006, FDI flows in Lithuania fell by 18.4% compared to the corresponding period of the previous year. Over a year, the moving sum of FDI in Lithuania has dropped from 3.6% to 3.4% of GDP. Changes in the structure of FDI in Lithuania, such as stable flows of equity capital and growing re-investments, show that investors are content with investment returns; this notwithstanding, investment in share capital does not grow for certain reasons (e.g. shortage of labour force). In the second quarter of 2006, the four-quarter moving sum of the investment portfolio went down to –1.7% of GDP. A year ago, this indicator stood at 0.5% of GDP. The downward trend of net flows of the investment portfolio was mainly owing to investments by commercial banks in debt securities of foreign states. A rapid growth of lending forced commercial banks to continue borrowing abroad. In the second quarter of 2006, the four-quarter moving sum of long-term and short-term liabilities of commercial banks was 9% and 3.2% of GDP, respectively. As the majority of these loans have been taken from leading institutions, the probability that commercial banks will face liquidity risks is low.

Fig. 11. Financing sources of the current account deficit



Source: Bank of Lithuania

New “green field” investment in Poland and Slovakia and the EU accession of Romania and Bulgaria, countries with large and cheap labour force, prompt the conclusion that Lithuania’s economy will have a competitive advantage over these countries only if new advanced programmes of promotion of investments are implemented.

Table 8. Sectoral balances

Indicator	ESA code	% of GDP			
		2005	2006	2007	2008
1. Net borrowing	B.9N	-5.8	-6.6	-7.5	-7.0
of which:					
- balance of goods and services		-7.3	-9.4	-10.4	-10.2
- balance of income and transfers		0.2	0.9	0.6	1.0
- capital account*		1.3	1.9	2.2	2.2
2. Net surplus (+)/deficit (-) of the private sector		-5.3	-5.4	-6.6	-6.5
of which:					
- corporate sector		-	-	-	-

Indicator	ESA code	% of GDP			
		2005	2006	2007	2008
- households and NPISHs		-	-	-	-
3. Net surplus (+)/deficit (-) of general government	B.9N	-0.5	-1.2	-0.9	-0.5
4. Statistical discrepancy		-	-	-	-

*Sources: Ministry of Finance, *Bank of Lithuania*

The current level of the CAD raises no concerns given the rapid economic growth and the relatively low total external debt. The CAD is projected to account for 8.6-9% of GDP in 2006.

Risk-related aspects of economic development

20. In its Financial Stability Review of 2006, the Bank of Lithuania states that "over the medium-term, the risk stems from the existing imbalances in the real estate market, potential correction of asset prices and a significant slowdown in the growth of the national economy". This statement is a cornerstone of the macroeconomic projections used in the planning of the budget for 2007. The potential GDP growth will remain close to 6%; however, the existing risk factors may significantly retard economic growth in the medium term, and the future of the economic sectors which have recently experienced a boom will depend on their flexibility with regard to real estate prices. The return of real estate prices back to economically justified levels might slow down GDP growth by several percentage points.

21. Cyclical impact of credit increase on the demand has reached such a level that in the light of a change of an economic cycle and a faster slowdown of credit increase, the upward impact of EU support on the demand would be capable of compensating these cyclical slowdowns only in part. Therefore, further consistent implementation of prudent general government fiscal objectives would be very important for economic risk management.

22. The issues of "overheating" and two correction scenarios, "slow cooling" and "sharp decline", which are discussed in macroeconomic overviews by commercial banks, show that medium-term economic risks depend on the country's capacity to get prepared for natural economic cycles in time and efficiently.

In their macroeconomic overviews, commercial banks project that "this year interest rates clearly started climbing a mountain the top of which is difficult to see yet", which suggests that economic entities might have to expand their financing strategies with new solutions aimed at managing the risk of growth of interest rates.

23. Inflation may increase in the medium term due to a faster growth of wages prompted by the "heating" of the economy. However, there is a positive risk of reoccurrence and persistence for some time of the downward movement of oil prices as in September 2006.

If this is the case, annual inflation of the month in question will be 0.1-0.3% lower than projected.

Persistence of expectations for a strong rise of prices and a faster growth of wages could change consumer behaviour and increase nominal GDP growth and the CAD of the balance of payments by several percentage points. Growth of wages and nominal GDP could also be several percentage points higher if credit growth went up, rather than down.

24. If IMF concerns about the likely correction in “heated” neighbouring economies proved true and commercial banks changed their credit supply policies too quickly, Lithuania’s economic growth in the years of correction would be several percentage points slower, but would subsequently come equal to the high potential GDP growth.

25. In recent years, Lithuania’s exports of goods were impressively growing as a result of growth of re-exports and prices of oil products. Re-exports to Eastern markets, which collect more income due to higher oil prices, have improved Lithuania’s foreign trade indicators by about 10 percentage points. Rising prices of oil products consequential on higher oil prices have also improved general export indicators by about 10 percentage points. Therefore, if oil prices go down, Lithuania’s general exports may experience a sudden delusive slowdown, although export of products of Lithuanian origin will maintain its recent stable nominal growth of 6-9%. Risks posed by changes in oil prices should not be viewed as a background in assessing the economic outlook for Lithuania.

III. PUBLIC FINANCES

Financial policies

26. The medium-term objective is the reduction, by ensuring the implementation of economic policy priorities, of the structural deficit down to 1% or below in 2008 and further down in later years. Efforts will be made to balance government finances or run surpluses in the future, when the need for structural reforms is lower. Fiscal policy goals have been tightened in the light of faster-than-projected trends of nominal GDP growth.

27. The medium-term fiscal policy (macroeconomic policy) will be further geared towards the implementation of the following priorities:

27.1. to match the fiscal policy with the priorities of social policy;

27.2. to continue the tax reform aimed at balancing labour and capital taxation;

27.3. to promote further reforms in energy and agriculture;

27.4. to continue the pension reform ensuring a long-term sustainability of general government finances;

27.5. to create favourable conditions for the improvement of labour efficiency, improve competitiveness of the economy, attract more FDI, and successfully implement EU structural policies;

27.6. to keep, as far as possible, the impact of demand on prices under control, by pursuing an anti-cyclical fiscal policy.

Discussions about possibilities to reform higher education and studies are due in 2007. If higher education and studies reform were approved as a priority in 2007, the impact of these reforms on general government finances would be described in the next update of this Programme.

28. Seeking to maintain confidence in the currency board arrangement, Lithuania will, as part of its fiscal policy, further create favourable conditions for improving labour efficiency, improve tax administration, create favourable investment climate, and ensure effective use of public funds allocated for investment. Any additional general government revenue or unspent expenditure allocations will be used for the achievement of the fiscal deficit objective and for measures aimed at ensuring long-term sustainability of government finances.

29. *Actions planned for 2006 to 2008.* Once personal income tax reform has been implemented, i.e. a better balance is achieved between capital and labour taxation, there will be better conditions to develop human capital intensive industries and to implement Lisbon strategy goals in the labour market, by promoting job creation. Efforts will be made to ensure that the balance between labour and capital taxation is achieved without adding to the fiscal deficit and that it creates conditions to enhance business competitiveness.

In 2005-2006, Lithuania successfully mitigated negative effects of the shadow economy on general government finances. In the medium term, tax collection will continue to be further improved; therefore, the revenue plan is expected to increase by about 0.4% of GDP in 2007; any extra revenues will be used to achieve fiscal deficit targets. Further efforts will be made to ensure maximum efficiency of general government expenditure: investments and social transfers and, as far as possible, expenditure on health-care and education (as a percentage of GDP) will be increased.

An assumption is made that the agreement between parliamentary parties on fiscal discipline that is currently being discussed will facilitate the negotiations for additional structural measures aimed at managing the inflationary impact of demand and at achieving fiscal deficit targets. The aggregate impact of the additional measures is likely to help reduce fiscal deficit by 0.4% of GDP in 2007 and by about 1% of GDP in 2008 and 2009.

Actions planned for the period 2006-2008:

29.1. seeking that a balance between labour and capital taxation facilitates the achievement of fiscal deficit target;

29.2. making further efforts to mitigate the adverse impact of the shadow economy on general government finances and seeking to ensure that these efforts result in the augmentation of the planned income by about 0.4% of GDP in 2007;

29.3. seeking to ensure maximum efficiency of general government expenditure;

29.4. using unspent expenditure allocations for the achievement of fiscal deficit target;

The Government of the Republic of Lithuania has submitted to the Seimas of the Republic of Lithuania a draft law on the approval of financial indicators of the state budget and municipal budgets of 2007, which provides that state budget revenue collected in excess of the plan (except unspent funds under special programmes) will be used for the implementation of state budget deficit.

30. The rapid economic development is a proof that the fiscal policy pursued has helped to win confidence of local and foreign investors.

In 2001, the direction of fiscal policy was radically changed with a view to achieving fiscal consolidation. In 2000, general government fiscal deficit accounted for 3.2% of GDP, followed by a drop to 2.1% of GDP in 2001. The pension reform launched in 2004 and payments to the EU Own Resources have lessened possibilities to reduce fiscal deficit faster. As a result, general government budget deficit grew slightly (to 1.5% of GDP), and structural deficit grew to 1.8% of GDP in 2004.

