THE GOVERNMENT OF THE REPUBLIC OF LITHUANIA

RESOLUTION No 1323

of 12 December 2005

ON THE CONVERGENCE PROGRAMME OF LITHUANIA OF 2005

Vilnius

Acting pursuant to Article 7 of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, as last amended by Council Regulation (EC) No 1055/2005 of 27 June 2005, which lays down a multilateral surveillance procedure of the European Union Member States carried out in the form of stability and convergence programmes, the Government of the Republic of Lithuania has resolved:

1. To approve the Convergence Programme of Lithuania (appended);
2. To charge the Ministry of Finance with the task of submitting the Convergence Programme of Lithuania as approved hereby, to the European Commission.

Prime Minister Algirdas Brazauskas

Minister of Finance Zigmantas Balčytis

APPROVED by:
Resolution No 1323
of 12 December 2005
of the Government of the Republic
of Lithuania

CONVERGENCE PROGRAMME OF LITHUANIA

I. FINANCIAL POLICY OVERVIEW

1. Lithuania's economic policy serves the goal of ensuring a rapid real convergence and approximation to the high level of productivity and subsistence within the Economic and Monetary Union, with the ultimate goal of a full-fledged participation in the Economic and Monetary Union. Lithuania pursues to introduce the euro on 1 January 2007. The Convergence Programme of Lithuania (hereinafter referred to as this Programme) outlines the Government's economic policy commitments aimed at ensuring that Lithuania's economic performance satisfies, in a sustainable manner, the convergence criteria.

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. a deeper economic integration into the EU.

3. Despite the temporary difficulties related to extra tensions on the budget, Lithuania has undertaken in this Programme to pursue the fiscal and monetary policy that ensures the stability of prices and government finances so as to maintain a strong confidence in the continuity of the currency board arrangement in Lithuania and to successfully participate 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 monetary and fiscal policy, an assessment of risks and of the quality of government finances, and a description of Lithuania's readiness to overcome the effects of ageing population, as well as an outline of major structural reforms underway.

5. This Programme also examines and assesses the preconditions for the achievement of the declared economic policy goals. The economic development projections given herein are based on the assumption that Lithuania's external economic environment will, in principle, remain stable during the period concerned. Other assumptions used herein are close to those made by the EU Commission. The commitment to maintain a strict fiscal discipline as laid down in this Programme have been enforced by the Council of the European Union which has unanimously tightened, in June 2005, fiscal policy requirements under the Stability and Growth Pact, namely: the states participating in the ERM II have to reduce structural 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's participation in the ERM II marks the stage of a close economic cooperation between Lithuania and the EU, built on coordination of economic policies, which is a necessary precondition for ensuring a sustainable and deeper integration of Lithuania into the EU single market. With the re-pegging of the litas to the euro in 2002 and the enlargement of the European Union in 2004, Lithuania's export of goods to the EU has grown from 48% in 2001 to 67% in the nine months of 2005. Lithuania is integrated with the low-risk economies of the EU; therefore, the economic development remains on a solid and fast track.

6. As a result of the re-pegging of the national currency to the euro under the currency board arrangement, inflation remained low, i.e. only 0.2% in 2004; however, a growth to 2.7% is projected due to the recent rise of oil prices. A record-high increase in oil prices over 2004–2005, a projected growth of interest rates, and lower growth of credits coupled with an inert absorption of EU support at the start of the new financial perspective (2006–2007) will have an effect on the economic cycle. The rapid economic development will be maintained through the improvement of the quality of general government finances and the balance between capital and labour taxation as well as the adherence to the requirements under the Stability and Growth Pact.

7. Growth of exports and investment remains of a fast track in Lithuania, with unemployment going down at the highest pace among the EU states. Over the past three years, the level of employment has grown by 4%. The orientation of Lithuania's fiscal policy towards the achievement of the goals under the Stability and Growth Pact has strengthened market expectations about the approaching membership in the Economic and Monetary Union and has reduced the risks associated with investment in Lithuania. 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. The tight fiscal policy pursued since 2001 and the prudent re-pegging of the litas to the euro in 2002 have aroused market expectations about an early membership in the EMU, thus reducing the gap between interest rates on loans in the litas and in the euro and making euro-

denominated-loans more popular. With the drop of interest rates, the private demand financed by the rapidly expanding financial intermediation sector has contributed to the development of new production capacities and the improved utilisation of the existing ones.

9. The successful collection of taxes from the shadow economy, the allocation of saved expenditure for the reduction of fiscal deficit, the temporary taxation of capital income with a new social tax, the creation of equal conditions for commercial-economic entities to compete in the market (by expanding the real estate tax base), all have helped to implement the provisions of the EU and Lithuania's economic policy communication regarding Lithuania's participation in the ERM II. The implementation of measures set out in Convergence Programme of Lithuania for 2004 as approved by Resolution No 568 of 11 May 2004 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 79-2793, 2004) has in part helped to prevent the projected jump of demand and its inflationary impact. Inflation projections for 2005 have been lowered by 0.2 percentage points. 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 for 2004 will be pursued under this Programme, too. A consistent implementation of measures set out in this Programme will help to ease the concerns about sustainability in implementing Maastricht criteria.

10. The rapid growth of demand under the conditions of a fixed exchange rate of the litas has inspired a rapid growth of imports and Lithuania's current account deficit of the balance of payments. Thus, to ensure the continuity of foreign capital inflows, the government should further improve business and investment environment, give maximum support to investment that is promoted statutorily, and create particularly favourable conditions for "green field" investment, as well as maintain market confidence in an early integration of the country into the euro zone. In the coming years, EU support will finance an increasingly larger share of the CAD.

Given the need to implement structural reforms aimed at ensuring productivity and a 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 fiscal deficit target is set at around 1% of GDP. For later years, the medium-term fiscal deficit target will be tightened to take note of the Commission's latest estimates suggesting that general government debt will approach to 80% of GDP in 2050, unless fiscal policy is tightened. EU Commission's estimations for 2005 suggest that in order to implement ambitious social guarantees to pensioners in 2030 to 2050, despite the problem of ageing population, and to secure a long-term stability of government finances which is a requisite in the euro area, Lithuania's primary structural surplus should reach about 2.6% of GDP over the medium term. Therefore, once major structural reforms have been completed, a cyclically-balanced or surplus budget will again be a medium-term fiscal policy goal.

11. Currently, Lithuania's capacity to plan for a fiscal deficit below 1% of GDP is prejudiced by temporary budgetary difficulties associated with payments to the EU Own

Resources, increasing co-financing, accelerating pension reform, and a radical tax reform. Thanks to the strict fiscal discipline, government current expenditure will remain at the lowest level in the EU. The GDP share of government expenditure will slightly grow due to the implementation of the Public Investment Programme and the increasing investment support from the EU. Fiscal discipline will be maintained by holding the GDP share of government current expenditure down over the medium term and by keeping the share of social expenditure at about 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 0.8 percentage points of GDP. The reduction of the personal income tax which is expected to ensure a better balance between labour and capital taxation will contribute to the successful implementation of Lisbon objectives in the labour market, to increase employment and the potential GDP, and to mitigate the effects of ageing population for government finances. Although the 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 fiscal deficit and economic cycle, will be possible only on the condition that additional tax revenue is collected as a temporary measure. As a longer-term goal, Lithuania will make efforts to promote housing renovation aimed at saving heating and reducing the dependability of the economy on natural gas prices.

12. The fiscal policy pursued in compliance with the strict regulations of the Stability and Growth Pact will allow to consistently reduce government debt until government finances become capable of fulfilling, in a sustainable manner, the commitments under the Maastricht Treaty, given that the number of pensioners will significantly grow in the third decade, whereas the number of employed population will be decreasing.

II. ECONOMIC OUTLOOK

Assumptions

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

In the period of 2005 to 2008, an important assumption is the absorption of the EU structural funds and other financial assistance from the EU. The absorption of the EU support funds will be important for the growth of GDP of a respective year. According to estimations by the Ministry of Finance based on the data of appropriation managers about the implementation of contracts, the EU support will provide the largest stimulus for economic growth in 2006. In

2006, the EU support will offset the negative effects of oil prices on the demand; therefore, GDP projections for 2006 remain principally unchanged.

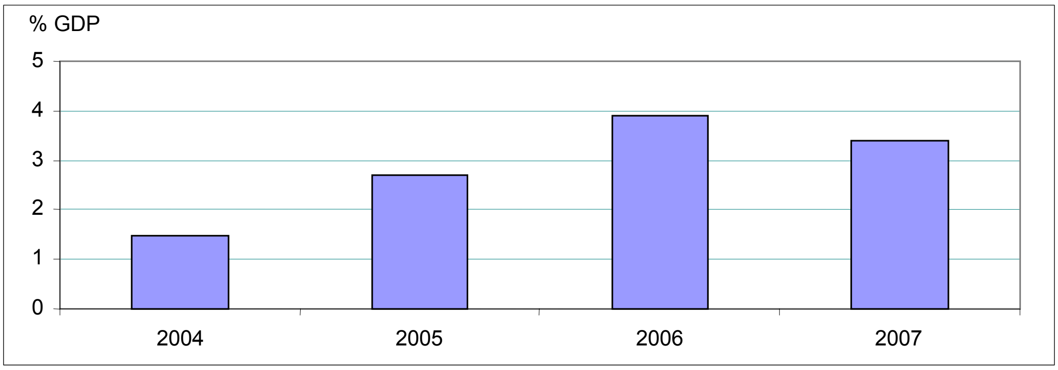
As no agreement on the EU financial perspective for 2007 to 2013 has been reached yet, the absorption of the new wave of EU support in 2007 is assumed to reflect the 2004 trends. Low absorption of the new wave of EU support in the first year (2007) will not have a positive impact on a solvent demand, which means a lower GDP growth in that year. In 2008, EU support will better contribute to GDP growth; therefore, a larger GDP growth is projected.

Table 1. Key assumptions

	2004	2005	2006	2007	2008
Short-term interest rates	2.3	2.3	2.7	3.0	3.2
Long-term interest rates	4.6	3.6	4.0	4.1	4.2
USD/EUR exchange rate (euro area and ERM II countries)	1.24	1.25	1.21	1.22	1.22
Nominal effective exchange rate	6.1	-0.8	-1.1	0.2	0.2
(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	5.1	4.9	4.6	4.6
EU-25 GDP growth	2.4	1.5	2.1	2.4	2.4
Growth of key export markets	2.4	1.5	2.1	2.4	2.4
World import volumes, excluding EU	5.7	8.8	8.8	8.5	8.5
Oil prices (Brent, USD/barrel)	38.0	55.0	61.4	60.3	60.3

Source: Department of Statistics, Ministry of Finance, European Commission

Fig. 1. EU net* support (in % of GDP)



*Payments from the EU budget (less payments to the EU budget)

Source: estimates by the Ministry of Finance

Fig. 2. Annual increase of EU net support as compared to previous years (% of GDP)

Source: estimates by the Ministry of Finance

In 2007, EU net support will be slightly lower due to higher payments to the EU budget. The experience in assessing Single Programmes of other EU Member States enables to estimate that EU financial assistance will have increased GDP by over 3% over 2004 to 2008.

The rapid growth of lending to private customers in 2003 and 2004 stimulated the growth of consumption and investment. According to estimates, investors' and consumers' loan portfolio may be assumed to continue to grow fast but its growth in 2005 will be close to that in 2003 and 2004 meaning no additional stimulus to the rapidly increasing demand. In 2006 to 2008, the decreasing impact of credit growth on the demand will be partially offset by the absorption of EU support.

The key assumptions about 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. The projection of average oil prices for 2006 has been raised to USD 61.4 per barrel. In 2007, oil prices are projected to drop to USD 60.3 per barrel.

In the medium term, Lithuania will maintain the rapid economic growth: GDP growth may reach 7% in 2005, 6% in 2006, 5.3% in 2007, and 6.8% in 2008.

Monetary and exchange rate policy

14. The implementation of the fixed exchange rate mechanism under the currency board arrangement has played an important role in achieving a non-inflationary and stable macroeconomic development, which has stabilised inflationary expectations, lowered country and currency risk premiums, and boosted confidence in the economic policy of the country.

From 1 April 1994 to 2 February 2002, the litas was pegged to the U. S. dollar. On 2 February 2002, the litas was re-pegged to the euro, chosen as the anchor currency, at the official exchange rate of 3.4528 litas to 1 euro (calculated by multiplying the U. S. dollar exchange rate vis-à-vis the euro (0.8632 U. S. dollar to 1 euro) announced by the European Central Bank on the date of the re-pegging (1 February 2002) by 4 (the former official litas exchange rate vis-à-vis the U. S. dollar)), which has not changed upon accession to the ERM II on 28 June 2004.

15. Lithuania seeks to be ready for the introduction of the euro in early 2007. A number of economic considerations also spur a changeover to the euro in Lithuania:

15.1. a historical success in maintaining a tight, fixed exchange rate;

15.2. Lithuania has unilaterally re-pegged its national currency to the euro; however, it does not fully enjoy the advantages of the single currency: economic entities suffer exchange losses in converting currencies to/from the euro, and a deeper integration of trade and finances with the EU is precluded.

Cyclical developments and a medium-term macroeconomic scenario

Goods and services markets

16. In recent years, Lithuania's economy has been growing at an accelerating pace. In 2003 and 2004, Lithuania was one of the fastest-growing economies of the world, with GDP grew of 10.5% and 7%, respectively. This is a testimony of a successful implementation of structural reforms.

In the three quarters of 2005, GDP grew by 6.9%, according to preliminary estimations by the Department of Statistics under the Government of the Republic of Lithuania (hereinafter referred to as the Department of Statistics). The economic growth was driven by the growth of the domestic demand surpassing the growth of GDP and by unused capacities that existed in the economy.

In recent years, the economic growth was mainly driven by the domestic demand. The rapid growth of borrowing was among the key factors that promoted the growth of investment, household consumption, and thus the GDP. A surplus capacity, rapid investment, growth of employment, efficient competition in the retail sector, all has helped to keep a balance between the growth of the demand, the supply and imports. GDP grew rapidly thanks to low inflation and a moderate growth in wages and salaries. The tight fiscal policy coupled with the carry-forward of EU support to cyclically better periods as well as other circumstances has helped to prevent an external and price imbalance. The projected growth of interest rates in 2006 and 2007 will also limit the growth of loans and the demand, thus creating favourable conditions to maintain economic balances. In 2004 and 2005, the growth of loans slowed down, EU fiscal stimulus was carried forward to later periods, and oil prices reached their record high. For these reasons, GDP gap is projected to shrink from 2006 onwards.