Despite higher expenditure attributable to successful implementation of the pension reform in 2005, general government structural deficit was reduced to 1% of GDP. The tightening of general government fiscal deficit targets for 2005 was possible thanks to the implementation of measures aimed at improving tax administration. Lower nominal fiscal deficits in 2005 and 2006 were achieved thanks to supply which was financed with large and still accelerating credit increase and thus higher-than-projected growth of employment and wages. In the light of the faster growth of wages, employment and prices and the worsening of the current account, nominal fiscal deficit of 2006 is expected to be almost 1 percentage point lower than projected, mainly due to surplus in the social insurance sector. The application of the Hodrick Prescot (HP) filter approach for the calculation of structural deficit may produce a result that the structural fiscal deficit, calculated by using reference data, will continue to be close to the MTO. On the other hand, this positive trend might be corrected by an independent decision of municipalities to reduce their surpluses.

With the aim of ensuring that the target of 3% is not exceeded and social commitments for future pensioners are implemented as much as possible, and as the impact of tax reduction passes after the medium term, general government structural deficit will turn into surplus.

The structure of general government finances will change in the period 2005-2008 from that in 2004, mainly due to the impact of the tax reform on general government revenue and expenditure.

31. This Programme fundamentally changes general government financial projections owing to the following factors: the carry-forward to 2008-2009 of the use of funds allocated for fixed capital formation; the objective to further improve tax administration; tax measures necessary with a view to compensating a loss, caused by tax reduction, of structural budgetary revenues.

Table 9. General government budgetary (S13) projections, 2005-2009* (% of GDP)

	ESA code	Level in 2005	% of GDP				
			2005	2006	2007	2008	2009
1. General government	S.13	-371.2	-0.5	-1.2	-0.9	-0.5	0.0
2. Central government	S.1311	-751.1	-1.1	-1.6	-0.9	-0.5	0.0
3. State government	S.1312	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
4. Local government	S.1313	-36.9	-0.1	0.1	0.0	0.0	0.0
5. Social insurance funds	S.1314	416.8	0.6	0.3	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	23529.5	33.0	33.3	33.9	34.5	35.9
7. Total expenditure	TE	23900.7	33.6	34.5	34.8	35.0	35.9
8. Net lending/borrowing	B.9	-371.2	-0.5	-1.2	-0.9	-0.5	0.0
9. Interest expenditure	D.41	585.7	0.8	0.8	0.9	0.9	0.8
10. Primary balance		214.5	0.3	-0.4	0.0	0.4	0.8
Revenue components							
11. Total taxes (11=11a+11b+11c)		14439	20.3	20.7	20.7	20.3	20.5
11a. Indirect taxes	D.2	7950.7	11.2	11.8	12.1	12.3	12.5
11b. Direct taxes	D.5	6486.0	9.1	8.9	8.6	8.0	8.0
11c. Capital taxes	D.91	2.3	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	6088.8	8.6	8.1	8.3	8.7	8.8
13. Property income	D.4	532.6	0.7	0.5	0.6	0.6	0.6
14. Other (14=15-(11+12+13)		2469.1	3.5	3.9	4.3	4.9	6.0
15. Total revenue (15=6)	TR	23529.5	33.0	33.3	33.9	34.5	35.9
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		20527.8	28.8	28.8	29.0	29.1	29.2
Expenditure							
16. Collective consumption	P.32	5025.9	7.1	6.9	6.3	6.0	5.9
17. Social transfers	D.62+D.63	13259.5	18.6	16.9	19.3	19.2	19.0
17a. Social transfers in kind	P.31=D.63	6855.0	9.6	10.8	10.0	9.5	9.5
17b. Social transfers other than in kind	D.62	6404.5	9.0	8.8	9.5	10.0	10.1
18. Interest expenditure (18=9)	D.41	585.7	0.8	0.8	0.9	0.9	0.8
19. Subsidies	D.3	492.5	0.7	0.7	0.8	0.8	0.8
20. Gross fixed capital formation**	P.51	2471.1	3.5	3.7	4.2	4.5	5.1
21. Other (21=22-(16+17+18+19+20))		2065.9	2.9	2.9	2.8	3.1	3.3
22. Total expenditure (22=7)	TE	23900.7	33.6	34.5	34.8	35.0	35.9

Sources: Statistics Lithuania, Ministry of Finance

*Due to rounding, the sum of revenue and expenditure components may be different from the amounts given under “total revenue” and “total expenditure”.

** Figures marked with asterisks would be lower if EU support was absorbed more slowly than assumed.

In the medium term, general government revenue (as a percentage of GDP) will grow. Accounting for 33% of GDP in 2005, it will grow to 33.3% of GDP in 2006 and to 33.9% of GDP in 2007. According to the new financial perspective, EU support is likely to grow, making it possible to raise revenue to 35.9% of GDP in 2009.

The GDP share of revenue collected in indirect taxes will be on track for growth throughout the medium term. Improved tax administration will serve to increase indirect taxation revenue to 11.2% of GDP in 2006 and 12.1% of GDP in 2007. Despite a better administration of personal income tax and corporate income tax (i.e. profit tax), the reduction of the personal income tax rate will force direct taxation revenue down to 8.9% of GDP in 2006, which is 0.2% of GDP lower than in 2005, and further down by 0.3 percentage points in 2007. According to the basic scenario, the GDP ratio of tax revenues in 2007 and 2008 will go down as a result of tax and pension reforms. The downward movement of the GDP share of tax revenues will be somewhat slowed down by a faster-than-GDP growth of compensations to employed people, but only in part.

In 2005, the GDP share of total general government expenditure grew by 0.3 percentage points of GDP to 33.6% of GDP for the first time since 1997; this was owing to larger EU support, payments to the EU Own Resources and subsidies to agriculture. The absorption of the EU support funds and national investment will raise expenditure to 34.5% of GDP in 2006. The commitment under the Stability and Growth Pact to reduce structural deficit by about 0.5 percentage points of GDP annually does not affect plans to improve government finances. Gross fixed capital formation is expected to grow, owing to the absorption of EU support, from 3.3% of GDP in 2004 to 5.1% of GDP in 2009.

Government expenditure (as a percentage of GDP) will be slightly up owing to the Public Investment Programme and growing EU investment support. Fiscal discipline may be maintained by reducing, in the medium term, the share of government current expenditure. Once the planned projects are implemented, the share of social expenditure will account for over 9% of GDP and may exceed 10% of GDP in 2008-2009.

Successful implementation of the pension reform will make it possible to prepare for the reduction of government debt projected for 2050 and encourage private persons to individually save funds for the old-age pension. Tax revenues to be allocated in 2007 for the pension reform will settle at 0.9 percentage points of GDP.

Growing support for agriculture and implementation of tax and pension reforms call for additional funds. To be able to reach medium-term general government fiscal deficit objectives, collective consumption expenditure will have to be cut from 7.1% of GDP in 2005 to 5.9% of GDP in 2009. Support to agricultural entities financed from national resources will be increased by 0.1% of GDP compared with 2006, to account for over 0.8% of GDP in 2007.

Borrowings for repayments under previous commitments will increase interest expenditure from 0.8% of GDP in 2006 to 0.9% of GDP in 2007-2008.

32. *General government subsectoral balances.* Subsectoral balance of social insurance funds continued to run surpluses: a surplus of 0.6% of GDP was recorded in 2005.

Despite better-than-planned collection of municipal revenues in 2005 owing to better tax administration and faster growth of wages and employment, the overall local government subsectoral balance ran deficit. In 2005, local government subsectoral deficit was below 0.1% of GDP. In the medium term, a close-to-balance local government subsectoral balance is projected.

As a result of the structural and tax reforms carried out in recent years, the total general government deficit consisted of the central government subsectoral deficit, which accounted for 1.1% of GDP in 2005.

Owing to growing social transfers, the surplus of the State Social Insurance Fund will decrease; however, the growth of employment and wages makes it possible to expect larger social contributions.

A reduction of the central government subsectoral deficit will mean a reduction of the total general government deficit in the medium term.

The reduction of general government structural deficit by about 0.5% of GDP annually in the period 2005-2009 is shown in Table 13 below.

Structural deficit and sustainability of fiscal policy

33. New calculations suggest that the maximum cyclical fluctuation of general government deficit in the period 2000-2004 was 1.1% of GDP, which is more or less in line with the preliminary estimations by the EU Commission. In 2006, cyclical income will account for about 1 percentage point of GDP. By determined continuation of the expenditure-down and revenue-up policy, efforts will be made to force the cyclically-adjusted general government deficit down to 0.2% of GDP in 2009. The reduction of the cyclically-adjusted deficit will activate automatic stabilisers in the economic cycle.

34. *Estimation of the output gap.* The GDP cycle was estimated by applying the Hodrick Prescot (HP) filter approach. The results obtained point to a positive output gap in the medium term.

In 2006, the output gap will be 2.8%, followed by a drop to -2.7% in 2007, -1.9% in 2008, and 0.6% in 2009.

However, owing to short time-lines under the Hodrick Prescot filter approach or under the production function approach (using NAIRU), the estimate of Lithuania’s output gap is not absolutely accurate. Conclusions obtained under the production function approach (based on the NAIRU conception) are, for the time being, not acceptable owing to short time-lines, a lack of reliable data and a plenitude of structural breaks. The NAIRU approach ignores “structural shocks”. First, the recent rapid growth of constructions significantly contributes to cyclical reduction of unemployment, which, under the NAIRU approach, might be treated as permanent. Second, the European single labour market will affect cyclical fluctuations of employment: integration will reduce cyclical unemployment as a part of unemployed people may choose emigration. Cyclical unemployment might develop into permanent reduction of labour force.

Table 10. Cyclical developments

Indicator	ESA code	% of GDP				
		2005	2006	2007	2008	2009
1. Real GDP growth, %		7.6	7.8	6.3	5.3	4.5

Indicator	ESA code	% of GDP				
		2005	2006	2007	2008	2009
2. Net lending (+)/borrowing (-) of general government	B.9N	-0.5	-1.2	-0.9	-0.5	0.0
3. Interest expenditure		0.8	0.8	0.9	0.9	0.8
Potential GDP growth (%)		6.9	6.7	6.4	6.1	5.8
of which:						
- labour		N.A	N.A	N.A	N.A	N.A
- capital		N.A	N.A	N.A	N.A	N.A
- total factor productivity		N.A	N.A	N.A	N.A	N.A
5. Output gap		1.7	2.8	2.7	1.9	0.6
6. Cyclical budgetary component		0.5	0.8	0.8	0.5	0.2
7. Cyclically-adjusted balance (2-6)		-1.0	-2.0	-1.7	-1.0	-0.2
8. Cyclically-adjusted primary balance (7+3)		-0.2	-1.2	-0.8	-0.2	0.6

Sources: Statistics Lithuania, Ministry of Finance

The Hodrick Prescot (HP) filter approach has a disadvantage, in that it smoothes structural changes even when they show an obvious shift in the output. Moreover, this approach suffers from the so-called “end-point bias”. The weaknesses of the two approaches must be taken into account if they are to be used to estimate structural deficit. Neither approach is good enough to assess income received on a temporary basis as a result of a deepening external imbalance.

In the period 1995-2003, only one-third of the cyclical GDP fluctuation would turn into general government deficit. This feature of general government finances can be explained by a low elasticity of revenues in the presence of GDP fluctuations and a historically very low level of expenditure associated with unemployment in Lithuania.

Relying on the actual quarterly figures of general government budget revenues for the period 1995-2002 (period of observations 7 years), elasticity was estimated for customs duties, value added tax, excise, personal and corporate income taxes, and current expenditure.

As Table 11 below shows, revenue from tobacco has zero elasticity. It has been estimated that revenue from fuel is most elastic, i.e. consumption of fuel is very sensitive to income fluctuations. These elasticity estimates would have been more accurate, if their quality had not been affected by numerous changes in tax legislation. This Programme continues to calculate deficit by making stricter assumptions about cyclical fluctuations of current expenditures: the elasticity figure has been reduced from 0.97 to 0. If the historic link between a slowdown of the growth of general government current expenditure and GDP persisted, the share of the cyclical deficit would be as low as one-tenth of the output gap in the medium term.

The cyclically-adjusted general government deficit has been estimated by taking account of the macroeconomic and budgetary projections described in this Programme.

Table 11. Elasticity of general government budgetary revenues

ESA’95 code		Cyclical elasticity values
1. D.212	Duties	0,84

ESA’95 code		Cyclical elasticity values
2. D.211	VAT	0,97
3. D.214	Excises	1,36
	of which:	
	alcohol	1,09
	tobacco	0
	fuel	1,57
4. D5	Income and profit taxes	1,03
5. D61	Social contributions	0,98
6.	Current expenditure	0

Source: Ministry of Finance

Debt levels and developments

35. General government debt has been continuously decreasing in recent years to account for 18.7% of GDP at the end of 2005.

Government borrowing volumes are strictly regulated by annual laws on the approval of financial indicators of the state budget and municipal budgets, which set annual limits on the net borrowing by the Government of the Republic of Lithuania, on municipal borrowing and on government-guaranteed liabilities of guarantee-issuing institutions.

The largest part of general government debt consists of central government debt (about 96%), whereas municipal and social insurance funds debt account for only about 4%.

Central government debt has a rather conservative structure: 10% of the total debt consists of short-term liabilities (by outstanding maturity), and 2% of floating interest rate debt. Debt in foreign currencies with a floating exchange rate vis-à-vis the litas or the euro accounts for only 4% of the total debt. This structure of the debt portfolio poses quite low risks on public finances.

36. The key objective of the medium-term government debt management policy is to finance Government borrowing requirement, as laid down in laws of the Republic of Lithuania, at the lowest possible cost and with acceptable risk in the medium term, without exceeding the limits placed on government debt and on new borrowing and in line with the requirements imposed on the EU Member States seeking to adopt the euro.

37. The borrowing strategy of the Government of the Republic of Lithuania has not changed from that in 2005.

The largest share of the Government’s borrowing requirement in the coming years will consist of repayment of foreign and domestic debt and state budget deficit financing.

38. In the medium term, the Government envisaged implementing the following borrowing policy measures:

38.1. financing the Government’s borrowing requirement in the litas and the euro or other currencies to be converted to the litas or the euro using derivatives;

38.2. gradually reducing debt liabilities undertaken on behalf of the state and denominated in those foreign currencies, the fluctuations of which vis-à-vis the litas and the euro might cause adverse fluctuations in debt servicing costs;

38.3. financing the Government's borrowing requirement mainly by issuing GS on the domestic and foreign markets;

38.4. consolidating GS to be issued both domestically and on foreign markets into large issues, thus enhancing their liquidity;

38.5. using T-bills, credit lines, repos and other short-term borrowing instruments for cash management purposes.

39. *General government debt projections.* In 2006, general government debt is projected to go down to 18.4% of the projected GDP, to be followed by a slight increase to 19.2% of the projected GDP in 2007 and then by a continuous decline to 17.7% of the projected GDP by the end of 2009.

Table 12. General government debt projections

Indicator	% of GDP				
	2005	2006	2007	2008	2009
1. General government debt as of year-end	18.7	18.4	19.2	19.0	17.7
2. Change of general government debt	-0.8	-0.3	0.8	-0.2	-1.3
Contributions to change in general government debt					
3. Primary balance	0.3	-0.4	0.0	0.4	0.8
4. Interest	0.8	0.8	0.9	0.9	0.8
5. Debt change adjustment	-0.4	-0.7	0.8	0.2	-0.4
implicit interest rate on debt (%)	4.6	4.7	5.0	4.7	4.6
Other relevant variables					
6. Liquid financial assets					
7. Net debt (7=1-6)					

Source: Ministry of Finance

Implications of structural reforms on general government finances

40. The structural budget balance shows the likely difference between general government revenue and expenditure if the actual GDP equalled the potential GDP. Structural deficit is calculated with reference to the effect of the business cycle. Table 13 below may be used to calculate the shrinkage of the structural deficit in the light of structural changes in government finances such as the commencement of co-financing of EU support and the progress of the pension reform. It has been calculated, taking into consideration these structural financial changes and the temporary measures, that general government budgetary plans will facilitate the reduction of the structural deficit adjusted in the light of the structural reforms and temporary measures by 0.5% of GDP on average over 2005 and 2009. The required additional financial resources will be available thanks to better tax administration and other additional structural measures. The additional structural measures will be described in future updates of this Programme.

Table 13. General government structural and cyclical fiscal deficit projections

	Indicator	% of GDP				
		2005	2006	2007	2008	2009
1.	General government fiscal deficit target	-0.5	-1.2	-0.9	-0.5	0.0
2.	Cyclical fiscal deficit (-)	0.5	0.8	0.8	0.5	0.2
3.	Structural fiscal deficit	-1.0	-2.0	-1.7	-1.0	-0.2
4.	EC Own Resources	1.0	1.0	1.0	1.0	0.9
5.	Co-financing requirement	0.3	0.5	0.5	0.8	0.4
6.	Pension reform	0.4	0.6	0.9	0.9	0.9
7.	Structural deficit less the amount of payments to the EU Own Resources, co-financing requirement and loss of revenue or temporary revenue	0.7	0.1	0.8	1.6	2.1
8.	Structural measures implemented annually in general government, to fulfil the commitments under the Stability and Growth Pact	-1.4	0.6	-0.7	-0.9	-0.4

Source: Ministry of Finance

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Economic development risks and their budgetary implications

41. Budget projections are made herein on the basis of preliminary projections by the EU Commission made available prior to the update of this Programme.

A medium-term growth of floating and fixed market interest rates by one percentage point would mean an increase of the interest payable on the central government debt (including new borrowing) of LTL 48m in 2007, LTL 76m in 2008, and LTL 85m in 2009, respectively, or about 0.1% of GDP on average.

42. There is a risk that market expectations about economic development aroused delusively by the impression of success in recent years will serve to accelerate credit increase and broaden the gap between the demand and the medium-term output potential. If this is the case, GDP, prices and wages will grow faster than projected, to be followed by a faster cyclical slowdown. The increase of credit levels has reached such a magnitude when the use of EU support alone is no longer capable of fully compensating cyclical fluctuations of the economy; therefore, the setting of prudent general government fiscal objectives and their consistent implementation is very important for economic risk management. For the time being, it is difficult to estimate accurately the loss of revenues; it is probable, however, that in the event of sudden external balancing of Lithuania's economy and disinflationary processes, the loss of revenues will account for over one percentage point of GDP. An agreement between parliamentary parties on fiscal discipline that is currently being discussed will facilitate the negotiations for additional structural measures aimed at managing these risks.