In 2003 and 2004, a rapid growth of demand and a lack of supply caused a jump of real estate prices(housing and land). Seeking to create equal opportunities for entities engaged in commercial-economic activities to compete in the market, by discouraging, at the same time, speculations in real estate prices, Lithuania will impose, from 2006 onwards, a real estate tax not only on real estate owned by legal persons, but also on real estate owned and used by natural persons for commercial-economic purposes. Publicity measures aimed at informing the public that income derived from real estate might be taxed, in accordance with the procedure laid down in legal acts, with VAT and income tax have also encouraged people to assess long-term real estate price trends with more care. This policy will help to maintain confidence in the economic balance.

Over the period of 2005 to 2008, a rapid growth of investment and consumption is projected. Lithuania's export performance will remain on a positive track. Nominal export growth will be promoted by the liberalisation of trade with the EU, which has crated better conditions for trade. The rise of oil prices and the lack of oil production capacities facilitate export trade for *Mažeikių nafta* (oil refinery company).

Table 2. Macroeconomic prospects

		2004	2004	2005	2006	2007	2008
	ESA code	level	rate of change	rate of change	rate of change	rate of change	rate of change
Real GDP	B1*g	61583.9	7.0	7.0	6.0	5.3	6.8
Nominal GDP	B1*g	62440.2	10.0	9.7	9.9	8.2	9.6
Components of real GDP							
Household consumption expenditure + NPISHs	P.3	40393.4	9.7	8.6	8.4	6.7	6.9
General government consumption expenditure	P.3	11306.3	7.5	9.0	3.0	2.5	2.5
Gross fixed capital formation	P.51	13824.3	12.3	13.5	12.2	12.0	7.3
Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	3934.4	6.4	5.1	4.1	4.2	4.4
Exports of goods and services	P.6	33025.4	4.2	12.9	7.0	6.0	5.9
Imports of goods and services	P.7	40899.9	14.8	13.9	8.9	8.8	5.7
Contributions to real GDP growth							
Domestic demand		69458.3	13.8	9.4	8.3	8.3	7.6
Changes in inventories and net acquisition of valuables	P.52 + P.53	13824.3	3.6	-0.9	-0.7	0.3	0.5
Balance of goods and services	B.11	-7874.5	-6.8	-2.4	-2.3	-3.0	-0.9

Source: Department of Statistics, Ministry of Finance

EU financial assistance will create the conditions for active investment despite the lower credit growth. With stronger investor confidence in the stability of the economy, investment will account for an increasingly larger share of GDP. Although the impact of EU support on the demand has in part been carried forward to cyclically more acceptable periods, the strongest stimulus of EU support on investment is projected in 2005. At the end of the period covered, the share of gross fixed capital formation will account for over 25% of GDP.

A positive impetus to consumption in the period covered will be provided by the accelerating growth of wages and salaries resulting from higher productivity, by the decreasing unemployment, by the opening of EU labour markets and positive consumer expectations about economic development. In 2005 to 2008, final consumption expenditure will grow by 6.9% on the average. The increasing pressure exerted by the domestic demand will be eased by the decreasing GDP share of general government consumption expenditure.

In 2004, the degree of utilisation of industrial production capacities stabilised at over 70%; therefore, the increase in the domestic demand projected for the period covered will be largely met by imports and investment. Import of new technologies will strengthen the capacity of the economy to compete in international markets. In later periods, the increased production capacities stimulated by EU support will create the conditions to meet the domestic demand to an increasingly higher extent, by supplying domestically produced goods and services.

Year 2005 results of foreign trade evidence that Lithuanian economy remains competitive. The new approach employed in foreign trade makes it difficult to project export growth potential; nevertheless, Lithuania will still have possibilities to access new export markets and compete in the existing ones in the period covered. At the end of the period covered, export growth will be promoted by the conversion of the expectation about the changeover to the euro into reality.

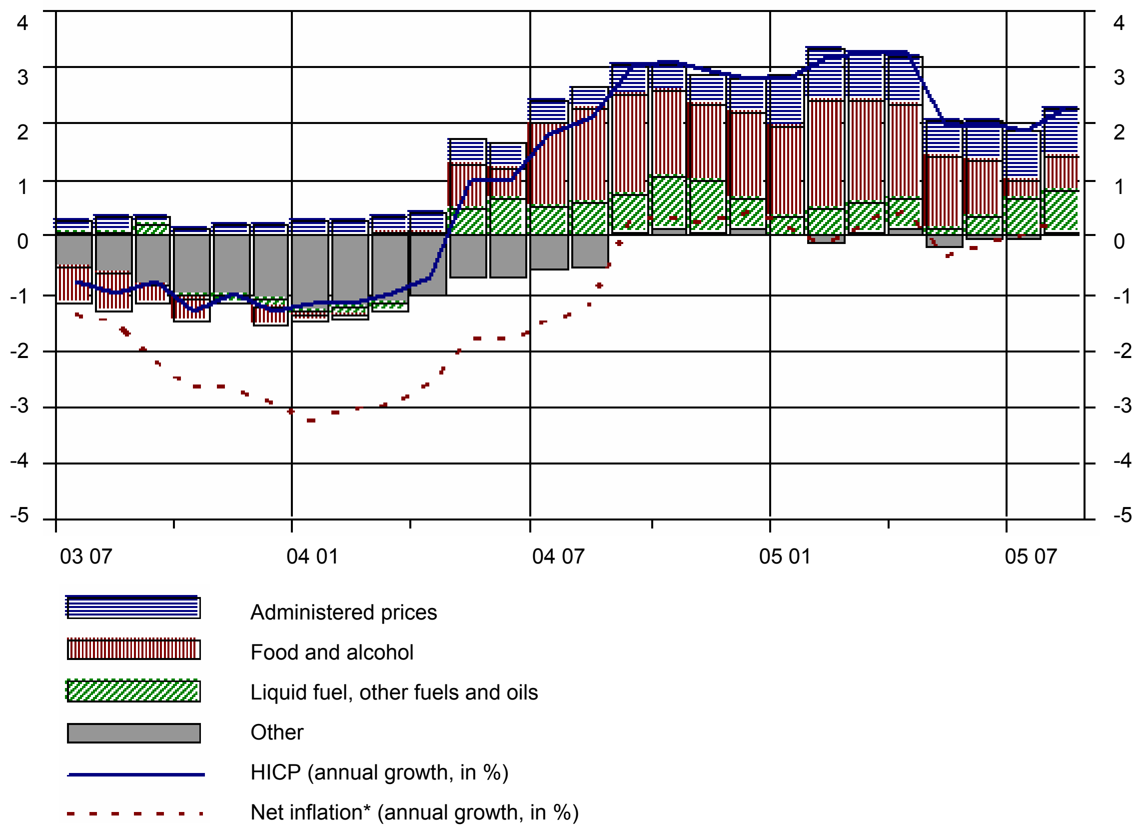
A changeover to the euro on 1 January 2007 will spur foreign investment and growth of exports. Based on assessments made by other countries of the impact of the changeover and taking account of the impact of EU support, GDP is projected to grow by 6.8% in 2008. Productivity should continue to grow rapidly beyond 2008, being a major factor in ensuring that Lithuania approximates the EU average level of living in the period covered by the 2007-2013 financial perspective.

The expectation about a balanced economic development continues. Exporting industries will play an important role in maintaining sustainability of economic growth. Competitiveness of the services sector is expected to grow further. The continuing rapid growth of consumption will facilitate a stable growth of retail and wholesale trade.

17. After the effects of the one-off price boom in May 2004 have been neutralised, the monthly average inflation has dropped to 2%. Fluctuations in prices of food and fuel, principal categories of goods and services causing inflation, and in administered prices in August have raised annual inflation by 0.6%, 0.9% and 0.7% percentage points, respectively. The impact of food prices in particular has weakened compared with January-April (when the effects of the price boom of May 2004 were still felt). In this period, changes in food, administered and fuel prices have caused, respectively, 1.7, 0.9 and 0.5 percentage points of the four-month average inflation on the average.

Net annual inflation (annual inflation according to the harmonised index of consumer prices (hereinafter referred to as the HICP)), excluding the effects of food, administered and fuel prices) averaged at about zero in the first half of 2005.

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



Higher inflation is recorded for those categories of consumption goods and services which are less sensitive to competition.

In May-October 2005, annual inflation was largely influenced by food and transport (including fuel) prices. The dynamics of dairy prices has lowered the convergence indicator for inflation by about 0.4 percentage points. A rise of transport prices has further worsened the inflation indicator by about 1 percentage point. But for inflation in food and transport sectors, the overall level of prices would have increased by 1 percentage point only.

If the assumptions underlying the estimates prove true, the annual inflation will average at 2.7% in 2005 to 2007.

The projection of the 2006 price level has been raised by 0.2 percentage points due to changes in assumptions. As actual data suggest, the record-high impact of oil prices on the cost of goods has not raised inflation above the level required under the Maastricht Treaty which lays down the principles of assessing convergence in terms of inflation. In July, annual inflation was below 2%, despite the rise of oil prices by almost 50% over the year and the inflation in the transport sector of 0.9 percentage points.

The easement of the tax burden on labour scheduled as from 1 July 2006 and from 2008 will ensure that businesses keep confidence in their competitiveness despite the growth of oil prices. A part of the income to be saved through the easement of the tax burden is likely to be used to keep prices down, for competition. Moreover, lower taxes will mean higher net wages and salaries; therefore, average nominal wages and salaries for general government-financed budgetary organizations in 2007-2008 are projected to remain at approximately the 2006 level. It is expected that segments of the private sector will follow this practice. The reduction of tax rates will help to keep inflation resistant to any pressure from the nominal wages and salaries for three years to come. Employers will be less pressed to raise nominal wages and salaries, having in mind that their employees will receive higher net income by virtue of lower taxes.

The reduction of personal income tax, a more efficient utilisation of the economic potential and the growth of productivity that essentially offset the increasing growth of the average monthly wages and salaries will hold down the rise of prices in the future. At the end of the period covered, the stable inflation rate will average at about 2.5% and will meet, in a sustainable manner, the Maastricht criterion for inflation provided that inflation in other EU Member States is not particularly low.

Fuel excise policy is unlikely to raise inflation in Lithuania. Lithuania meets the requirements for transitional minimal rates of excises on fuel. For 2008, excises on fuel will have to be raised by 12%. This increase is not likely to cause a higher CPI inflation than 0.2 percentage points (if oil prices fell from 59 to 54 dollars per barrel in 2007-2008, inflation would remain completely unaffected).

The projected rise of GDP deflator in 2004-2006 is owing to the facilitation of trade achieved through the convergence of prices of goods (oil and foodstuffs) and services (construction) with the EU, i.e. liberalization of trade in foodstuffs and a freer movement of labour after accession.

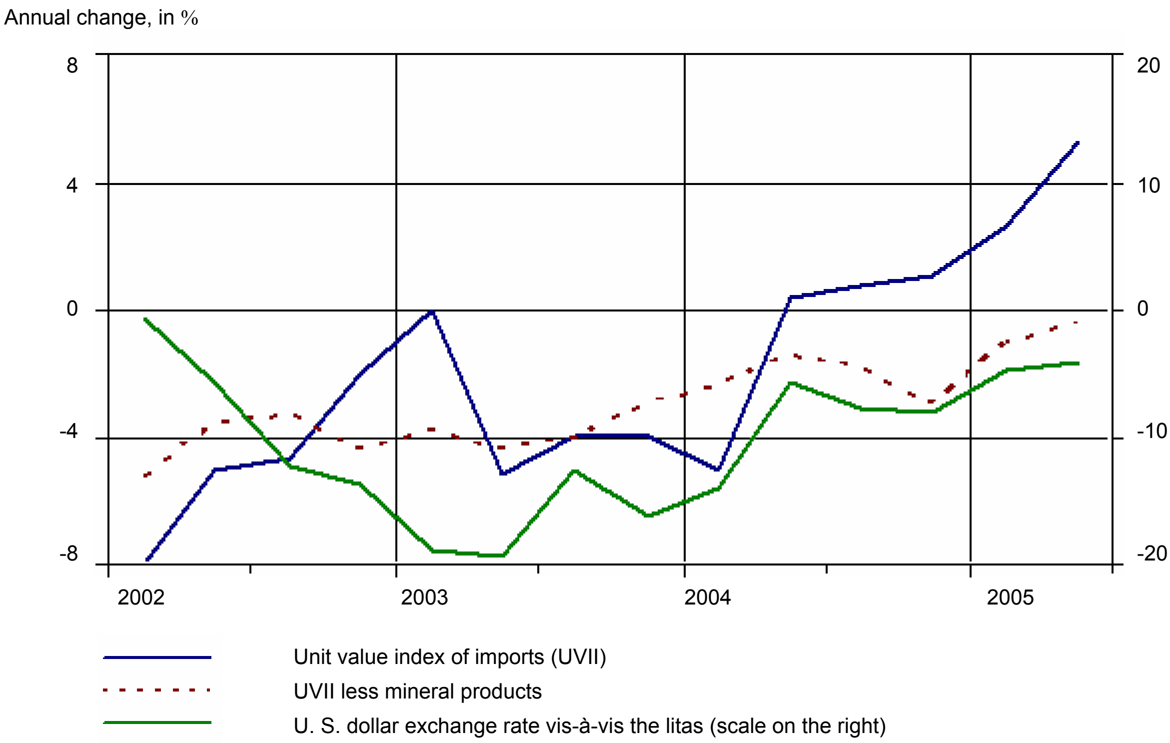
Table 3. Price developments

		2004	2004	2005	2006	2007	2008
	ESA code	level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		101.4	2.8	2.4	3.6	2.7	2.6
2. Private consumption deflator		74.9	0.7	2.8	2.4	2.2	2.2
3. HICP*		118.2	1.1	2.7	2.7	2.7	2.5
4. General government consumption deflator		74.9	0.7	2.8	2.4	2.2	2.2
5. Investment deflator		84.9	-7.6	-6.4	4.1	4.9	2.9
6. Export price deflator (goods and services)		101.4	7.5	8.0	2.2	1.8	2.5
7. Import price deflator (goods and services)		101.4	-0.5	4.9	1.1	1.8	1.8

Source: Department of Statistics, Ministry of Finance

It was largely owing to the jump of oil prices that import prices grew at an accelerating pace in the past quarters. In the second quarter, the annual change in import prices grew by 5.3% (cf. 0.4% in the second quarter of 2004). A rise of prices of imported mineral products was the cause of the annual growth of import prices by 5.9 percentage points.