43. If IMF concerns about the likely correction in "heated" neighbouring economies proved true and commercial banks changed their credit supply policies too quickly,

Lithuania's economic growth in the years of correction would be several percentage points slower, but would subsequently come equal to the rapid potential GDP growth. In times of unexpected slowdowns of GDP growth, growth of nominal fiscal deficit in the presence of favourable conditions for borrowing and without prejudice to the provisions of the Stability and Growth Pact could possibly be used as an economic stabiliser. Nominal GDP growth might also be slowed down by several percentage points by a return of real estate prices back to economically justified levels.

A risk of strong cyclical fluctuations is inherent not only in the acceleration of annual credit increase of up to 15% of GDP but also in unexpected sharp and too fast slowdown of credit increase or even reduction in credit volumes. A rapid slowdown of credit increase would imply a deeper subsequent phase of the economic cycle. Timely dissemination of information enables businesses to assess economic outlook realistically and is aimed at creating conditions for an early and manageable correction of GDP growth rates in the next years, ensuring a rapid and sustainable average GDP growth of 6% in later years.

The growth of wages is likely to be faster than projected, driven by a more rapid integration of Lithuania's labour market with trade partners from the EU. Since labour income marginal rates are higher than those of capital income, the GDP share of general government tax revenue would grow faster than projected and would thus contribute to a faster improvement of health care and education financing without prejudicing the Stability and Growth Pact regulations.

Fiscal risks

44. The main projected sources of fiscal risks include deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises, savings restitution, decommissioning of the Ignalina Nuclear Power Plant (hereinafter referred to as the Ignalina NPP), and reimbursement of the part of pension which has previously been cancelled for working pensioners (about LTL 180-200m).

45. *Deposit insurance*. As of 1 August 2006, the total amount of insured deposits was LTL 27375.04m or 33.6% of GDP.

46. *Savings restitution*. As of 1 October 2006, these commitments stood at LTL 1247.7m or 1.8% of GDP. In 2005, the Law of the Republic of Lithuania on Savings Restitution (*Valstybės žinios* (Official Gazette) No 58-1330, 1997; No 118-4266, 2005) was amended to provide for an additional source of funding, i.e. state budgetary funds and/or funds borrowed by the Government on behalf of the state within borrowing limits. Implementing Measures of the Government Programme 2006-2008 approved by Resolution No 1020 of 17 October 2006 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 112-4273, 2006) provide that payments to depositors of all groups defined in the Law of the Republic of Lithuania on Savings Restitution shall be fully made by the end of the fourth quarter of 2008. Allocations for compensation of savings will

amount to LTL 216m in 2006, LTL 534m in 2007, and LTL 614.6m in 2008. These amounts will be revised, if it is later decided to use, in addition to state budget allocations, borrowed funds for such compensation due in 2006.

47. *Restitution of real estate ownership rights.* The financing requirement for compensations to be paid for the land, forest area and bodies of water repurchased by the state totalled LTL 346.3m or 0.4% of the projected GDP as of 1 October 2006.

The financing requirement for the restoration of ownership rights to citizens for surviving residential houses, parts thereof or apartments, and for compensations to be paid to religious communities for the real estate repurchased by the state totals LTL 200m or 0.2% of the projected GDP in 2006 and LTL 72m or 0.1% of the projected GDP in 2007 (these amounts may be adjusted upwards as a result of correction of the value as prescribed by the Law of the Republic of Lithuania on the Amounts, Sources, Terms and Procedure for Payment of Compensation for Real Estate which is Repurchased by the State as well as on Government Guarantees and Privileges Provided in the Law on the Restoration of the Rights of Ownership of Citizens to Existing Real Estate (*Valstybės žinios* (Official Gazette) No 61-1728, 1998; No 102-4582, 2003). No funding in this area has been planned for 2008-2009 as yet.

Article 8.2 of the Law on the Amounts, Sources, Terms and Procedure for Payment of Compensation for Real Estate which is Repurchased by the State as well as on Government Guarantees and Privileges Provided in the Law on the Restoration of the Rights of Ownership of Citizens to Existing Real Estate provides that compensation payable to citizens in the current year shall be adjusted annually for inflation of the previous year, and Article 9.14 of the Law provides that to honour government guarantees in favour of tenants a re-assessment of the market value of residential premises leased must be performed.

48. *Decommissioning of the Ignalina NPP.* The operation of the Ignalina NPP and foreign financing for the termination of its operation entail certain risks. Expenditure allocations in the budget of the Ignalina NPP Decommissioning Fund total LTL 64m (0.1% pf GDP) for 2006 and LTL 39m (0.05% of GDP) for 2007.

Table 14. Allocations for the Special Programme of Administration of Support to Ignalina NPP (LTL thou)

	2006 budget	2007 preliminary budget	2008 preliminary budget	2009 preliminary budget
EU funds	96678.0	65603.0	104000.0	104000.0
Co-financing	550.0	29682.0	30000.0	30000.0

Source: Ministry of Finance

*administered by the Ministry of the Economy

49. *Government guarantees.* No new government guarantees have been extended since 2003, except where they were needed for the repayment of the existing government-guaranteed loans.

As of 31 August 2006, government-guaranteed loan portfolio accounted for about 1% of GDP projected for 2006. This figure is expected to remain at 1% of GDP or below over the medium term.

50. *On-lending of the loans taken on behalf of the state and government-guaranteed loans.* With a view to improving credit risk management, loans issued or guaranteed by the state are classified into 5 risk groups (in line with commercial banking practices). The risk group is determined on the basis of the borrower's performance assessed with reference to the regularity of repayments, instances of debt restructuring or refinancing, the borrower's financial and economic position, and the actual implementation of investment projects.

As of 30 June 2006, borrowers of the fifth risk group collectively had LTL 219.857m worth of outstanding loans on-lent to them from loans taken on behalf of the state and LTL 28.508m worth of outstanding government-guaranteed loans.

As of 30 September 2006, state-owned enterprises and stock companies in which the state held over 51% of shares had an outstanding debt of LTL 176.371m worth of loans on-lent to then from loans taken on behalf of the state and LTL 314.987m worth of government-guaranteed loans.

Comparison with previous update

51. GDP projections have been revised to reflect the actual figures of the first nine months of 2006 announced by *Statistics Lithuania* and the changes in oil prices as well as the recent trends of economic development.

Table 15. Change in GDP, general government deficit and general government debt projections compared to the previous Convergence Programme

Indicator	ESA code	% of GDP				
		2005	2006	2007	2008	2009
Real GDP growth						
Previous update		7.0	6.0	5.3	6.8	N.A.
Current update		7.6	7.8	6.3	5.3	4.5
Difference		0.6	1.8	1.0	-1.5	N.A.
General government net lending(+)/borrowing(-)	EDP B.9					
Previous update		-1.5	-1.4	-1.3	-1.0	N.A.
Current update		-0.5	-1.2	-0.9	-0.5	0.0
Difference		-1.0	-0.2	-0.4	-0.5	N.A.
General government gross debt						
Previous update		19.2	19.9	19.8	18.9	N.A.
Current update		18.7	18.4	19.2	19.0	17.7
Difference		-0.5	-1.5	-0.6	0.1	N.A.

Sources: Statistics Lithuania, Ministry of Finance

General government deficit and debt projections have been made according to ESA'95.

V. QUALITY OF GENERAL GOVERNMENT FINANCES

52. *Policy strategy.* As part of the budgeting reform, off-budgetary funds have been incorporated into the state budget and a number of legal amendments were passed to enable the accumulation of the Reserve (Stabilisation) Fund, with the Privatisation Fund being its primary source of income, to be drawn on in extreme situations and in the event of economic threats so as to ensure smooth functioning of the economy. As of 1 October 2006, the Reserve (Stabilisation) Fund had LTL 1353.4m (1.7% of the projected GDP).

Table 16. General government expenditure by function

Indicator	COFOG Code	% of GDP	
		2004	2009
1. General public services	01	4.7	–
2. Defence	02	1.4	–
3. Public order and safety	03	1.9	–
4. Economic affairs	04	3.6	–
5. Environmental protection	05	0.5	–
6. Housing and community amenities	06	0.4	–
7. Health	07	4.1	–
8. Recreation, culture and religion	08	0.7	–
9. Education	09	5.9	–
10. Social protection	10	10.1	–
11. Total expenditure		33.1	35.9

Sources: Statistics Lithuania, Ministry of Finance

Thanks to fiscal consolidation, the share of public administration expenditure in Lithuania (% of GDP) remains low in comparison with that of other EU Member States. According to Eurostat, public administration expenditure in EU-25 accounted for 2.4 to 7.4% of GDP in 2004. In Lithuania, this indicator was 4.7% of GDP in 2004. Given the intention to maintain the required quality of heath-care and education services, the implementation of the Stability and Growth Pact in Lithuania will limit these functions to the lowest extent. EU support will increase the share of GDP allocated for economic functions by another several percentage points.