Fig. 4. Dynamics of import prices, oil prices and U. S. dollar exchange rate



Source: Department of Statistics, estimates by the Bank of Lithuania, Bloomberg

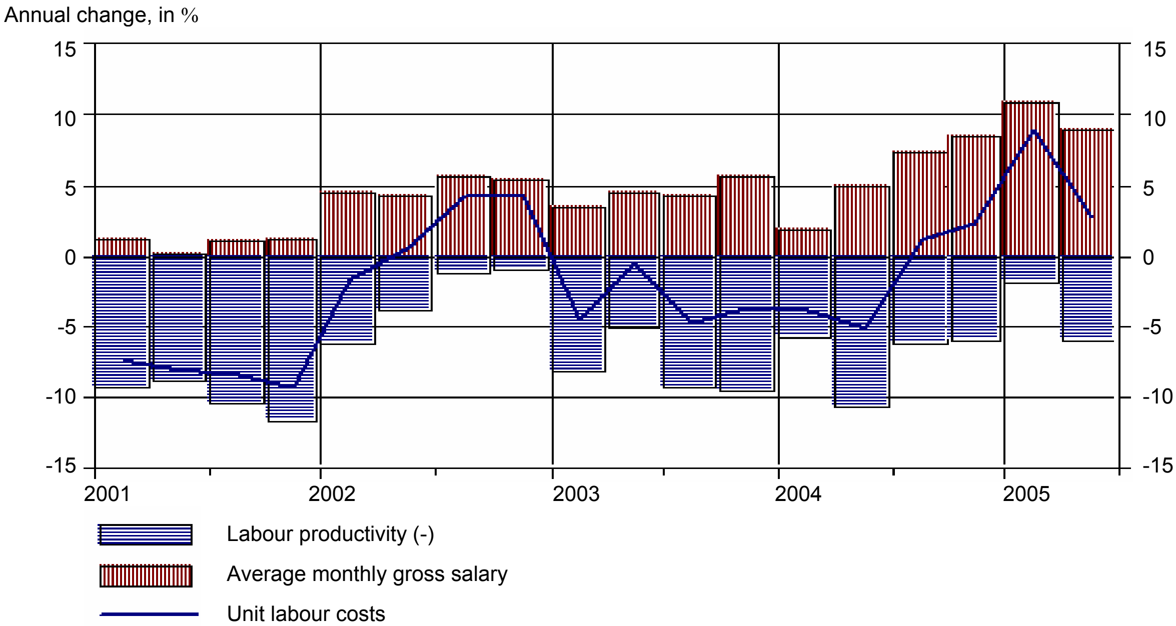
Excluding the impact of oil prices, the annual deflation of import prices slowed down from –1.5% in the second quarter of 2004 to –0.5% in the second quarter of 2005. The lower import deflation may be partly explained by the appreciation of the U. S. dollar vis-à-vis the euro in the past months: the average month-on-month nominal value of the U. S. dollar was 10.3% higher in June than at the beginning of the year.

Like in the previous periods, cheaper means of transport and imported equipment were the key contributors to the annual fall of import prices (excluding mineral products), accountable for 1.1 and 0.7 percentage points, respectively, over 2005.

In the eight months of 2005, industry producer prices of products sold in the domestic market (hereinafter referred to as domestic producer prices) grew at a rate of 5.2% a year on the average. A large part of industry production consists in energy products, the dynamics of which, therefore, has had the largest impact on the rise of domestic producer prices (accounting for 4.3 percentage points of the annual inflation of domestic producer prices in the eight months of 2005 on the average). Ignoring the impact of energy prices, the annual inflation of domestic producer prices averaged at 2.5% in January-April 2005. In May, it dropped to 2% as a result of a weaker impact of prices of fast consumption goods (food in particular) and stayed at around this level in the past months.

As far as labour costs are concerned, the annual increase of wages and salaries in the past quarters of 2005 was slightly higher than in the first half of 2004 (in the second half of 2005, the average gross monthly salary, excluding sole proprietor companies, grew by 9% year-on-year). Acceleration of the growth of wages and salaries is particularly vigorous in sectors closed to external trade (health care, education, construction). In earlier periods, a faster growth was recorded in labour productivity, and now in wages and salaries, which suggests a cyclicity of unit labour costs. To illustrate, from 2003 to mid-2004, as labour productivity grew rapidly, unit labour costs were declining, and from mid-2004, the growth of wages and salaries started to catch up with labour productivity that grew earlier.

Fig. 5. Wages and salaries, labour productivity and unit labour cost



Source: Department of Statistics, estimates by the Bank of Lithuania

Labour market

18. Structural reforms have stimulated a rapid growth of labour productivity. The largest rates of growth of productivity and added value were recorded in production and agriculture-related activities. The growth of productivity in recent years exceeded the growth of wages and salaries thus enabling to maintain competitiveness in the conditions of appreciation of the nominal exchange rate of the litas: during 2001-2003, wages and salaries grew by 9.2%, whereas labour productivity grew by over 20%. By the data of the Department of Statistics, real labour productivity and nominal wages and salaries grew by 8% and 5.8% in 2003, respectively, and by

7.1% and 7.9% in 2004, respectively. Nominal growth of wages and salaries is close to real growth of productivity.

Over the past three years, the level of employment has grown by 4%, meaning lower unemployment. According to the data of an employment survey, the average annual level of unemployment has dropped from 17.4% in 2001 to 11.4% in 2004. In the second quarter of 2005, the unemployment figure stood at 8.5%.

Table 4. Labour market developments

		2004	2004	2005	2006	2007	2008
	ESA code	level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons		1436.3 thou	-0.1	1.7	2.0	1.3	1.0
2. Employment, hours worked		2 608 388.0	1.1	0.0	0.0	0.0	0.0
3. Unemployment rate (%)		184.4 thou	11.4	9.6	8.6	7.9	7.5
4. Labour productivity		LTL 40 382.9	6.6	6.6	6.1	5.3	6.7
5. Labour productivity, hours worked		-	-	-	-	-	-
6. Compensation of employees		LTL 24 586.2m	10.5	10.2	10.5	9.5	9.9

*ESA – European System of Accounts.

Source: Department of Statistics, Ministry of Finance

Average monthly gross wages and salaries are projected to grow from LTL 1 158 in 2004 (by preliminary estimations) to LTL 1 600 in 2008. Accelerated accumulation of investment will increase productivity and mitigate the impact of the growth of wages and salaries. Corporate profits and productivity that have demonstrated a growth in recent years will also have an upward effect on wages, without causing a loss of competitiveness.

In the first and second quarters of 2005, the number of the employed population grew by 2.5% and 2.2%, respectively, compared with the same periods of 2004. The continuing upward trend in employment shows that enterprises have used the available labour force resources in full and will have to hire additional staff to be able to further increase their production volumes. Financial support from the EU will stimulate a further growth of employment. The number of the employed population is projected to grow throughout the period covered, thus increasingly contributing to the growth of production.

With a drop of employment in agriculture in 2004, labour productivity in the sector grew by about 13%: those who stayed in agriculture managed to cope and keep the previous production volumes. Hence, re-training and re-allocation of labour force from a low-productivity sector to a higher one in the period covered becomes an important GDP growth factor in that it is capable of preventing a shortage of labour force.

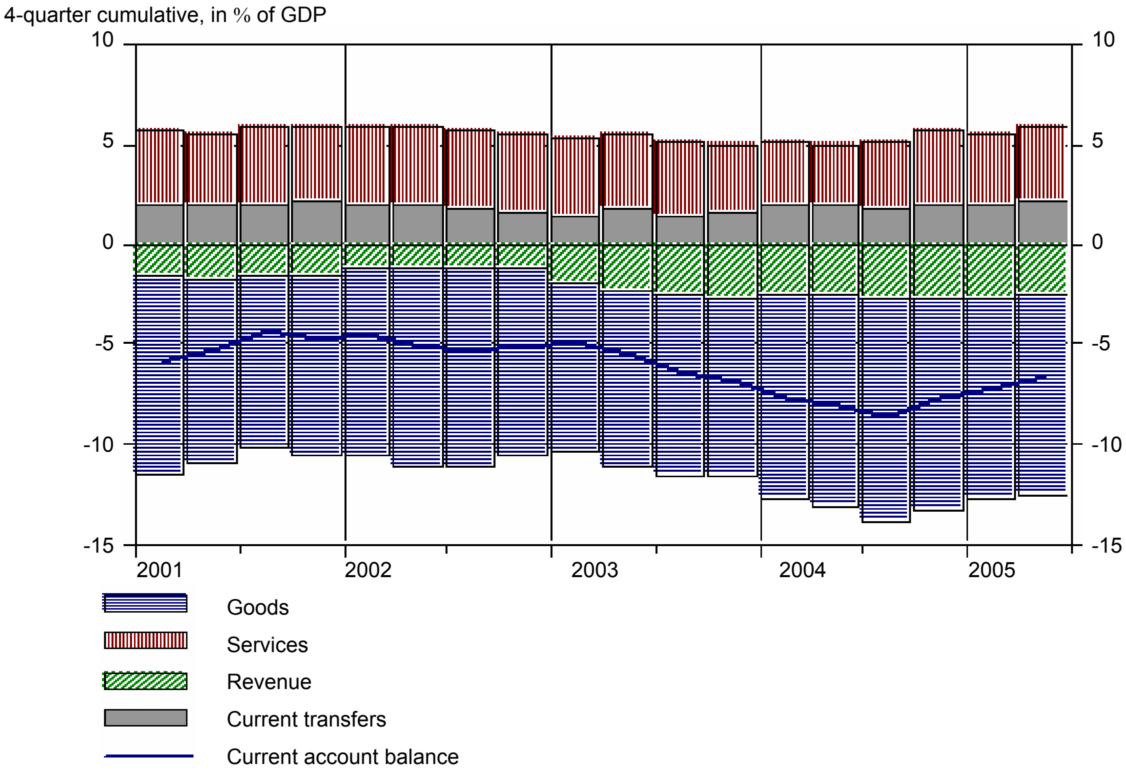
Owing to a growing demand for labour force, unemployment is projected to shrink from 11.4% in 2004 to 7.5% in 2008 (according to the data of an unemployment survey).

Balance of payments

19. In the first half of 2005 compared with the same period of 2004, Lithuania's CAD fell to account for 6.5% of GDP (cf. 9% of GDP in the first half of 2004). The reduction of foreign trade deficit was the largest stimulator of the change in the CAD. Because exports grew faster than imports, foreign trade deficit fell by 1.3% over the year, to account for 10.1% of GDP in the first half of the year. Owing to inflows from the EU, positive balance of current transfers grew by 0.2%, and income deficit slightly fell (by 0.7% of GDP). The positive balance of services grew to 3.6% of GDP.

Analysis of cumulative CAD of four quarters reveals a downward movement of this indicator in the second half of 2004. In the third quarter of 2004, cumulative CAD of four quarters hit the highest level in the past five years (8.7% of GDP), followed by a downward movement in the second half of 2004 to drop to 6.5% of GDP in the second quarter of 2005. With export growth surpassing the growth of GDP, this downward trend was largely determined by the shrinkage of foreign trade deficit. As far as savings and investment are concerned, the downward movement of CAD was determined by the higher domestic saving rate rather than the slower investment.

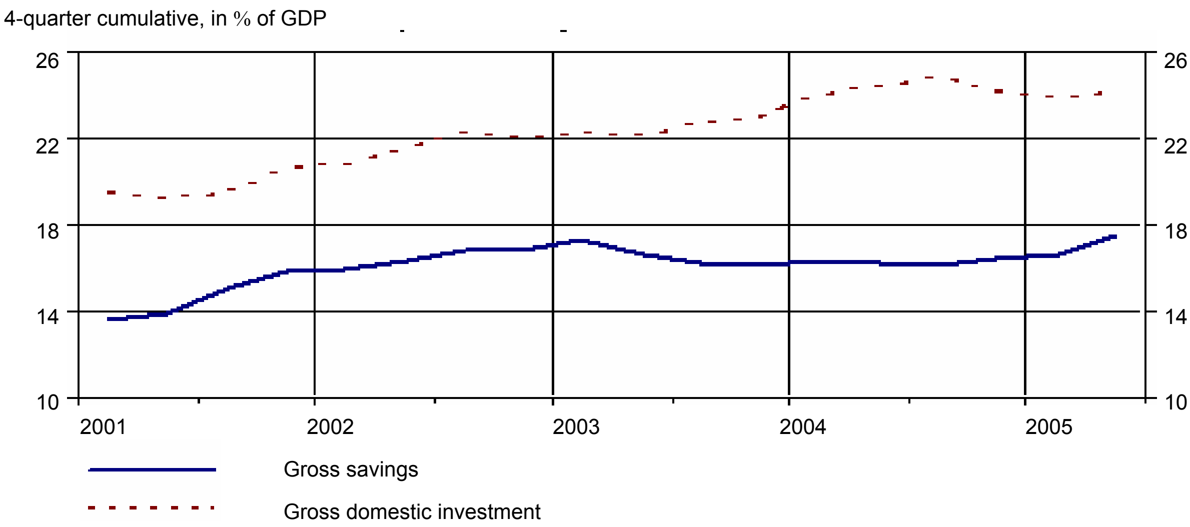
Fig. 6. Components of the current account balance



Source: Department of Statistics, Bank of Lithuania, estimates by the Bank of Lithuania

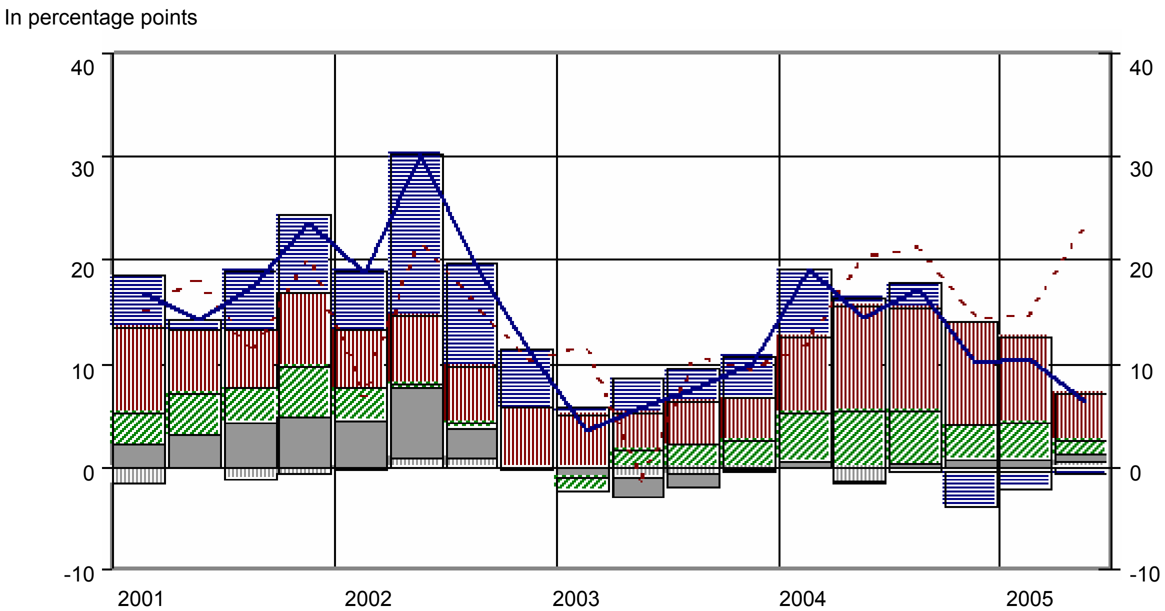
After a slowdown in the fourth quarter of 2004 and the first quarter of 2005, the annual nominal import growth rate resumed growth in the second quarter of 2005 and reached 24.1%. This was largely owing to higher volumes of import of oil products. Excluding fuel and petrol, the annual growth of imports went down to 6.4% in the second quarter. This slowdown of the growth of imports may, to a certain extent, be explained by a slowdown of the growth of the domestic demand (final consumption and investment).