General government expenditure

53. *Objectives.* State budget expenditure targets and priorities are defined in a number of policy papers that are interrelated and form a single integrated set. Documents defining the key national budget expenditure targets and priorities include the Long-Term Development Strategy of the State approved by Resolution No IX-1187 of 12 November 2002 of the Seimas of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 113-5029, 2002), the Single Programming Document of Lithuania for 2004-2006 approved by Resolution No 935 of 2 August 2004 of the Government of the Republic of Lithuania (*Valstybės žinios*

(Official Gazette) No 123-4486, 2004), the National Lisbon Strategy Implementation Programme approved by Resolution No 1290 of 22 November 2005 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 139-5019, 2005), also the Programme of the Government of the Republic of Lithuania for 2006-2008, the Strategy for the Use of EU Structural Support for 2007-2013, and regional development plans. The state budget for 2007-2009 is formed and relevant programmes are prepared in line with the following strategic goals (priorities) approved by Resolution No. 855 of 11 September 2006 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 97-3765, 2006):

53.1. improving welfare of the population, strengthening family values, reducing poverty and social exclusion, enhancing good-quality employment, ensuring healthy and safe living environment, seeking further rural economic and social development;

53.2. enhancing productivity in all sectors of the economy, developing economic infrastructure, creating favourable business climate, and strengthening economic security;

53.3. promoting scientific and technological progress in the country, developing information and knowledge society, improving financing of education, culture, science, and health-care;

53.4. strengthening public administration and self-governance, ensuring public order, improving performance in the legal system, seeking to curb corruption;

53.5. seeking to become a full member of the Economic and Monetary Union as early as possible, and integrating into the Schengen area;

53.6. pursuing a coordinated foreign policy, actively participating in the European Union's activities, and developing the national defence system as part of NATO's collective security and defence system.

54. With a view to ensuring a more efficient use of EU support, the 2006 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets authorises the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 150-5462, 2005), or another institution authorised by the Government, to reallocate EU support and national co-financing designated for programmes and projects as well as funds designated for paying value added tax under these programmes and projects, also other expenditure related to these projects and provided for in legal acts, among appropriation managers, areas of investment and items of economic classification. Moreover, the 2006 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets makes it possible to reallocate the funds designated for EU co-financed programmes and projects that were unspent in 2005 (compared with the plan), to other co-financed projects, such reallocations to be treated as unspent funds of special programs; the Law also provides that temporarily idle EU financial support funds may be employed, with an obligation to pay them back, to finance budgetary needs related to payments to the EU budget and to co-finance EU programmes as well as to bridge budget shortages, all with a view to ensuring timely financing by the Republic of Lithuania of EU financial support special programmes.

The government investment strategy is detailed, by investment area, in the Public Investment Programme for 2006-2008 which defines the financing requirement for investment projects implemented as part of government-supported programs, as well as the sources of financing and the timeframes for implementation of the investments projects concerned. The Public Investment Programme for 2006-2008 attributes higher priority to those investment projects that are co-financed by the EU and that are in line with the EU requirements as well as to those that aim at developing national defence as part of the collective security and defence system.

Since accession to the EU, Lithuania has been receiving support from the EU Structural Funds and the Cohesion Fund, the strategy and measures of usage whereof are outlined in the Single Programming Document for 2004-2006 and in the Cohesion Fund Strategy for 2004-2006 approved by Joint Order No 1K-054/D1-79/3-99 of 20 February 2004 of the Ministers of Finance, Environment, and Transport and Communications (*Valstybės žinios* (Official Gazette) No 33-1071, 2004). The EU Structural Funds and the Cohesion Fund, as financial instruments of EU structural policy, are employed to co-finance priority projects in the EU Member States. Lithuania's Single Programming Document for 2004-2006 defines the strategy, priorities and measures for the use of EU Structural Funds and the respective national co-financing, and the Cohesion Fund Strategy for 2004-2006 defines the strategy for the use of the Cohesion Fund and the respective national co-financing as well as the projects financed. The Government of the Republic of Lithuania also prepares a medium-term policy paper about Lithuania's strategy for 2007-2013 for the use of EU structural support which sets goals and priorities of the use of structural support, in line with strategic guidelines of the European Community Cohesion Fund, European Community priorities and national policy priorities.

55. *Actions Planned.* In the period 2006-2009, the following actions are planned:

55.1. to restructure general government budgetary expenditure, i.e. to allocate funds by priorities and by the need to co-finance EU financial support;

55.2. to build institutional and administrative capacities to ensure the most efficient use of EU budget allocations;

55.3. to improve financial management in municipalities;

55.4. to improve financial management in the health-care system;

55.5. to complete privatisation of state-owned property;

55.6. to enhance the efficiency of management of general government financial flows, thus seeking to ease the extra burden on the budget that can potentially be placed by extra expenditure related to membership of the EU and NATO.

56. Public financial management is being improved by adopting the methodology applied in the EU Member States in public financial accounting and in assessing and forecasting financial performance, by improving the technical base and by enhancing labour skills.

The scheme of matching budgetary resources with the EU support is being improved.

In addition to that, the Strategic Planning Methodology approved by Resolution No 827 of 6 June 2002 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 57-2312, 2002) is being updated to facilitate the match between strategies of different periods and budgeting processes.

It is planned that general government expenditure allocations that might remain unused owing to delays in co-financing EU support or for other reasons are intended to be used for a further reduction of the fiscal deficit.

General government revenue

Tax reform

57. Originally, tax reform was carried out in accordance with the tax policy provisions of the Government's Action Programme for 2004-2008. Now, the reform is continued in accordance with appropriate provisions of the Government's Action Programme for 2006-2008 approved by Resolution No X-43 of 14 December 2004 of the Seimas of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 181-6703, 2004).

58. *Amendments to the Law of the Republic of Lithuania on Personal Income Tax*. On 7 June 2005, the Seimas of the Republic of Lithuania passed the Law Amending and Supplementing Articles 6, 20, 27, 37 of the Law of the Republic of Lithuania on Personal Income Tax (*Valstybės žinios* (Official Gazette) No 76-2743, 2005), which provides for a gradual reduction, in the period 2006-2008, of the rate of personal income tax from 33% to 24%: to 27% (by 6 percentage points) from 1 July 2006 and to 24% (by 3 percentage points) from 2008. These changes will make it possible to achieve a better balance between labour and capital taxation, cut labour costs and create favourable conditions for the growth of competitiveness vis-à-vis neighbouring countries. Moreover, tax burden will be eased for natural persons and net wages will be higher.

With a view to matching the training of students and pupils with business needs and encouraging economic entities to contribute to the training of specialists, the Law Amending Article 17 of the Law on Personal Income Tax (*Valstybės žinios* (Official Gazette) No 41-1462, 2006) provides (the provision came into effect on 1 October 2006) that non-taxable income shall include scholarships paid to students and pupils of educational establishments by entities under trilateral agreements between the entity, educational establishment and the student or pupil on the covering of studying and subsistence expenses for the student or pupil concerned.

The Law Amending Articles 17 and 21 and Supplementing Annex of the Law on Personal Income Tax (*Valstybės žinios* (Official Gazette) No 111-4197, 2006) passed on 3 October 2006 has narrowed the scope of application of a tax relief on housing loans: personal income received over a tax period may be reduced by interest paid on one loan (or a part thereof) taken out for the acquisition of one housing or by interest paid on financial lease (leasing) of one housing. This restriction of the tax relief could help to balance housing demand and supply and at the same time prevent further growth of housing prices. Moreover, these amendments make it possible to achieve the primary goal of the tax relief, i.e. to create, with the help of tax measures, better conditions for people to acquire housing.

59. *Temporary Law of the Republic of Lithuania on Social Tax.* Present and future budgetary commitments do not allow tax rates to be reduced and other tax regulations likely to adversely affect the budget to be amended without introducing offsetting measures. Therefore, temporary measures will be adopted in the transitional period to facilitate personal income tax reform. For this purpose, a temporary social tax will be introduced for the tax periods 2006 and 2007. To date, no legislative proposals have been made to extend the period of applicability of the temporary social tax.

The temporary social tax is payable by legal persons on their taxable profits as calculated in the manner prescribed in the Law of the Republic of Lithuania on Corporate Income Tax (*Valstybės žinios* (Official Gazette) No 110-*3992, 2001), at the rate of 4% for the taxable year 2006 and 3% for the taxable year 2007. The tax base is established in accordance with the principles laid down in the Law of the Republic of Lithuania on Corporate Income Tax; thus, exemptions from the temporary social tax are principally the same as those applied to the corporate income tax.

60. *Law of the Republic of Lithuania on Real Estate Tax.* The new Law on Real Estate Tax aims at creating a sustainable real estate taxation system. The Law creates equal business conditions for commercial-economic persons, i.e. expands the real estate tax base to cover not only real estate owned by legal persons, but also real estate owned by natural persons and used for commercial-economic purposes, also real estate put to the disposal of legal persons for an unlimited period or for a period exceeding one month. Pursuant to the new Law on Real Estate Tax, international principles of property valuation for tax purposes will be used, i.e. the taxable value of the real estate will be the average market value of that property established by using the overall appraisal method, except in certain cases.

A provision of Article 6 of the Law on Real Estate Tax giving municipal councils the freedom to independently set the rate of real estate tax within the range from 0.3% to 1% of the taxable value of the real estate concerned comes into force from 1 January 2007. A municipal council will have the right to set several different tax rates, taking account of the criteria laid down in the Law on Real Estate Tax (category of the taxpayer, position of the real estate, etc.)

61. With a view to implementing the commitment to gradually raise, in the period until 31 December 2009, excises on cigarettes until they reach the minimal rate set in the EU *acquis*, and to preventing a sharp growth of cigarette prices, excises on cigarettes will be raised by 30%, with effect from 1 March 2007. The proposed excise rate will consist of the specific component of LTL 66 (EUR 19.2) for 1000 cigarettes and the *ad valorem* component of 15% (LTL 32 (EUR 9.3) for 1000 cigarettes of most popular brands).