Fig. 7. Structural factors of the current account deficit



Source: Department of Statistics, estimates by the Bank of Lithuania

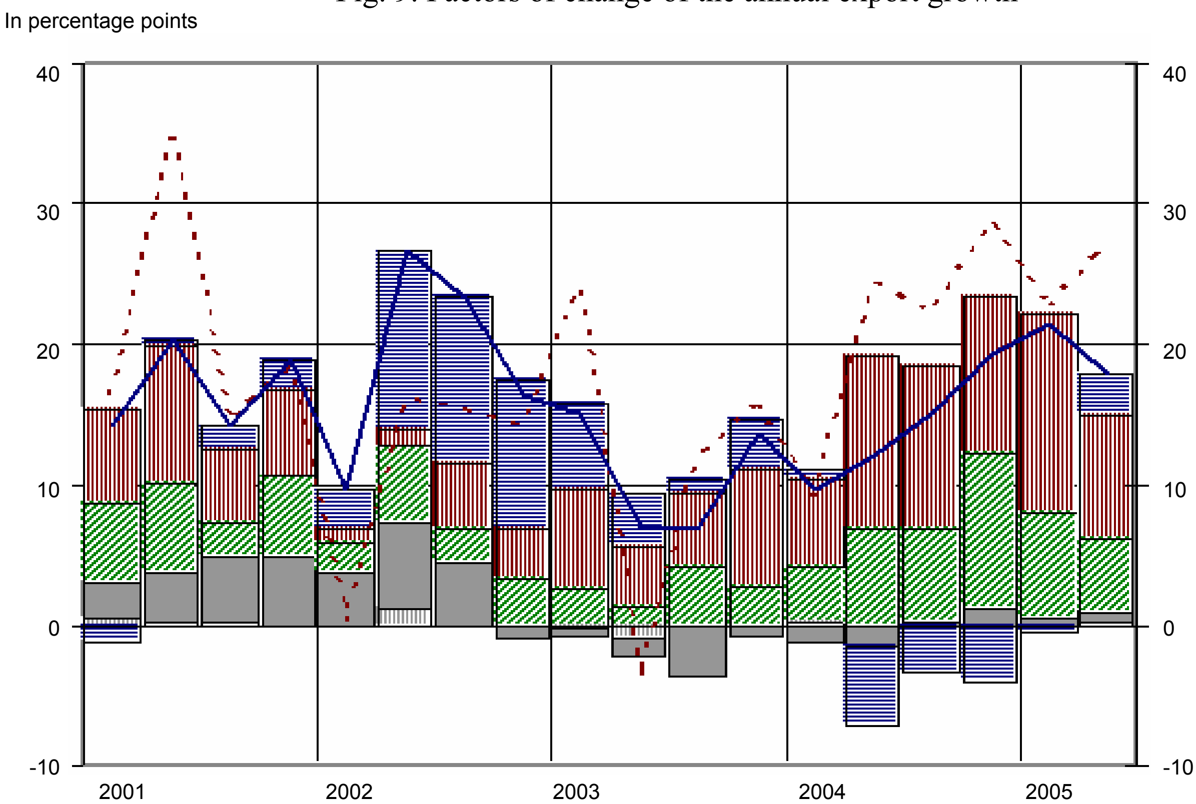
Fig. 8. Factors of change of the annual import growth



Source: Department of Statistics, estimates by the Bank of Lithuania

As a result of a slowdown of import of final consumption goods, the annual growth of imports (excluding fuel and petrol) increased by only 1.4 percentage points in the second quarter of2005. Apart from the deceleration of the domestic demand, this could also be attributable to the effect of a high comparative base: expecting a rise of import prices after accession, local manufacturers imported particularly many investment and interim consumption goods in the first quarter of 2004. In the second quarter of 2005, the effect of import of interim consumption goods on the annual growth fell to 4.4 percentage points.

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



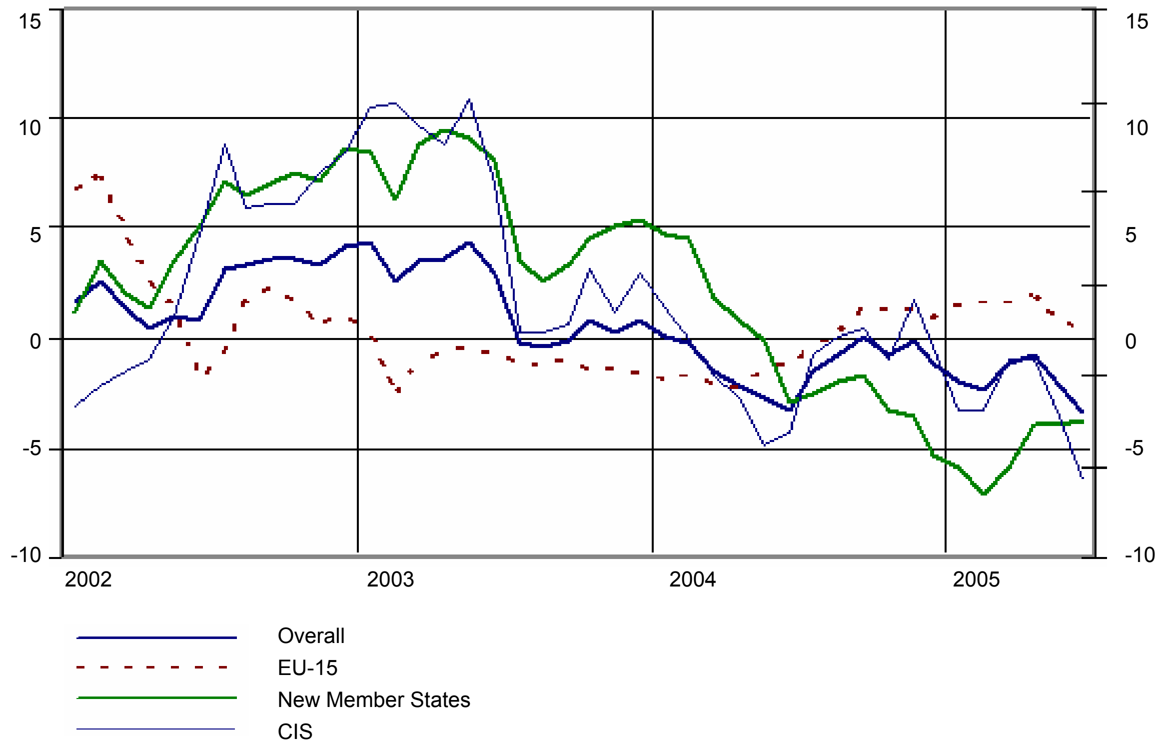
Source: Department of Statistics, estimates by the Bank of Lithuania

In the first half of 2005, like in 2004, nominal exports grew rapidly, by 24.8% year-on-year. Excluding the effect of fuel and petrol, the annual export growth rate was also quite high in the first quarter of 2005, 17.9%. The rapid growth of exports was mainly driven by access to EU markets and EU export subsidies for exports of certain agricultural products to non-EU countries. Particularly, the growth of exports was due to the increasing export of interim consumption (9.9 percentage points) and consumption goods (5.1 percentage points), food in particular.

The rapid growth of exports and a stable real effective exchange rate of the litas point at the capability of Lithuanian exporters to compete in prices. In the first half of 2005 compared with the same period last year, the CPI-based real effective exchange rate of the litas was down by 2% in foreign trade with all key partners. Mainly owing to the depreciation of the nominal litas exchange rate vis-à-vis currencies of the new EU member states and countries of the Commonwealth of Independent States (hereinafter referred to as the CIS), the real effective litas exchange rate dropped by 5.1% over the year. On the other hand, with inflation in Lithuania slightly higher than the EU-15 average, the real effective litas exchange rate compared with these states slightly grew (1.2%) over the year.

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

Annual change, in %

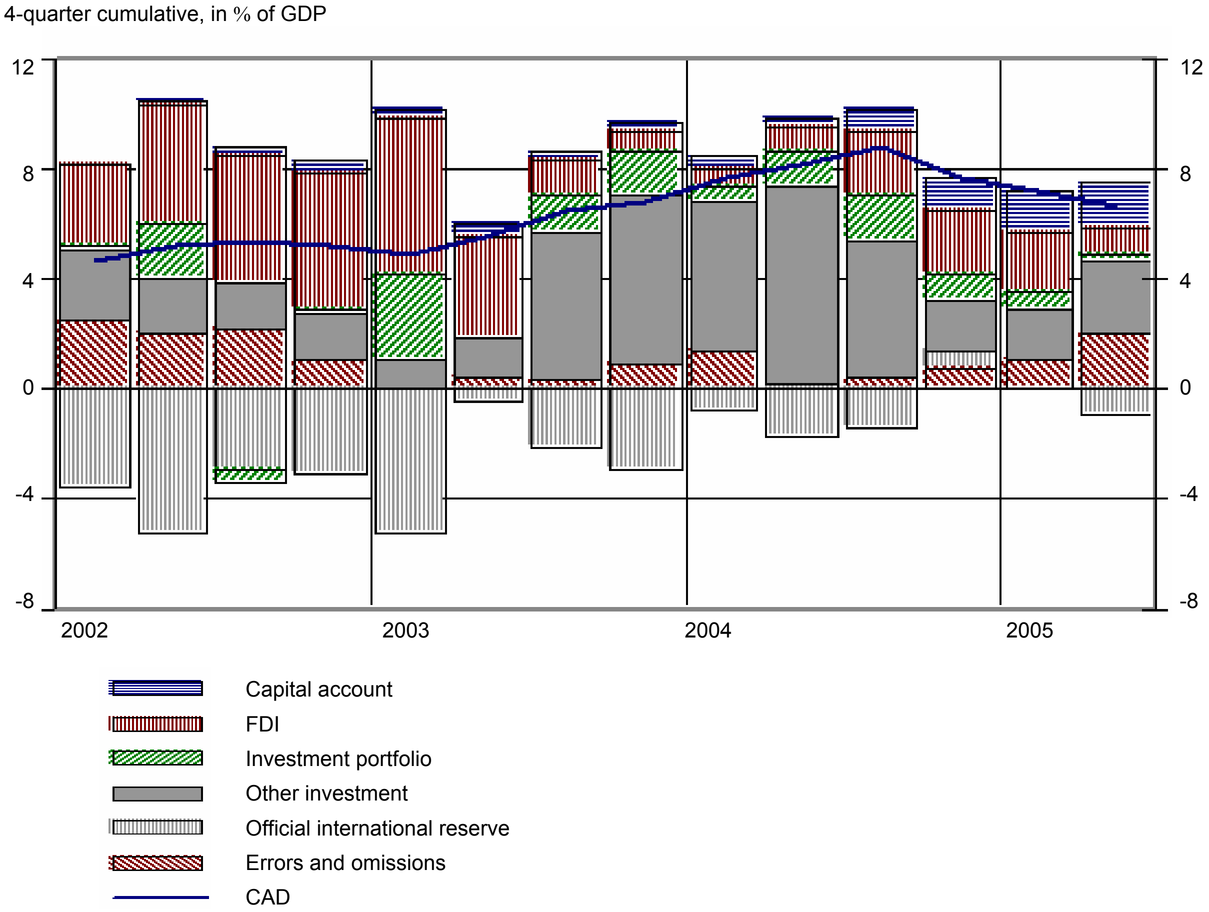


Source: Bank of Lithuania

As far as medium-term trends are concerned (analysing cumulative values of four quarters), the flow of foreign direct investment (hereinafter referred to as FDI) and capital transfers to Lithuania, i.e. debt-neutral capital flows, financed 46.5% of CAD in the first half of the year. Net inflows of other investment accounted for 2.2% of GDP, and investment portfolio inflows for 0.4% of GDP. A slight drop was recorded in the official foreign reserves (-0.4% of GDP).

In the second quarter of 2005, there was a slight change in international capital flows: a drop of net flow of FDI to Lithuania, a slight fall of net inflows of investment portfolio, and a growth of other investment.

Fig. 11. Sources of financing of the current account deficit



Source: Bank of Lithuania, estimates by the Bank of Lithuania

Even though the net flow of FDI (in % of GDP) was down by 1.1 percentage points, it should be noted that recent quarters witnessed not only a growth of FDI flows to Lithuania but also a growth of direct investment of Lithuanian investors in foreign countries. True, a bit more than a half of all FDI flows to Lithuania are reinvestment, whereas foreign investment by Lithuanian investors are mainly direct investments into corporate share capital. The four-quarter sum of reinvestment in Lithuania accounted for 2% of GDP in the first quarter and 1.1% of GDP in the second quarter, whereas investment in the share capital accounted for 1.6% and 1.2% of GDP, respectively. The four-quarter sum of investment by Lithuanian investors in foreign countries accounted for 1% of GDP in the first quarter and 1.1% of GDP in the second quarter, of which investment in the share capital accounted for 0.7% and 0.6% of GDP, respectively.

In 2005, the current account deficit is projected to stand at around 7.5% of GDP.

Table 5. Sectoral balances

% of GDP	ESA code	2004	2005	2006	2007	2008

1. Net borrowing		-6.6	-5.5	-4.7	-5.4	-4.8
of which:						
- Balance of goods and services		-7.1	-6.6	-7.0	-8.7	-8.1
- Balance of incomes and transfers		-0.7	-0.9	-2.0	-2.0	-2.1
- Capital account		1.3	2.1	3.8	3.3	3.6
2. Net surplus (+)/deficit (-) of the private sector		-5.1	-3.9	-3.3	-4.1	-3.9
of which:		0	0	0	0	0
- corporate sector		0	0	0	0	0
- households and NPISHs		0	0	0	0	0
3. Net surplus (+)/deficit (-) of general government		-1.4	-1.5	-1.4	-1.3	-1.0
4. Statistical discrepancy		0	0	0	0	0

As the credit boom gained momentum, the four-quarter sum of the flow of foreign loans extended to Lithuanian economic entities reached the highest level ever (6.1% of GDP). As banks were increasingly borrowing in the domestic market in the past quarters, the volume of lending by the main banks dropped sharply. In the first quarter, the four-quarter sum of the flow of loans to Lithuania was 2.1% of GDP.

A successful absorption of EU support funds will facilitate the financing of Lithuania's current account of the balance of payments and will be equally important as FDI: funds to be transferred by the EU are projected to account for 3.6% of GDP in 2008.

Structural reforms that will ensure a more economical use of energy resources will reduce the country's requirement for the import of oil and oil products for domestic use.

Higher transfers by Lithuanian residents working abroad are also likely to improve the position of Lithuania's current account of the balance of payments to a larger extent than projected so far.

GDP growth implications of major structural reforms

20. In the near future, the dynamics of government finances will be determined by two major structural reforms with a high GDP growth potential.

Personal income tax reform

21. Overview. Currently, there is a deep gap between labour and capital taxation in Lithuania: in 2003, the implicit tax rate on labour stood at 38.4%, and the implicit tax rate on corporate income, at 5%. Moreover, Lithuania currently applies one of the lowest marginal profit tax rates in the European Union, 15%, whereas personal income tax rate is one of the highest in the Baltic States, 33%; labour income is also subject to social security contributions at a rate of 34%. A heavier tax burden is on labour, with capital taxation being much lower; therefore, the tax system in principle supports legal personality in business and affects the growth of competitiveness in the region plus causes high labour costs. The high marginal tax rates on labour income also have the effect of poorer tax collection efficiency.

22. Goal. The key goal of the reform is to ensure the implementation of Lisbon strategy in the labour market: to increase participation of population, reduce unemployment, and increase employment. Once the gap between labour and capital taxation is reduced, the overall tax burden will be eased for people, labour emigration to foreign states will be held down, and GDP potential will be increased. Higher economic participation of population in the economy will mitigate the effects of ageing population.

23. Measures. On 7 June 2005, the Seimas of the Republic of Lithuania passed a law amending and supplementing Articles 6, 20, 27 and 37 of the Law on Income Tax of Individuals (*Valstybės žinios* (Official Gazette) No 76-2743, 2005), to provide for a gradual reduction of personal income tax from 33% to 24% over the years 2006 to 2008: to 27% (by 6 percentage points) from 1 July 2006 and to 24% (by 3 percentage points) from 1 January 2008. The Seimas also passed a temporary Law on Social Tax with effect as from 1 January 2006. The Law aims at ensuring financing for the implementation of social programmes and measures aimed at reducing poverty and social exclusion. The social tax will be payable by legal persons on taxable profits calculated in the manner prescribed in the Law of the Republic of Lithuania on Profit Tax, at the rate of 4% for the taxable year 2006 and 3% for the taxable year 2007. This implies a temporary increase of the marginal tax rate on corporate income to 19% in 2006 and to 18% in 2007.

24. Impact. By preliminary estimations, the personal income tax reform together with partly offsetting measures will bring revenue losses to the general government budget in the amount of around 0.09% of GDP in 2006, around 0.84% of GDP in 2007, and 1.98% of GDP in 2008.

The lower personal income tax rate will improve elasticity of the tax, promote the growth of employment and GDP potential and bring higher budgetary revenues in the long run. The introduction of the temporary social tax enables to take up the reduction of personal income tax earlier, without prejudicing the commitments under the Stability and Growth Pact, and to pursue a cyclically adjusted fiscal policy. The temporary social tax that will be reduced in 2007 and abolished in 2008 will help to mitigate a cyclical slowdown of GDP growth.

As pointed out in the World Bank EU-8 Quarterly Economic Report (first quarter), preliminary empirical estimations show that the increase of the tax burden by 1 percentage point means a slowdown of the growth of employment by 0.5 to 0.7 percentage points. Based on this estimation, we can preliminarily conclude that the cut of personal income tax rate by 1 percentage point would bring the potential GDP up by 0.3 to 0.4%, while the entire reform would bring it up by about 2.7 to 3.6%. At present, marginal rates of factors of production differ significantly. A rapid reduction of these differences will allow to come closer to an optimal utilization of factors of production and thus the GDP potential may increase more than by the linear approach. A significant cut of personal income tax rate will facilitate a faster development of household services and a more efficient fulfilment of household needs.

The tax reform will reduce general government structural revenues by 2 percentage points, and GDP potential will grow by about 2.7 to 3.6%, which suggests that the tax reform is economically efficient. As the increase of the GDP potential would be sufficient to cover about a half of general government structural revenues earmarked for the tax reform, the reform may in the essence be seen as an advance reduction of the tax burden achieved through a set of temporary tax measures. In the future, this reduction would be financed by the overall growth of productivity and the decline of GDP share of general government expenditure.

Apartment Houses Modernisation Programme

25. The Apartment Houses Modernisation Programme has been approved by Resolution No 1213 of 23 September 2004 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 143-5232, 2004, No 78-2839, 2005). The Programme is in line with the European Union directives directly dealing with improvement of energy efficiency in buildings, such as Council Directive 93/76/EEC of 13 September 1993 to limit carbon dioxide emissions in improving energy efficiency (SAVE) and Directive 2002/91/EC of the European Parliament and the Council of 16 December 2002 on the energy performance of buildings.

The Apartment Houses Modernisation Programme implements the goal of Lithuania's Housing Strategy approved by Resolution No 60 of 21 January 2004 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 13-387, 2004), i.e. to ensure efficient use, maintenance, renewal and modernisation of the existing housing stock and a rational use of energy resources. The Programme is scheduled for the period of 2005 to 2020.

26. Overview. The issue of a rational use of energy in residential buildings becomes increasingly painful and cannot be solved by homeowners alone. In Lithuania, more than 60% of apartment houses were built during the last four decades of the last century. The use of energy is not efficient in these buildings (20% to 30% of heating is lost). Their maintenance costs are very high in winter, and their owners, who are often low-income people, cannot pay heating bills. For low-income families, a part of expenses on heating and hot water is covered by the state. By the data of the Ministry of Social Security and Labour, about 7% of Lithuania's population are entitled to the reimbursement of expenses on heating. With the rise of energy prices, more budgetary funds would be needed for compensations. A large part of energy resources is imported, which has a negative effect on the balance of payments.

27. Goals. Lithuania's Housing Strategy provides that existing blocks of flats and, where possible and economically efficient, their engineering and technical installations will be renovated and modernised by 2020. For about 70% of apartment houses, relative consumption of thermal energy will be down by 10% to 30%.

The key goal of the Programme is to help owners of apartment houses and low-income families to modernise their homes, by improving energy efficiency and reducing expenses on heating.

28. Measures. State-supported measures aimed at modernising blocks of flats include: major repair or reconstruction of heating and hot and cold water supply installations; hermetisation or replacement of windows and outer doors; major repair or reconstruction of roofs through additional thermal insulation, including the construction of new sloping roofs (excluding construction of attic premises); glassing of balconies (loggia); thermal insulation of exterior walls and reinforcement of wall structures; hermetisation of walls and junctures of block houses; thermal insulation of cellar ceilings; major repair or replacement of lifts; replacement or reconstruction of common use electric installations. The Apartment Houses Modernisation Programme provides for the allocation of state support to owners of blocks of flats by reimbursing up to 30% of their investment in the modernisation of such houses, depending on the energy-efficiency of individual modernisation projects. Low-income families (one-person households) will be supported additionally, by reimbursing a larger part of the related costs.

29. Financing. Modernisation of blocks of flats will be financed by the homeowners' private funds, long-term loans from commercial banks, municipal funds, targeted support by the State, and from other sources.

Only houses built before 1993 are eligible to the state support

To take up an investment project under the Apartment Houses Modernisation Programme, homeowners have to pool a down payment of at least 10% of the total estimated value of the investment to be made. Banks, too, contribute to investment projects by granting loans. Such loans are granted for up to 90% of the value of the investment.

State support is given in the following manner: by reimbursing a portion of the investment in the modernisation of a block of flats depending on the energy-efficiency of the project or by reimbursing the costs for low-income families.

It has been estimated that the implementation of the Programme will require at least 7 billion litas in the period until 2020 or, for comparison, 7.9% of the GDP of 2008. 30% of this expenditure would be financed from the state budget, through statutory state support. A certain amount of the expenditure would be borne by general government. The state budget of 2006 allocates 6 million litas for this Programme or 0.01% of the GDP of 2006. For 2007 and 2008, budget allocations are expected to amount to 15 million and 25 million litas, respectively. In the future, state budget appropriations for the Programme will be planned by taking into consideration the financial capacity of the state to implement the provisions of the Stability and Growth Pact.

30. Economic Impact. The Apartment Houses Modernisation Programme will improve sustainability of general government finances in the long run and will be beneficial for the following reasons:

30.1. the future requirement for general government funds for heating compensations to socially disadvantaged groups of population will be lower, meaning better utilisation of general government finances;

30.2. small and medium construction business will be promoted;

30.3. expenditure on fuel (purchased during the heating season) will be lower, meaning a lower current account deficit;

30.4. positive social (promotion of reduction of unemployment) and environmental (lower levels of CO_2 emissions) aspects.

A research into how much GDP productivity will grow as a result of housing renovation projects that will lower the consumption of fuel for heating is planned.

III. PUBLIC FINANCES

Financial policies

31. The key goal of the fiscal policy in the medium term is the reduction, by implementing economic policy goals, of the structural deficit below or to 1% of GDP. 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 adjusted up, to implement the revised Stability and Growth Pact and the Broad Economic Policy Guidelines.

32. The medium-term fiscal policy will aim at implementing the following priorities of the macroeconomic policy:

32.1. to ensure macroeconomic stability by pursuing an anti-cyclic fiscal policy;

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

32.3. to implement a tax reform aimed at balancing labour and capital taxation;

32.4. to promote further reforms in energy and agriculture;

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

32.6. to match fiscal policies with the priorities of social policy.

33. Seeking to maintain confidence in the currency board arrangement, Lithuania will further improve, as part of its fiscal policy, the conditions for a long-term institutional saving and for a higher labour efficiency, and will ensure a successful completion of structural reforms, improve tax administration, promote investment, create favourable business environment, and ensure an effective use of public funds allocated for investment. Any additional general government revenue or unspent expenditure allocations will be used for the achievement of fiscal deficit target and for measures aimed at ensuring a long-term sustainability of government finances.

34. Actions planned for 2006 to 2007. Once a 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 the creation of jobs. Efforts will be made to make sure that the balance between labour and capital taxation is achieved without adding to the fiscal deficit, that it helps to prevent a pro-cyclic policy and creates conditions for businesses to enhance their competitiveness and profitability.

In 2005, Lithuania successfully mitigated negative effects of the shadow economy on general government finances. Owing to better tax administration, tax collection in 2005 is expected to be over one percentage point of GDP higher than planned. In the medium term, tax collection will be increasingly improved further; therefore, revenue plan is expected to be increased by about 0.2% to 0.4% of GDP. Any extra revenues, like in 2005, will be used to achieve fiscal deficit targets. Further efforts will be made to ensure a maximum efficiency of general government expenditure, by increasing investments and, as far as possible, expenditure on health-care and education (as a percentage of GDP).

Like in 2005, general government budget allocations that might remain unspent due to delays in co-financing the EU support or for other reasons will be used for the reduction of fiscal deficit.

Actual balances and implications of the forthcoming budget on medium-term goals

35. The rapid economic development is a proof of the pragmatic and insightful character of the sustainable fiscal policy pursued in recent years, which has ensured the stability of public finances and 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 budget deficit amounted to 3.5% of GDP, followed by a drop to 2% of GDP in 2001. In 2002, Lithuania reached its medium-term goal: general government structural fiscal deficit accounted for 0.8% of GDP in 2002. The pension reform launched in 2004 and payments to the EU Own Resources have lessened possibilities to reduce fiscal deficit quicker. As a result, general government budget deficit slightly grew (to 1.4% of GDP), and the structural deficit grew to 1.9% of GDP in 2004.

Despite a higher co-financing of the EU support funds in 2005 and a successful implementation of the pension reform and other social programmes, general government budget deficit is projected to be much lower than planned in 2005. The tightening of general government fiscal deficit targets for 2005 is possible thanks to the implementation of measures envisaged in this Programme: better tax administration will ensure that revenue plan will be outreached by over one percentage point of GDP, and the expenditure that will be saved will account for more than 0.5 percentage points of GDP.

Seeking to ensure that the target of 3% is not overpassed and the ambitious social commitments for future pensioners are implemented, and as the temporary budget burden imposed by the membership in the EU eases and the need for structural reforms falls over the medium term, general government budget will start running surpluses.

The structure of general government finances will change in the period of 2005 to 2007 from that in 2004, mainly due to the impact of the tax reform on general government revenues and expenditures.