To prevent a sharp jump of cigarette prices during the gradual shift to the minimal rate, excise rates on cigarettes could be raised by 35% annually, to LTL 132.7 per 1000 cigarettes in 2008 and LTL 179.2 in 2009.

With a view to implementing Council Directive 2004/74/EC of 29 April 2004 amending Directive 2003/96/EC as regards the possibility for certain Member States to apply, in respect to energy products and electricity, temporary exemptions or reductions in the levels of taxation, excises on energy products will be raised, with effect from 1 January 2008, by LTL 166 or 12.6% per tonne (to LTL 1484 per tonne) on unleaded petrol, and by LTL 123 or by 12.3% per tonne (to LTL 1125 per tonne) on diesel fuel.

62. In 2006 and later years both direct and indirect taxation policy will be pursued taking account of the actual economic and social environment in Lithuania, primary goals of Lithuania's tax system, developments in the EU tax policies, case law of the European Court of Justice, results of activities of the European Commission's working groups, and the worlds' best practice in the field of taxation. This tax policy will guarantee that taxes in Lithuania are calculated in accordance with universal taxation principles that are equally interpreted both in Lithuania and other Member States, which will help to create more uniform conditions for business (as far as they relate to taxes), thus making a positive impact on the competitive environment.

Further efforts will be made to balance labour and capital taxation.

63. *Financing of tax reform.* By preliminary estimations, the personal income tax reform will bring general government budgetary revenue losses in the amount of about LTL 490m (0.6% of GDP) in 2006, LTL 1264.3m (1.41% of GDP) in 2007, and LTL 2177.5m (2.25% of GDP) in 2008. This general government revenue loss consequential on the reduction of personal income tax will be offset, for some time, by the new social tax payable by legal persons on their taxable profits. The social tax is projected to generate additional budgetary revenue of about LTL 840m in 2006-2008: about LTL 400m in 2006, about LTL 420m in 2007, and about LTL 20m in 2008. Positive developments are also associated with the expansion of the real estate tax base: from 1 January 2006, tax is payable not only on real estate owned by legal persons, but also on real estate owned by natural person and used for commercial purposes.

VI. SUSTAINABILITY OF PUBLIC FINANCES

64. In the long term, sustainability of public finances will be influenced by changes in the demographic structure of population. In 2005, Lithuania prepared an integrated budgetary projection of sustainability of public finances (hereinafter referred to as the Projection) that makes it possible to assess the impact of demographic developments on the long-term sustainability of the pension system, health care system, and education system, and to provide for appropriate actions to ensure the stability of these systems in the future.

The Projection is based on the Eurostat's demographic projection for Lithuania for the period until 2050. According to this Projection, Lithuania's population will shrink to 2.9 million or by 16.4% in the period 2004-2050. The number of people aged between 0 and 14 will drop from 17.7% to 13.7%, and the number of people of working age (aged 15–64) from 67.3% to 59.6%, whereas the number of elderly people (aged 65+) will grow from 15% to 26.7%.

65. Table 17 below gives projections of long-term sustainability of public finances (pensions, health care and education systems) for the period until 2050. The projections have been made using preliminary statistical data for 2005 and the economic and employment projections for the period 2010-2050 provided by the Economic and Financial Affairs Directorate-General of the European Commission. Expenditure on health protection and on long-term health care as well as on education have been projected applying the methodology used by the Ageing Working Group (AWG) of the Economic and Financial Affairs Directorate-General of the European Commission in making analogical projections for EU-15 in 2001 (*The 2005 EPC projections of age-related expenditure (2004-2050) for the EU-25 Member States: underlying assumptions and projection methodologies*; European Economy, Special Report No 4, 2005). The projection of expenditure on unemployment benefits included in Table 17 under “Other age-related expenditures” has been calculated using the methodology employed for analogical projections for EU-15 in 2003.

Table 17. Long-term sustainability of public finances

Indicator	% of GDP					
	2000	2005	2010	2020	2030	2050
1. Total expenditure	39.13	33.66	35.67	35.30	36.64	38.62
of which: age-related expenditure		17.27	16.34	15.97	17.31	19.29
Pension expenditure	7.8	6.6	6.13	6.61	7.49	8.82
Social security pensions	7.8	6.6	6.13	6.61	7.49	8.82
Old-age and early pensions	6.9	5.60	5.17	5.64	6.53	7.77
Other pensions (disability, survivors)	0.94	0.94	0.97	0.98	0.96	1.05
Occupational pensions (in general government)	–	–	–	–	–	–
Health care		4.3	4.51	4.72	4.90	5.29
Long-term health care		0.5	0.54	0.55	0.63	0.85
Education expenditure*	5.7	5.8	5.09	4.01	4.21	4.25
Other age-related expenditure**	0.19	0.09	0.06	0.08	0.08	0.08
Interest expenditure	1.74	0.82	0.58	0.37	0.43	1.64
2. Total revenue	35.58	33.14	35.88	35.88	35.88	35.88
of which: property income	1.16	0.72	0.60	0.60	0.60	0.60
of which: from pensions contributions (or social contributions if appropriate)	7.09	6.96	6.94	6.95	6.96	6.95
Pension reserve fund assets	0.13	1.72	N.A	N.A	N.A	N.A
of which: consolidated public pension fund assets***	0.00	0.49	4.14	11.53	19.42	32.98
3. Assumptions						
Labour productivity growth	9.7	7.1	5.3	3.6	2.7	1.7
Real GDP growth	4.1	7.6	6.4	3.0	1.9	0.4
Participation rate males (aged 20-64)	82.1	81.5	85.6	87.6	88.0	86.3
Participation rate females (aged 20-64)	74.2	72.7	77.8	81.4	82.2	79.7

Indicator	% of GDP					
	2000	2005	2010	2020	2030	2050
Total participation rate (aged 20-64)	77.9	76.9	81.5	84.4	85.0	83.0
Unemployment rate****	16.4	8.3	5.1	7.0	7.0	7.0
Population aged 65+ over total population (beginning of the year)	13.7	15.1	16.1	17.5	21.4	26.7

Sources: Statistics Lithuania, Ministry of Finance, Ministry of Social Security and Labour, Ministry of Health, Ministry of Education and Science

*excluding expenditure on payments to households and private entities and direct capital expenditure on education establishments
**unemployment benefits
***financial assets in private pension funds of Tier II of Pillar I of the pension system
****according to the latest data, the unemployment level will be lower

Table 17 gives expenditure on social security pensions: social insurance pensions and state pensions (including social benefits and excluding private pension funds administered by pension accumulation companies), and revenues from social insurance contributions. State pensions are financed directly from the state budget of the Republic of Lithuania. Expenditure on state pensions will increase continuously, from 0.55% of GDP in 2004 to 1.61% of GDP in 2050.

66. According to the projections, as the number of children and working-age people decreases and the number of elderly people increases, general government budgetary expenditure on pensions and health care, as a share of GDP, will increase and expenditure on education will decrease. By 2050, expenditure on pensions and on health care will have grown by 2.27% and 1% of GDP, respectively, expenditure on education will have gone down by 1.58% of GDP, whereas expenditure on unemployment benefits will hardly change. The total increase of expenditure related to ageing population will account for 2.02% of GDP.

67. Expenditure on pensions will show the fastest growth. For this reason, a pension reform was launched in 2004, and Lithuania’s National Strategy Report on Adequate and Sustainable Pensions of 2005 sets out measures to be taken by the Government to ensure stability of the pension system (see section “Pension reform” in Chapter VIII).

68. The projection of expenditure on education shows a decline of expenditure, explained by the future decrease in the number of pupils in basic education (ISCED 1 and 2) and upper secondary education (ISCED 3 and 4). In 2050, the share of people aged 18 will be 46.12% lower than in 2004.

69. Over the period covered, the total general government expenditure will increase by 5 percentage points of GDP, from 33.66% of GDP in 2005 to 38.6% of GDP in 2050. Age-unrelated expenditure, which was fixed at the 2009 level and treated as constant, will grow by 2.93 percentage points of GDP. General government budgetary revenue will grow by 2.74% of GDP, from 33.14% to 35.88% of GDP. If age-unrelated expenditure had not been fixed at the 2009 level and, instead, account had not been taken of later dynamics of the GDP share of investment and revenue, the projections for long-term financial sustainability would have been more favourable.

70. If the projections took into account the planned increase in the retirement age to 65 years for men and women as provided for in Lithuania's National Strategy Report on Adequate and Sustainable Pensions of 2005, the primary surplus target which is currently set at about 1.9% of GDP to be achieved in order to ensure general government sustainability would be significantly lower. As calculated by the European Commission, general government debt would come close to 77% of GDP in 2050, unless the planned fiscal policies are tightened or the consequences of the problem of ageing population for government finances are dealt with. Successful implementation of the measures envisaged in Lithuania's National Strategy Report on Adequate and Sustainable Pensions of 2005 would help to ensure financial sustainability of general government.

71. Pension reserve fund assets given in Table 17 above consist of reserves of social insurance funds and assets of public pension funds. The reserve of social insurance funds consists of the reserves of the State Social Insurance Fund, Mandatory Health Insurance Fund and the Employment Fund (according to the European System of National Accounts), with the larger part consisting of fixed tangible and financial assets (see Table 18 with actual figures for 2000-2005). Financial assets accumulated in private pension funds of Tier II of Pillar I of the pension system is given in Table 17: financial assets that are projected to account for 33% of GDP in 2050 (with the average annual yield of 3%) will in principle be accumulated through re-allocation of social insurance contributions to private pension funds.