The many-year practice has shown that planned capital investment accounting for about 0.5 percentage points of GDP is being saved annually; thus, the deficit calculated in the manner prescribed in the draft budget law (see Table 6) may be reduced accordingly, i.e. Lithuania can reach the medium-term fiscal deficit target earlier than provided for in the draft budget legislation currently with the Seimas.

36. This Programme fundamentally changes general government financial projections due to the following factors: the carry-forward to 2007 and 2008 of the absorption of funds allocated for fixed capital formation; tax measures aimed at achieving a balance between labour and capital taxation and at improving competitiveness; the commitment to further improve tax administration; and Eurostat's decision regarding the accounting approach of restitution of real estate and rouble savings for citizens. Classification of the expenditure on the pension reform as a loss of general government revenue rather than transfers to the private sector will also have a downward effect on general government revenue (as a percentage of GDP). Following Eurostat guidelines, EU support for the private sector is not assigned to general government, in this Programme.

Table 6. General government budgetary (S13) projections, 2005 to 2008 (% of GDP)

		2004	2004	2005	2006	2007	2008
	ESA* code	level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. General government	S.13	-888.9	-1.4	-1.5	-1.4	-1.3	-1.0
2. Central government	S.1311	-1398.9	-2.2	-1.7	-1.4	-1.3	-1.0
3. State government	S.1312	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
4. Local government	S.1313	91.8	0.1	0.2	0.0	0.0	0.0
5. Social security funds	S.1314	418.2	0.7	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	19855.7	31.8	33.5	33.8	33.3	33.0
7. Total expenditure	TE	20744.7	33.2	35.1	35.2	34.6	34.0
8.Net lending/ borrowing	B.9	-888.9	-1.4	-1.5	-1.4	-1.3	-1.0
9. Interest expenditure	D.41	623.8	1.0	0.9	0.8	0.8	0.8
10. Primary balance		-265.0	-0.4	-0.6	-0.6	-0.6	-0.2
Revenue							
11. Indirect taxes	D.2	6937.5	11.1	11.6	11.6	11.8	12.1
12. Direct taxes	D.5	5464.0	8.8	9.4	9.3	8.6	7.6
13. Capital taxes	D.91	1.7	0.0	0.0	0.0	0.0	0.0
14. Social contributions	D.61	5440.0	8.7	8.2	7.9	7.8	7.8
15. Property income	D.4	453.2	0.7	0.6	0.6	0.6	0.6
16. Other (16=17-(11+12+13+14+15))		1559.3	0.0	0.0	0.0	0.0	0.0

		2004	2004	2005	2006	2007	2008
	ESA* code	level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
17=6. Total revenue	TR	19855.7	31.8	33.5	33.8	33.3	33.0
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		12403.2	19.9	21.0	20.9	20.5	19.7
Expenditure							
18. Collective consumption	P.32	4531.4	7.3	7.1	7.0	6.4	6.1
19. Social transfers in kind	P.31=D.63	6498.1	10.4	9.5	9.9	10.0	9.2
20. Social transfers other than in kind	D.62	5653.6	9.1	9.4	9.3	9.3	9.2
21=9. Interest expenditure	D.41	623.8	1.0	0.9	0.8	0.8	0.8
22. Subsidies	D.3	341.6	0.5	0.7	0.7	0.9	0.9
23. Gross fixed capital formation**	P.51	2148.7	3.4	4.1	4.5	5.1	5.2
24. Other (24=25-(18+19+20+21+22+23))		947.4	1.5	3.4	3.0	2.1	2.7
25=7. Total expenditure	TE	20744.7	33.2	35.1	35.2	34.6	34.0
Compensation of employees	D1	6747.2	10.8	11.0	11.0	10.1	9.8

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

Source: Department of Statistics, Ministry of Finance

In the medium term, general government revenue (as a percentage of GDP) will be growing. Accounting for 31.8% of GDP in 2004, it will grow to 33.5% of GDP in 2005 and to 33.8% of GDP in 2006. In 2007 and 2008, the GDP share of general government revenue will decline to 33.3% of GDP and 33% of GDP, respectively, as a result of the reduction of personal income tax and the pension reform.

The GDP share of revenue collected as indirect taxes will be on the track of growth throughout the medium term. The improved tax administration will serve to increase indirect taxation revenue from 11.6% of GDP in 2005 to 12.1% of GDP in 2007. Owing to better administration of personal income tax and profit tax, direct taxation revenue will account for 9.4% of GDP in 2005, up by 0.6% of GDP from the 2004 level.

As a result of fiscal deficit strategy, total general government expenditures have been declining to reach 33.2% of GDP in 2004. The absorption of EU support funds and national investment will raise the GDP share of expenditure to 35.1% in 2005. To be able to implement fiscal policy objectives matched to the economic cycles, general government expenditure should shrink to 34.6% of GDP in 2007. Owing to efficient collective consumption and the retention of average net wages and salaries in the public sector at the level of 2006 (with the reduction of personal income tax rate, gross wages and salaries will grow rapidly), general government expenditure will be down to 34% of GDP in 2008. The decline of general government expenditure has hardly any effect on investment expenditure that is projected, in this Programme, to grow by nearly 2 percentage points (comparison of 2004 and 2008). The commitment under the Stability and Growth Pact to reduce structural deficit by 0.5 percentage points of GDP annually does not affect plans to improve government finances. Gross fixed capital formation is expected to grow, due to the absorption of EU support, from 3.4% of GDP in 2004 to 5.2% of GDP in 2008. The rapid growth of investment will improve the quality of public finances.

As a result of a consistent implementation of a strict fiscal discipline, Lithuania's government current expenditure will remain at the lowest level in the EU. Government expenditure (as a percentage of GDP) will be slightly up by the Public Investment Programme and the growing EU investment support. Fiscal discipline will be maintained by reducing, in the medium term, the share of government current expenditure and by keeping the share of social expenditure above 9% of GDP.

The successful implementation of the pension reform will allow to prepare for the reduction of government debt projected for 2050 and encourage private persons to individually save funds for the old-age pension. In 2008, tax revenue allocation for the pension reform will account for 0.8 percentage points of GDP.

General government expenditure for payments to the EU budget will be increasing in 2005 and 2006 and will stabilize at 1.1%of GDP.

A number of factors, such as the need to co-finance EU support, the increase of support to agriculture, and the tax and pension reforms will call for additional funds. To be able to reach medium-term general government fiscal deficit targets, collective consumption expenditure will have to be down from 7.3% of GDP in 2004 to 6.1% of GDP in 2008. Support to agriculture financed from national resources will be increased by 0.2% of GDP compared with 2004, to account for over 0.4% of GDP in 2005. The decision to top up towards the EU level in making direct payments to agriculture was adopted by Resolution No. 1391 of 8 November 2004 of the Government of the Republic of Lithuania on direct payments to agricultural entities of Lithuania in 2005 (*Valstybės žinios* (Official Gazette) No 164-5982, 2004), which lays down that direct payments to agriculture for agricultural holdings shall reach 60% of the EU average in 2005.

The successful implementation of the borrowing policy will lead to the reduction of the GDP share of interest payments from 0.9% in 2003 to 0.6% in 2008.

37**.** *General government subsectoral balances*. Budgets of social security funds continued to run surpluses: a surplus of 0.7% of GDP was recorded in 2004.

Better administration of collection of municipal revenues and a strict control over municipal borrowing have served to form a slight overall surplus of municipal budgets in 2004 (about 0.1% of GDP). In 2004, actual municipal budgetary revenues exceeded the plan by 0.6% of GDP.

As a result of the structural and tax reforms carried out in recent years, the whole general government deficit consisted in the central government budget deficit, which accounted for 1.35% of GDP in 2004.

It is projected that a surplus or a close-to-balance municipal budget will be achieved in the medium term. As the costs of the pension reform will be increasing with time, the surplus of the Social Security Fund will decrease; however, the growth of employment and wages will sustain a slight social sub-sector surplus.

The decrease of the central government deficit will exert a downward pressure on the general government deficit over the medium term.

The reduction of general government structural deficit by about 0.5% of GDP is shown in Table 10.

Structural deficit and sustainability of fiscal policy

38. For the calculation of the structural deficit, this Programme uses stricter assumptions about the cyclicity of current expenditures: it is assumed that current expenditure is hardly responsive to cyclical fluctuations.

The highest cyclic fluctuation of general government deficit was 0.52% of GDP in 2000-2004. By a determined continuation of the expenditure-down and revenue-up policy, efforts will be made to bring the cyclically-adjusted general government deficit down by 1 percentage point over 2005-2008 to 0.9% of GDP by the end of the projected period. The reduction of the cyclically-adjusted deficit will activate automatic stabilisers in the economic cycle.

39. **Estimation of the output gap.** The GDP cycle was estimated by applying the *Hodrick Prescot* (HP) filter. The results of this estimation point at a positive output gap today and at a change of the economic cycle in 2007.

In 2005, the output gap will be 1.72%, followed by a drop to 0.88% in 2006, -0.47% in 2007, and -0.22% in 2008.

Table 7. Cyclical developments (in % of GDP)

% of GDP	ESA code	2004	2005	2006	2007	2008
1. Real GDP growth (%)		7.0	7.0	6.0	5.3	6.8
2. Net borrowing (+)/lending(-) of general government		-1.4	-1.5	-1.4	-1.3	-1.0
3. Interest expenditure		1.0	0.9	0.8	0.8	0.8
4. Potential GDP growth (%)		7.0	7.0	6.9	6.7	6.5

% of GDP	ESA code	2004	2005	2006	2007	2008
of which:		0.0	0.0	0.0	0.0	0.0
- 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	1.7	0.9	-0.5	-0.2
6. Cyclical budgetary component		0.5	0.5	0,3	-0.1	-0,1
7. Cyclically-adjusted balance (2-6)		-1.9	-2.0	-1,7	-1.2	-0,9
8. Cyclically-adjusted primary balance (7-3)		-0.9	-1.1	-0,8	-0.3	-0,2

Source: Department of Statistics, Ministry of Finance

However, due to short time-lines under the Hodrick Prescot filter approach or under the production function approach (using NAIRU), the estimation of Lithuania's output gap is not completely accurate. Conclusions obtained under the production function approach (using NAIRU) are, for the time being, not acceptable due to short time-lines, a lack of reliable data and a plenitude of structural breaks. The Hodrick Prescot filter approach has a disadvantage, lying in the fact 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". Thus, the weaknesses of the two approaches must be taken into account if they are to be used to estimate the structural deficit.

In the period from 1995 to 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 of 1995 to 2002 (period of observations: 7 years), elasticity was estimated for customs duties, value added tax, excises, revenues, profit taxes, and current expenditure.

As Table 8 below shows, revenue from tobacco has a zero elasticity. It has been estimated that revenue from fuel is most elastic, i.e. fuel is a commodity the consumption of which 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 calculates 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 general government current expenditures and a slowdown of GDP growth persisted, the share of the cyclical deficit would make as little as one-tenth of the output gap in the medium term.

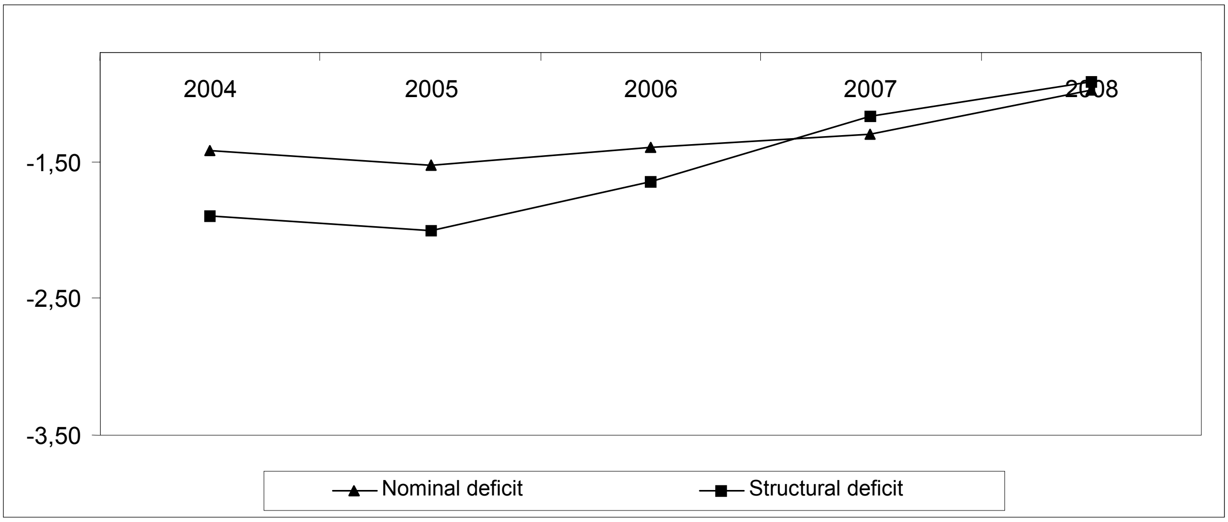
Table 8. Elasticity of general government budgetary revenues

ESA'95 code		Cyclical easticity values
D.212	Duties	0.84
D.211	VAT	0.97
D.214	Excises	1.36
	Of which:	
	on alcohol	1.09
	on tobacco	0
	on fuel	1.57
D5	Income and profit taxes	1.03
D61	Social contributions	0.98
	Current expenditure	0

Source: Ministry of Finance

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

Fig. 12. General government structural and cyclical budget deficit developments, 2004–2008



Debt levels and developments

40. General government debt has been continuously decreasing in the past years to account for 19.5% of GDP at the end of 2004.

The government borrowing volumes are strictly regulated by the Law on Approval of Financial Indicators of the State Budget and Municipal Budgets, which sets annual limits on the net borrowing by the Government of the Republic of Lithuania, on municipal borrowing and on newly contracted government guarantees. The larger part of general government debt consists of central government debt (about 96%), whereas municipal and social funds debt account for only about 4%.

Central government debt has a rather conservative structure: 9% of the total debt consists in short-term liabilities (by outstanding maturity), and 2%, in variable interest rate debt. Debt in foreign currencies with a variable exchange rate vis-à-vis the litas or the euro account for only 4% of the total debt. This structure of the debt portfolio poses quite low risks on public finances.

41. The key objective of the management policy of medium-term debt liabilities undertaken on behalf of the state is to ensure, in the medium term, that public expenditures and debt liabilities undertaken on behalf of the state are financed, as laid down in laws of the Republic of Lithuania, by borrowed resources at the lowest possible cost and with acceptable risks, without exceeding the limits placed on the stock of debt and on new borrowing and in line with the requirements placed on the EU Member States seeking to adopt the euro.

42. The borrowing strategy of the Government of the Republic of Lithuania has not changed from that of the previous year.

The largest share of the Government's borrowing requirement in the coming years will be necessitated by the repayment of foreign and domestic debt and budget deficit financing.

It is anticipated that the Reserve (Stabilisation) Fund will have accumulated about LTL 1353m by the end of 2005. In case of unfavourable developments in financial markets, the Government of the Republic of Lithuania has the right to draw on these resources to implement its debt-related property liabilities, with an obligation to pay them back.

43. In the medium term, the Government of the Republic of Lithuania has envisaged to implement the following borrowing policy measures:

43.1. to finance the Government's borrowing requirement in the litas and the euro or other currencies to be converted to the litas or the euro through derivatives;

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

43.3. to finance the Government's borrowing requirement mainly by issuing Government securities in the domestic and foreign markets;

43.4. to concentrate Government securities to be issued both domestically and in foreign markets into large issues, thus improving their liquidity;

43.5. to balance flows of public monetary resources by using T-bills, credit lines, repos and other short-term borrowing instruments.

44. *General government debt projections.* In 2005, general government debt is projected to fall to 19.2% of the projected GDP and stay at approximately the 2004 level, to be followed by a slight increase to 19.9% of the projected GDP in 2006 and then by a continuous decline over the medium term to reach 18.9% of the projected GDP by the end of 2008.

Table 9. General government debt projections

% of GDP		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
1. General government debt as of year-end		19.5	19.2	19.9	19.8	18.9
2. Change in general government debt		-1.7	-0.3	0.7	-0.1	-0.9
Contributions to change in general government debt						
3. Primary balance		0.4	0.6	0.6	0.5	0.2
4. "Snow-ball" effect		-1.0	-0.9	-0.9	-0.7	-1.0
5. Debt change adjustment		-1.2	0	1.0	0.2	-0.1
p.m. implicit interest rate on debt (%)		5.0	4.7	4.5	4.3	4.1

% of GDP		Year 2004	Year 2005	Year 2006	Year 2007	Year 2008
Other relevant variables						
6. Liquid financial assets						
7. Net debt (7=1-6)						

Implications of structural reforms on general government finances

45. 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 by removing the effect of the business cycle. Table 10 below may be used to calculate the shrinkage of the structural deficit in the light of structural changes in general government finances: the commencement of payments to the EU Own Resources and co-financing of the EU support, the progress of the pension reform and the tax reform. Figures in the Table also take account of the temporary social tax measures. It has been calculated, taking into consideration these structural changes in the finances and the temporary measures, that general government budgetary plans will create the conditions for the reduction of the structural deficit adjusted in the light of the structural reforms and temporary measures by about 0.5% of GDP over 2005 and 2006 and by about 1.5 percentage points of GDP over 2007 and 2008. In 2005–2008, Lithuania will need additional financial resources in the amount of 4.2 percentage points of GDP, or about 1 percentage point of GDP annually, for the implementation of new structural reforms. The required additional financial resources will be available thanks to a rapid growth of GDP and better tax administration as well as through saving in 2007 and 2008 to be achieved by leaving average net wages and salaries in the general government principally at the 2006 level. Through the planned reduction of the personal income tax rate, there will be a rapid growth in gross wages and salaries.

Table 10. General government structural and cyclical fiscal deficit projections, and the additional financing requirement associated with structural changes (% of GDP)

		2003	2004	2005	2006	2007	2008
1.	General government fiscal deficit target	-1.2	-1.4	-1.5	-1.4	-1.3	-1.0
2.	Cyclical fiscal deficit (-)	0.49	0.50	0.52	0.26	-0.14	-0.06
3.	Structural fiscal deficit	-1.69	-1.92	-2.04	-1.66	-1.16	-0.92
4.	EC Own Resources	0.00	0.66	1.09	1.10	1.09	1.09
5.	Co-financing requirement	0.23	0.14	0.26	0.56	0.53	0.49
6.	Pension reform	0.00	0.28	0.48	0.66	0.82	0.80

		2003	2004	2005	2006	2007	2008
7.	Tax reform				0.09	0.84	1.98
8.	Housing renovation				0.01	0.02	0.03
9.	Short-term increase in revenue (introduction of social tax)				-0.53	-0.44	-0.02
10.	Structural deficit less the amount of payments to the EU Own Resources, co-financing requirement and loss of revenue or temporary revenue	-1.46	-0.85	-0.20	0.23	1.65	3.32
11.	Structural measures implemented annually in general government, to fulfil the commitments under the Stability and Growth Pact		-0.61	-0.66	-0.43	-1.42	-1.66
	GDP projection, LTL m Lt	56772	62440	68469	75218	81368	89168

IV. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Economic development risks and their budgetary implications

46. Budget projections are made herein on the basis of preliminary assumptions by the EU Commission made available prior to the update of the Convergence Programme.

A medium-term growth of variable and fixed market interest rates by one percentage point would mean an increase of interest payable on central government debt (including new borrowing) of LTL 31m in 2006, LTL 49m in 2006, and LTL 72m in 2007, or about 0.1% of GDP on the average.

47. A successful absorption of EU support is a sufficient means to offset the factors that slow down the GDP growth: higher expenditure on oil, loss of revenue as a result of the decommissioning of Unit I of the Ignalina Nuclear Power Plant, and a cyclical fluctuation of the economy after the record-high growth of credits. In 2007 and 2008, GDP growth implications of high oil prices would be additionally offset by the EU support-driven improvement of economic infrastructure and higher production capacities.

48. Should the assumptions about growth-driving factors fail, the continued rise in oil prices could slow down the real GDP growth by about 0.5%, and unreasonable consumer expectations about the overall price boom could affect consumer behaviour, thus accelerating the nominal GDP growth: oil prices are not likely to affect the nominal growth of tax bases.

A slowdown of GDP growth in 2006 and 2007 would be a temporary situation. Medium-term growth of GDP over the period covered will remain close to the potential one, over 6%.

The growth of wages and salaries are likely to be faster than projected, driven by a rapider 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. As additional revenue becomes available and with a view to keeping skilled labour, wages and salaries in general government may be adjusted accordingly.

Fiscal risks

49. The main projected sources of fiscal risks include deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises to banks, savings restitution, and the decommissioning of the Ignalina Nuclear Power Plant.

50. *Deposit insurance*. As of 1 November 2005, the total amount of insured deposits was LTL 21399.4m or 31.3% of GDP.

51. *Savings restitution*. As of 1 November 2005, these commitments stood at LTL 1568.6m or 2.3% of GDP. In 2005, the Law of the Republic of Lithuania on Savings Restitution was amended to provide for an additional source of funding: state budgetary funds and/or funds borrowed by the Government on behalf of the state within borrowing limits.

52. *Restitution of real estate ownership rights.* The financing requirement for compensations for the land, forest area and water bodies to be repurchased by the state accounted for 0.9% of GDP as of 1 October 2005.

As of 1 October 2005, the financing requirement for the restoration of ownership rights for citizens to existing residential houses, parts thereof or apartments, and for compensations to be paid to religious communities for the real estate repurchased by the State accounted for 0.4% of GDP.

Article 8.2 of the Law on the Amounts, Sources, Terms and Procedure of Payment of Compensations for Real Property 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 the Existing Real Property provides that compensations 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 government guarantees shall be invoked in favour of tenants subject to the re-assessment of the market value of the residential premises leased.

53. *Decommissioning of the Ignalina Nuclear Power Plant.* Operation of the Ignalina NPP and foreign financing for the termination of operation entail certain risks. For the decommissioning of the Ignalina Nuclear Power Plant, the EU has allocated EUR 315m for the period of 2004 to 2006. According to Lithuania's calculations, the technical and socio-economic expenditures will require EUR 950m in the period of 2007 to 2013. The financing of this expenditure will depend on the outcome of negotiations about the EU financial perspective for 2007-2013.

54. *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 1 November 2005, government-guaranteed loan portfolio accounted for about 1.9% of GDP. This figure is expected to drop to 1.2% of GDP over the medium term.

55. *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 by the state and government-guaranteed loans are classified into 5 risk groups (in line with commercial banking practices). The risk group is determined on account 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 the investment project concerned.

As of 30 June 2005, borrowers of the fifth risk group collectively had LTL 341.816m worth of outstanding loans on-lent to them from loans taken on behalf of the state and about LTL 78.117m worth of outstanding government-guaranteed loans.

As of 30 September 2005, the stock of outstanding loans on-lent from loans taken on behalf of the state to Lithuanian economic entities in which the state held over 51% of shares totalled LTL 167.022m, and the stock of outstanding debt of Lithuanian economic entities in which the state held over 51% of shares, built up as a result of discharging by the Ministry of Finance of its obligations under government guarantees or in the failure by the borrower to implement their obligations under guarantee fee or other contracts, totalled LTL 86.466m.

Comparison with previous update

56. GDP projections have been revised to reflect the actual figures of the nine months of 2005 announced by the Department of Statistics and the new assumptions about oil prices. The revision of the actual data of 2004 and certain adjustments after the Eurostat clarification regarding the accounting approach for real estate restitution and savings restitutions have changed general government deficit figures. The projections below have been made according to ESA'95.

Table 11. Change in GDP, general government deficit and general government debt projections, by ESA'95 (% of GDP)

	ESA code	2004	2005	2006	2007	2008
Real GDP growth (%)						
Previous update		6.5	6.5	6.2	6.0	N.A.
Current update		7.0	7.0	6.0	5.3	6.8

Difference		0.5	0.5	-0.2	-0.7	N.A.
General government net borrowing (+)/lending(-) (% of GDP)	EDP B.9					
Previous update		-2.5	-2.5	-1.8	-1.5	N.A.
Current update		-1.4	-1.5	-1.4	-1.3	-1.0
Difference		-1.1	-1.0	-0.4	-0.2	N.A.
General government gross debt (% of GDP)						
Previous update		20.1	20.9	20.3	20.1	N.A.
Current update		19.5	19.2	19.9	19.8	18.9
Difference		-0.6	-1.7	-0.4	-0.3	N.A.

* Convergence Programme of Lithuania, January 2005

Source: Department of Statistics, Ministry of Finance

V. QUALITY OF GENERAL GOVERNMENT FINANCES

57. Policy strategy. As part of the budgeting reform, off-budgetary funds have been incorporated into the state budget of the Republic of Lithuania and a number of legal amendments were passed to enable the accumulation of public funds in the Reserve (Stabilisation) Fund, with the Privatisation Fund being its primary source of income, to be drawn on in extreme situations and economic threats so as to ensure a smooth functioning of the economy. As of 1 November 2005, the Reserve (Stabilisation) Fund had LTL 1,374.5m (2% of GDP), of which LTL 904.2m were used to implement debt-related property obligations of the state with the obligation to pay them back. LTL 459.2m will be paid back by 31 December 2005.

Thanks to fiscal consolidation, the share of public administration expenditure in Lithuania (in % of GDP) has dropped to one of the lowest figures in the European Union. According to Eurostat, expenditure on general public services accounted for 7% of GDP in EU-15 and only 3.4% of GDP in Lithuania in 2003. Given the intentions to maintain the quality of health care and education services, the implementation of the Stability and Growth Pact in Lithuania is likely to limit these functions to the lowest extent. Although the share of GDP reallocated in general government was one-third lower in Lithuania than in EU-15, the share of GDP allocated for energy, agriculture, transport and other activities was close to the EU-15 average. EU support will increase the share of GDP allocated for economic functions by another several percentage points.

Table 12. General government expenditure by function

% of GDP	COFOG Code	2003	2008
1. General public services		3.4	-
2. Defence		1.5	-
3. Public order and safety		1.9	-
4. Energy, agriculture		4.2	-
5. Environmental protection		0.4	-
6. Transport and communications, other services		0.6	-
7. Health care		4.3	-
8. Culture		0.8	-
9. Education		5.9	-
10. Social protection		10.0	-
11. Total expenditure		33.1	34.0

Source: Department of Statistics

General government expenditure

58. General government expenditure policy. The dynamics of general government expenditure was directly determined by the changes in the economic situation and fiscal policy objectives.

Over the period of 2000 to 2004, the GDP share of general government expenditure was continuously declining: from 39.5% in 2000 to 33.2% in 2004 (by preliminary data reported by the Department of Statistics). This downward trend was the outcome of the strict fiscal deficit reduction policy and the increasingly lower involvement of the government in the goods and services market. A steady reduction was recorded in private consumption expenditure (from 12.1% of GDP in 2000 to 10.4% of GDP in 2004), in collective consumption expenditure (from 9.5% of GDP in 2000 to 7.4% of GDP in 2004) and social transfers (from 10.5% of GDP in 2000 to 9.1% of GDP in 2004). The decreasing interest rates on Government securities and the favourable conditions on the international securities market have served to reduce interest payments on general government debt. General government subsidies varied at around 0.8% of GDP during 2000 to 2003. Upon accession, national subsidies were partly replaced by EU subsidies; as a result, the level of national subsidies fell to 0.5% of GDP.

Table 13. General government expenditure, -2000-2004, by ESA'95 (% of GDP)*

Indicators	ESA code	Year 2000	Year 2001	Year 2002	Year 2003	Year 2004
Total expenditure		39.5	35.0	34.1	33.1	33.2
Collective consumption	P32	9.5	8.1	7.7	7.6	7.4
Private consumption	P31	12.1	11.9	11.6	10.8	10.4
Capital depreciation	K1	2.0	1.8	1.4	1.3	1.3
Social transfers other than in kind	D62	10.5	10.6	9.3	9.1	9.1
Interest expenditure	D41	1.7	1.6	1.4	1.3	1.0
Subsidies	D3	0.8	0.8	0.8	0.8	0.5
Gross fixed capital formation	P51	2.4	2.2	2.9	3.0	3.4
Other		4.1	1.7	2.0	1.9	2.7
Budget balance	B9	-3.5	-2.0	-1.4	-1.2	-1.4

*data of the Department of Statistics

General government expenditure on gross fixed capital formation has been decreasing since 2000 to reach 2.2% of GDP in 2001, followed by a rapid upward movement in 2002 to reach 3.4% of GDP in 2004.