Table 18. Pension reserve fund assets: liquid financial assets, financial accounts (m LTL)

Code	Indicator	2000	2001	2002	2003	2004	2005
AF.21	Currency	30.26	–	–	–	–	–
AF.22	Transferable deposits	–	–	–	–	–	–
AF.29	Other deposits	58.39	73.87	153.9	294.11	622.66	864.39
AF.512	Shares and other equity (unquoted shares)	22.76	17.5	13.65	12.98	12.98	12.98

Source: Statistics Lithuania

VII. INSTITUTIONAL IMPROVEMENT OF GOVERNMENT FINANCES

72. *Private–public partnerships (PPP).* To ensure a more efficient use of state budget and EU funds, efforts must be made to create legal, institutional and administrative conditions for promoting private-public partnerships as an additional source of financing for state and municipal investment projects.

73. *Improvement of strategic planning.* According to the Strategic Planning Methodology approved by Resolution No. 827 of 6 June 2002 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No. 57-2312, 2002), authorities have to use, in drawing up their strategic activity plans (and programmes, where appropriate) for 2006-2008, not only product but also effect and outcome criteria. The Strategic Planning

Methodology regulates the preparation of strategic plans directly related to the state budgeting process. With certain amendments, the Methodology integrates into one whole the key national strategic documents (Lithuania's Single Programming Document for 2004-2006, the National Strategy for Sustainable Development), thus contributing to the improvement of strategic planning.

Preliminary state budget for 2007 was publicly assessed by experts of the independent Free Market Institute, universities, and commercial banks.

VIII. STRUCTURAL REFORMS

Pension reform

74. *Overview***.** The system of state social insurance pensions operates on the pay-as-you-go (PAYG) principle. The budget of the State Social Insurance Fund is separate from the state budget of the Republic of Lithuania.

Before 1995, the retirement age was 55 years for women and 60 years for men. Since 1995, the retirement age had been annually increased until the following age limits were reached: 60 years for women (by 2006) and 62 years and 6 months for men (by 2003). So, in 2006, the retirement age was 60 years for women and 62 years and 6 months for men.

The rate of pension social insurance contribution was 26% of the gross wage of a person covered by pension insurance in 2005, and 26.1% in 2006.

75. *Reform goal.* The main goal of the pension reform is the setting up, from 2004, of Tier II of Pillar I of the pension accumulation system, providing a possibility for the people of the Republic of Lithuania to privately save part of their compulsory social insurance contributions for their retirement.

76. *Reform measures.* In December 2002, the Seimas of the Republic of Lithuania passed the Law on Pension Reform (*Valstybės žinios* (Official Gazette) No. 123-5511, 2002) setting forth that:

76.1. the commencement date of the pension reform shall be 1 January 2004;

76.2. the employed shall be free to decide whether they are willing to save part of their compulsory social insurance contributions in a private account within private pension funds;

76.3. the rate of contributions to pension funds shall amount to 5.5% of the participants' income on which state social insurance contributions are payable (2.5% in 2004, 3.5% in 2005, 4.5% in 2006, and 5.5% in 2007). This part of the rate of the pay-as-you-go contributions will be transferred to private pension funds;

76.4. the total rate of state social insurance contribution will not change due to a transfer of part of the contribution to pension funds.

For persons who choose to participate in pension accumulation, for the years of their participation therein, the state social security old-age pension (the supplementary part of the old-age pension) shall be reduced in proportion to the rate of their contributions.

76.5. pension schemes will be operated by life insurance companies and management companies. They are subject, by law, to additional requirements (licensing, capital adequacy, liquidity of equity, separation of the pension assets of the participants in pension funds from the equity of the company operating the scheme, investment requirements). 11 enterprises were engaged in providing the pension accumulation service in 2005, and 10 in 2006.

77. It is planned that:

77.1. functioning of the current pension system based on the pay-as-you-go principle must be ensured for both current and future pensioners. In the period 2003-2006, the new pension accumulation system was joined by more than 783 thousand (62.5%) people covered by social insurance. Owing to the increasing number of the participants and the growing tariff for pension accumulation, transfers of part of social insurance contribution to private pension funds will increase annually, from LTL 314m (0.4% of GDP) in 2005, to LTL 497m (0.6% of GDP) in 2006 (projection), LTL 665.6m (0.8% of GDP) in 2007 (projection) and LTL 714.8m (0.8% of GDP) in 2008 (projection);

77.2. the loss of income of the State Social Insurance Fund as a result of the pension reform will be financed from privatisation proceeds, the state budget of the Republic of Lithuania, and other funding sources. It is planned that this loss of income to the budget of the State Social Insurance Fund will be partially covered by the surplus that has accrued in the State Social Insurance Fund's budget as a result of the short-term improvement of the demographic situation and economic growth.

78. *Effects of the reform.* With the completion of the pension reform, a three-pillar pension system was set up in Lithuania, consisting of a pay-as-you-go pillar, funded pension pillar (where a part of the compulsory social insurance contributions is accumulated), and a supplementary voluntarily funded pension pillar, resulting in the expansion of the long-term saving and investment infrastructure. The pension reform increases the liquidity of financial markets and accelerates economic development. Although a larger fiscal deficit will build up in the short term as a result of the pension reform, the resources accumulated in pension funds will reduce direct financial liabilities of the government towards future pensioners in the long term.

Table 19. Ratio of pension recipients and contributors (%)

Indicator	2004	2010	2020	2030	2050
Ratio of pension recipients and contributors, if the retirement age is 60 for women/62.5 years for men, %	76	75.2	81.9	100	123.5
Ratio of pension recipients and contributors, if the retirement age is 65/65 years, %	76	75.2	69.9	81	98.9

Sources: Statistics Lithuania, Ministry of Finance, Ministry of Social Security and Labour

Although the pension reform, i.e. the setting-up of Tier II of Pillar I (the funded pension system), has reduced the impact of ageing on the financial sustainability of the pension system, the pensions' replacement rate remains a matter of concern. Speaking about the strategy of ensuring sufficiency and stability of pensions, the Lithuanian National Report 2005 envisages measures that would allow the relative size of pensions to be raised and ensure financial sustainability of the pensions system. It is planned that social insurance pensions will be raised gradually during the period 2005-2015, in such a manner that (gross) replacement rate grows continuously from 31.3% to 42% and that the retirement age is increased, over 2012-2026, by 4 months a year for women and 2 months a year for men, until the retirement age reaches 65 years for both men and women in 2026. With the retirement age being increased, additional employment promotion measures must be introduced to allow older people remain active in the labour market.

The pension reform and the raising of the retirement age will make it possible to achieve a sufficiently well balanced pensions part of the budget of the State Social Insurance Fund in the long-term.

Health-care sector reforms

79. In order to develop a health-care system (covering health improvement, prevention of diseases, timely diagnosing, treatment, medical and social rehabilitation of patients) and to raise public awareness regarding preservation and improvement of health as the main precondition for a full social life, the following priorities have been set:

79.1. to develop the health insurance system;

79.2. to accelerate restructuring of personal and public health-care institutions and services.

80. The development of the health insurance system must aim at improving the quality of health-care services and access thereto for everybody, enhancing the efficiency of the health system, and introducing more efficient forms of use of the resources allocated for this purpose.

81. It has been estimated that the state budget expenditure of the Republic of Lithuania on insurance contributions for persons insured at the state's cost will total LTL 674.1m in 2007, which is 10.3% more than in 2006 (a contribution per person will increase from LTL 304.4 in 2006 to LTL 353.2 in 2007).

Table 20. The projected budget income and expenditure of the Mandatory Health Insurance Fund (hereinafter in the Table referred to as MHIF), 2005-2009

Indicator	2005		2006		2007		2008		2009	
	MHIF, m LTL	% of GDP	MHIF, m LTL	% of GDP	MHIF, m LTL	% of GDP	MHIF, m LTL	% of GDP	MHIF, m LTL	% of GDP
1. Income	2360.8	3.3	2885.2	3.5	3640.4	4.1	4080.1	4.4	4478.9	4.4
2. Expenditure	2360.8	3.3	2885.2	3.5	3640.4	4.1	4080.1	4.4	4478.9	4.4

Source: Ministry of Health

82. One of the key elements of the health system reform is the restructuring of personal and public health care, to be achieved by upgrading the network of health-care institutions and

streamlining the structure of services, ensuring a better response to health-related needs of the public, improving the quality, safety and accessibility of services, and ensuring a more efficient use of resources. The problem of the increasing funding requirement in the field of health-care is being addressed. The future growth of the funding requirement will be a consequence of ageing, rising prices of medicines and medical equipment, growing need for renovations in health-care institutions and modernisation of their equipment, and the necessity to increase wages in the health-care sector.

83. The reform of the public health system is aimed at modernising the infrastructure of the national public health-care system thereby facilitating better access for the community to public health care, streamlining the scope and structure of public health-care services, developing a common model of personal and public health-care services on the primary health-care level, responding rapidly to health threats, and performing public health monitoring.

84. To accelerate the process of restructuring of personal health care institutions, the Government of the Republic of Lithuania approved, by Resolution No 335 of 18 March 2003 (*Valstybės žinios* (Official Gazette) No 28-1147, 2003), the Healthcare Institutions Restructuring Strategy, which is being implemented in two stages, first stage covering the period 2003-2005, and the second stage covering the period 2006-2008. Taking the results of the first stage into account, the second stage was started and proceeded in 2006, by implementing the Healthcare Institutions Restructuring Strategy approved by Government Resolution No 647 of 29 June 2006 (*Valstybės žinios* (Official Gazette) No 74-2827, 2006). Measures of the second stage include further development of the primary level of health care and improvement of access thereto, by shifting most of the services over to family physicians who have contracts with territorial patients' funds; treatment of widespread diseases in health care institutions that are closer to people, with the most advanced technologies being concentrated in university hospitals or largest hospitals; development of the system of medical nursing and long-term palliative treatment services, by integrating these services into general hospitals and starting to provide them together with care services; improvement of the quality and speed of first medical aid, by integrating dispatcher services into the Emergency Response Centre that operates within the system of the Ministry of the Interior and by renewing, from time to time, the ambulance fleet. At the same time, efforts will be made to develop ambulatory rehabilitation, improve the system of prices of health care services and asset management of health care institutions, and develop and promote supplementary (voluntary) health insurance.

85. In 2004-2006, the Structural Funds assistance for health-care was provided in accordance with the Single Programming Document of Lithuania 2004-2006 endorsed by the European Commission Decision C(2004)2120 of 18 June 2004. Assistance was provided for two types of activities: strengthening and development of cardiological health-care services and development and modernisation of infrastructure of family physicians' services. EU Structural Funds assistance in the current programming period amounts to EUR 34.3m. In the period 2007-2013, EU Structural Funds assistance will be further used for investment in health care. Public capital investments are used to implement continued and new health programmes, to

introduce new medical technologies, to renovate health-care institutions, and to develop the national e-health system. Budget of the Mandatory Health Insurance Fund is drawn on to finance national and municipal projects aimed at restructuring health-care institutions.

Agriculture, food industry, and rural development

86. Production volumes and productivity in the agricultural sector have been increasing in recent years. To ensure the implementation of the EU common agricultural policy, to develop a competitive agricultural and food sector, and to promote sustainable economic and social development of rural areas, the following measures are being implemented:

86.1. measures aimed at securing income for entities engaged in agricultural activities, and market regulation measures (one-off payments for crop areas, systems of quotas, intervention procurements, private storage, import/export mechanisms, standards for supply of products to the market, etc.);

86.2. rural development measures set forth in the Rural Development Plan 2004-2004 approved by the Commission Decision No C(2004)2949) of 3 August 2004 (promotion of early retirement, less favoured areas and areas with environmental restrictions, afforestation of agricultural land, agri-environmental protection, support for semi-subsistence farms undergoing restructuring, compliance with EU standards, technical assistance);

86.3. measures listed in the Single Programming Document of Lithuania for 2004-2006 approved by Decision C(2004)2120 of 18 June 2004 of the European Commission and by Resolution No 935 of 2 August 2004 of the Government of the Republic of Lithuania, under the Priority “Rural Development and Fisheries” (investment in agricultural holdings; setting up of young farmers; improvement of processing and marketing of agricultural products; promotion of adaptation and development of rural areas; forestry; LEADER+ type measure; training; activities related to the fishing fleet; protection and development of aquatic resources; fishery; fishing port equipment; fish processing; marketing and fishing in internal waters; other activities related to fishery);

86.4. state aid measures (support for acquisition of breeding animals and certified propagating material of plants, animal breeding, compensation of credit interest and insurance premiums, development of production of quality products and the system of quality testing, research, training and advisory services to farmers, disposal of animal by-products, support in the case of a disaster; promotion of production of bio-fuels, and other measures);

86.5. the process of restitution of ownership rights to land, forest and bodies of water is approaching the end, to be followed by the next stage of land management process associated with a promotion of an efficient use of land, by preserving the ecological stability of the landscape and by developing a required rural infrastructure. The issue of selling agricultural land to Lithuanian legal persons and foreign citizens has been solved. Favourable conditions are being created to young farmers who wish to purchase land from the state on a hire-purchase agreement;

86.6. measures promoting the development of a competitive food sector, restructuring of the food sector, ensuring that only safe food is supplied to the market, and food control in the whole chain, i.e. "from stable to table";

86.7. measures aimed at strengthening administrative capacities so as to ensure the implementation of the EU Common Agricultural Policy; improvement of the EU and national support absorption mechanism; decentralisation of municipal responsibilities for public agricultural functions: part of public agricultural functions have been delegated to wards, thus bringing the services closer to local communities.

87. With a view to implementing strategic goals of the agricultural policy and becoming equal partners in the EU market, it is envisaged that the state budget will continue to finance national premiums of direct payments, the amount of which is set annually by the Government of the Republic of Lithuania, also fund state aid measures for agriculture approved by the European Commission, and such measures as land reform, land reclamation, market development, infrastructure, quality management, science and education, information and other needs, and that structural assistance and rural development measures will be co-financed.

88. Two strategic documents have been drafted and agreed on with social partners, namely the Rural Development Strategy of Lithuania for 2007-2013, and the Rural Development Programme of Lithuania for 2007-2013, which will serve as the basis for the use of the European Agricultural Fund's financial assistance for rural development. Much attention in these two documents is given to the achievement of Lisbon Strategy goals (promotion of competitiveness and employment, improvement of the quality of life) and other initiatives (ecological farming, use of renewable energy resources, preservation of forests and biological diversity, mitigation of climate change, etc.).

As part of implementing rural development policy in 2007-2013, the following key goals will be pursued: to ensure growth by enhancing competitiveness of the agricultural, food and forestry sectors, creating opportunities for diversification of economic activities and for enhancement of the quality of life in rural areas, and by upholding, at the same time, the existing environmental, human and other values, and reducing disparities between urban and rural areas and among individual regions.

89. To ensure proper administration of the European Fisheries Fund, two strategic documents have been drafted and discussed with social partners: Lithuania's Fisheries Sector National Strategic Plan for 2007-2013 and Lithuania's Fisheries Sector Action Plan for 2007-2013.

The primary goal for 2007-2013 is the development of the fisheries sector and improvement of competitiveness in the sector, thus ensuring economic, environmental and social sustainability, along with preservation and regeneration of fishing resources.

Table 21. Projected measured to achieve strategic goals of the agricultural policy

Measures	Funding				
	2005	2006	2007	2008	2009

	m LTL	% of GDP	m LTL	% of GDP	m LTL	% of GDP	m LTL	% of GDP	m LTL	% of GDP
1. Implementation of Common Agricultural Policy measures										
B. Net direct effect on the budget	-327.4	-0.5	-446.6	-0.5	-430.5	-0.5	-647.3	-0.7	-762.6	-0.7
B.1. Income	546.1	0.8	735.6	0.9	541.82	0.6	709.13	0.7	820.07	0.8
B.2. Expenditure	873.5	1.2	1182.2	1.5	972.3	1.1	1356.4	1.4	1582.7	1.5
2. Restructuring of the agricultural and fisheries sectors										
B. Net direct effect on the budget	-93.75	-0.1	-114.3	-0.1	-112.52	-0.1	-161.43	-0.2	-152.75	-0.1
B.1. Income	0.8	0.0	1.8	0.0	1.0	0.0	1.0	0.0	1.0	0.0
B.2. Expenditure	94.6	0.1	116.1	0.1	113.5	0.1	162.4	0.2	153.7	0.1
3. Land management and administration										
B. Net direct effect on the budget	-149.6	-0.2	-196.4	-0.2	-225.3	-0.3	-223.8	-0.2	-38.5	0.0
B.1. Income	0.08	0.0	0.06	0.0	0.03	0.0	0.03	0.0	0.03	0.0
B.2. Expenditure	149.7	0.2	196.4	0.2	225.4	0.3	223.8	0.2	38.5	0.0
4. Strengthening of institutional and administrative capacities										
B. Net direct effect on the budget	-77.3	-0.1	-100.9	-0.1	-111.3	-0.1	-103.5	-0.1	-99.6	-0.1
B.1. Income	6.2	0.0	8.5	0.0	9.5	0.0	9.5	0.0	9.5	0.0
B.2. Expenditure	83.6	0.1	109.4	0.1	120.8	0.1	113.1	0.1	109.2	0.1
5. SAPARD										
B. Net direct effect on the budget	-40.1	-0.1	-18.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B.1. Income (EU funds)	99.8	0.1	12.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B.2. Expenditure (EU funds and national co-financing)	139.9	0.2	30.9	0.0	0.0	0.0	0	0.0	0.0	0.0
6. Structural support and rural development measures										
B. Net direct effect on the budget	-133.6	-0.2	-304.8	-0.4	-213.1	-0.2	-369.1	-0.4	-317.9	-0.3
B.1. Income	496.9	0.7	1041.5	1.3	768.8	0.9	1173.3	1.2	1054.1	1.0
B.2. Expenditure	630.5	0.9	1346.4	1.7	982.0	1.1	1542.4	1.6	1372.0	1.3
7. Total direct effect on the budget										
B. Net direct effect on the budget	-821.7	-1.2	-1181.6	-1.5	-1092.8	-1.2	-1505.1	-1.6	-1371.3	-1.3
B.1. Income	1149.9	1.6	1799.6	2.2	1321.2	1.5	1893	2.0	1884.6	1.8
B.2. Expenditure	1971.6	2.8	2981.3	3.7	2414.0	2.7	3398.1	3.5	3255.9	3.1

Source: Ministry of Agriculture