With a view to ensuring a more efficient use of EU support, the 2005 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets authorises the Government of the Republic of Lithuania, or another institution authorised by the Government, to reallocate EU support and national co-financing funds allocated for programmes and projects and funds allocated for paying value added tax on these programmes and projects, among appropriation managers, areas of investment and items of economic classification. The Law also authorises the use of Lithuania's budgetary funds or borrowed resources to cover a temporary shortage, if any, of funds for EU support programmes and to make unanticipated payments to the EU budget. These provisions are also incorporated in the new version of the Law on the Budget Structure of the Republic of Lithuania. The 2005 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets also allows to reallocate unspent (compared with the plan) allocations for EU co-financed programmes and projects, to other co-financed projects, such re-allocations to be treated as unspent funds of special programmes. Moreover, the above-mentioned Law 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 a timely co-financing of EU financial support special programmes.

The government investment strategy is reflected in the Public Investment Program (hereinafter referred to as the PIP) which defines the financing requirement for investment projects implemented as part of government-supported programmes, as well as the sources of financing and the timeframes for implementation of the investments projects concerned. The PIP 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 a part of the collective security and defence system.

Since the 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 (SPD) for 2004-2006 and in the Cohesion Fund Strategy for 2004-2006, respectively. The Cohesion Fund Strategy for 2004-2006 has been approved by Order No. 1K-054/D1-79/3-99 of 20 February 2004 of the Ministers of Finance, Environment, and Transport and Communications and agreed with the EU Commission. The EU Structural Funds and the Cohesion Fund, as financial instruments of the EU structural policy, are employed to co-finance priority projects in Member States. Lithuania's SPD for 2004-2006 defines the strategy, priorities and measures of the use of the EU Structural Funds and the respective national co-financing, and the Cohesion Funds Strategy for 2004-2006 defines the strategy of the use of the Cohesion Fund and the respective national co-financing as well as the projects financed.

59. Objectives. In Lithuania, budgetary 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 (which is in line with Lisbon strategic goals), SPD, the Programme of the Government of the Republic of Lithuania, regional development plans, and the documents on the accession to the EU and NATO. The state budget for 2006-2008 is planned and relevant programmes are prepared in line with the following strategic goals (priorities) approved by Resolution No. 221 of 28 February 2005 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 30-944, 2005):

59.1. to strengthen Lithuania's say in forming the economic policy of the European Union and in making decisions on issues relevant to the country, and seek integration to the euro zone in 2007;

59.2. to develop the national defence system as a part of NATO's collective security and defence system;

59.3. to seek sustainable development and a smoother regional socio-economic development;

59.4. to ensure further improvement of the conditions for business development;

59.5. to seek smooth rural economic and social development, and ensure formation of a modern, cooperative and competitive agricultural and integrated food sector;

59.6. to ensure the development of national culture and the promotion of healthy life-styles;

59.7. to increase employment, ensure fair labour relations and acceptable working conditions, and reduce social exclusion;

59.8. to strengthen the intellectual potential of the country by seeking quality and efficiency in education and science;

59.9. to develop information and knowledge society and promote public awareness in the field of law;

59.10. to ensure public security and public order and a proper protection of the EU external border in Lithuania;

59.11. to ensure a sustainable development of public transport infrastructure.

60. Actions Planned. In the period from 2005 to 2008, the following actions are planned:

60.1. to complete the transposition to a program-based budgeting in municipalities;

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

60.3. to create institutional and administrative conditions to ensure a maximum absorption of EU budget allocations;

60.4. to improve financial management in municipalities;

60.5. to improve financial management in the health care system;

60.6 to complete privatisation of state-owned property;

60.7. 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 expenditures related to the membership in the EU and NATO.

61. Public financial management will be further 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.

As part of the budget reform, the scheme of matching budgetary resources with the EU support is being improved. In the planning area, this scheme of matching combines the preparation of the SPD, the budget cycle, and investment planning.

Also, the Strategic Planning Methodology was updated to facilitate the match between strategies and budgeting process of different cycles.

General government expenditure allocations that might remain unspent due to delays in co-financing the EU support or for other reasons are foreseen to be used for a further reduction of the fiscal deficit.

General government revenue

Tax reform

62. The tax reform is carried out in accordance with the tax policy provisions of the Government's Activity Programme for 2004-2008.

With a view to improving the tax system and implementing tax policy provisions of the Government's Activity Programme for 2004-2008, i.e. to ensure a better balance between labour and capital taxation and to reduce the personal income tax burden, particularly for low income families, the Seimas of the Republic of Lithuania amended, in June 2005, the Law on Income Tax of Individuals and passed a temporary Law on Social Tax and a Law on Real Estate Tax.

63. Amendments to the Law on Income Tax of Individuals. On 7 June 2005, the Seimas of the Republic of Lithuania passed a Law Amending and Supplementing the Law on Income Tax of Individuals, which provides for a gradual reduction 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.

64. Temporary Law on Social Tax. The present and future budgetary commitments do not give the luxury of reducing tax rates and amending other tax regulations likely to adversely affect the budget, without introducing offsetting measures. Therefore, temporary measures will be adopted in the transitional period to facilitate the personal income tax reform. For this purpose, a social tax will be introduced for the tax periods of 2006 and 2007.

The Law aims at ensuring financing for social programmes and measures aimed at reducing poverty and social exclusion, given that general government budget will suffer from revenue losses in the amount of about LTL 489m in 2006 alone, as a result of amendments to the Law on Income Tax of Individuals. This sharp loss of revenue could be detrimental to the implementation of budget-financed programmes, including social programmes and measures (promotion of employment, efficient social support, development of social services, social inclusion of socially vulnerable groups of population, etc.). Revenues to be collected as social tax should help to ensure adequate financing for the above-mentioned social programmes and measures.

Social tax will be payable by legal persons on their taxable profits as calculated in the manner prescribed in the Law on Profit Tax, at a rate of 4% in 2006 and 3% in 2007. The tax base will be established in accordance with the principles laid down in the Law on Profit Tax; thus, exemptions from the social tax shall be principally the same as those applied to the profit tax.

65. Law on Real Estate Tax. The Seimas also passed a Law on Real Estate Tax, to create a coherent system of taxation of real estate. The Law aims at ensuring equal business conditions for commercial-economic entities, i.e. to expand the real estate tax base to include not only real estate owned by legal persons, but also real estate owned and used by natural persons for commercial-economic purposes, and to shift over to internationally employed principles of property valuation for tax purposes.

66. Financing of the tax reform. By preliminary estimations, the personal income tax reform will bring general government budgetary revenue losses in the amount of about LTL 489m (0.65% of GDP) in 2006, LTL 1063m (1.31% of GDP) in 2007, and LTL 1802m (2.02% of GDP) in 2008. This general government revenue loss that will be caused by the reduction of personal income tax will be offset by the new social tax payable by legal entities on their taxable profits. The social tax is projected to generate additional budgetary revenue of about LTL 400m in 2006, LTL 360m in 2007, and LTL 20m in 2008, or about LTL 780m in the total. Positive developments are also associated with the expansion of the real estate tax base: from 1 January 2006, the tax will be payable not only on real estate owned by legal persons, but also on real estate owned and used by natural persons for commercial-economic purposes.

VI. SUSTAINABILITY OF PUBLIC FINANCES

67. In the long term, sustainability of public finances will be ensured by changes in the demographic structure of population. In 2005, Lithuania developed 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, in the period from 2004 to 2050, Lithuania's population will shrink to 2.9 million or by 16.4%. The number of people aged between 0 and 14 will drop from 17.7% to 13.7%, working-age people (aged 15–64) from 67.3% to 59.6%, whereas the number of elderly people (aged 65+) will grow from 15% to 26.7%.

68. Table 14 below gives projections of long-term sustainability of public finances (pensions, health care, education) for the period until 2050. The projections have been made by using preliminary statistics of 2000 and 2004 and the economic and employment assumptions for the period from 2005 to 2050 made available by the Economic and Financial Affairs Directorate General of the European Commission. Expenditure on health care and on long-term health care as well as on education have been projected by 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 projection of expenditure on unemployment benefits included in Table 14 under "Other age-related

expenditures" have been calculated by the methodology employed by the AWG for analogical projections for EU-15 in 2003.

The Table gives expenditures on social pensions: social security pensions and state pensions (including benefits and excluding private pensions funds administered by pension accumulation companies), and revenues from social security contributions. State pensions are financed directly from the state budget. Expenditure on state pensions will be continuously increasing, from 0.58% of GDP in 2004 to 1.42% of GDP in 2050.

69. 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 be increasing and expenditure on education will be decreasing. In the period from 2004 to 2050, expenditure on pensions and on health care will grow to 1.94% and 0.83% of GDP, respectively, whereas expenditure on education and on unemployment benefits will go down to 1.79% and 0.07% of GDP, respectively. The total increase of expenditures related to ageing population will account for 0.91% of GDP.

70. Expenditure on pensions will demonstrate 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 the chapter on the pension reform).

71. The projection of expenditure on education shows a decline of the GDP share of this expenditure, explained by the future decrease in the number of students in the primary and lower secondary education (ISCED 1 and 2) and upper and post secondary education (ISCED 3 and 4). From 2004 to 2050, the number of population aged between 7 and 18 will drop by 46.12%, and expenditure on education will go down by 38.7% or by 1.79 percentage points of GDP.

72. Over the period covered by the projections, the overall expenditure of general government will increase by 2.54 percentage points of GDP, from 33.22% of GDP in 2004 to 35.76% of GDP in 2050. Age-unrelated expenditure which was fixed as at the 2008 level and treated as a constant will grow by 1.63 percentage points of GDP. General government budgetary revenue will grow by 1.23% of GDP, from 31.80% to 33.03%. If age-unrelated expenditure were not fixed as at the 2008 level and, instead, account were taken of the likely later dynamics of the GDP share of investment and revenue, the projections of the long-term financial sustainability would be more favourable.

73. If the projections took into account the planned increase of 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 2.6% 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 80% 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. A successful implementation of the measures envisaged in Lithuania's National Strategy Report on Adequate and Sustainable Pensions would help to ensure financial sustainability of general government.

Table 14. Long-term sustainability of public finances

% of GDP	2000	2004	2005	2010	2020	2030	2050
Total expenditure	39.13	33.22	35.06	33.69	33.34	34.51	35.76
Of which: age-related expenditure		15.99	15.65	14.83	14.48	15.65	16.90
Pension expenditure	8.01	7.11	6.85	6.75	7.21	8.22	9.05
Social security pension	8.01	7.11	6.85	6.75	7.21	8.22	9.05
Old-age and early pensions	7.07	5.93	5.65	5.59	5.98	6.81	7.33
Other pensions (disability, survivors)	0.94	1.18	1.19	1.16	1.24	1.41	1.72
Occupational pensions (if in general government)	-	-	-	-	-	-	-
Health care		4.13	4.15	4.25	4.45	4.60	4.96
Long-term care		0.46	0.47	0.48	0.52	0.56	0.69
Education expenditure		4.62	4.53	3.74	2.75	2.77	2.83
Other age-related expenditures	0.19	0.13	0.12	0.09	0.07	0.06	0.06
Interest expenditure	1.74	1.00	0.87	N.A	N.A	N.A	N.A
Total revenue	35.58	31.80	33.53	33.03	33.03	33.03	33.03
of which: property income	1.16	0.73	0.63	0.60	0.60	0.60	0.60
of which: : from pensions contributions (or social contributions if appropriate)	7.09	6.70	6.66	6.32	6.08	5.97	6.14
Pension reserve fund assets	0.13	1.30	N.A.	N.A	N.A	N.A	N.A
of which: consolidated public pension fund assets***	0.00	0.30	0.74	4.29	14.02	28.01	52.76
Assumptions							
Labour productivity growth		6.2	6.3	5.3	3.6	2.7	1.7
Real GDP growth		7.0	6.7	6.4	3.0	1.9	0.4
Participation rate males (aged 20-64)	82.6	83.7	84.2	85.6	87.6	88.0	86.3
Participation rate females (aged 20-64)	74.5	75.0	75.6	77.8	81.4	82.2	79.7
Total participation rates (aged 20-64)	78.3	79.2	79.7	81.5	84.4	85.0	83.0
Unemployment rate***	16.7	11.9	11.2	8.9	7.0	7.0	7.0
Population aged 65+ over total population	14.2	15.0	15.2	16.1	17.5	21.4	26.7

*excluding expenditure on payments to households and private entities and direct capital expenditure on education establishments.

**unemployment payments

***financial assets in private pension funds of Tier II, Pillar I of the pension system.

****according to the latest data, the unemployment level will be lower.

Source: Department of Statistics, Ministry of Finance, Ministry of Social Security and Labour, Ministry of Education and Science, Ministry of Health

74. Pension reserve fund assets given in Table 14 above consist of the reserves of the State Social Security Fund, Mandatory Health Insurance Fund and the Employment Fund (according to the European System of National Accounts), with the larger part being fixed tangible and financial assets (see Table 15 with actual figures of 2000-2004). Financial assets accumulated in private pension funds of Tier II, Pillar I of the pension system is given in Table 14: financial assets that are projected to account for 53% of GDP in 2050 will in principle be accumulated through re-allocation of social security contributions to private pension funds.

Table 15. Pension reserve fund assets (liquid financial assets, financial accounts), in LTL m

Code		2000	2001	2002	2003	2004
AF.21	Currency	30.26	-	-	-	-
AF.22	Transferable deposits	-	-	-	-	-
AF.29	Other deposits	58.39	73.87	153.9	294.11	622.66
AF.331	Securities other than shares; T-bills	-	-	-	-	-
AF.332	Securities other than shares; bonds	-	-	-	-	-
AF.34	Securities other than shares; derivatives	-	-	-	-	-
AF.511	Shares and other equity (quoted shares)	-	-	-	-	-
AF.512	Shares and other equity (unquoted shares)	22.76	17.5	13.65	12.98	12.98
AF.52	Shares and other equity (mutual funds shares)	-	-	-	-	-

Source: Ministry of Social Security and Labour

VII. INSTITUTIONAL IMPROVEMENT OF GOVERNMENT FINANCES

75. Private–public partnerships (PPP). With a view to promoting public–private partnerships as an alternative source of financing and to create the necessary legal, financial and administrative conditions for the implementation of this approach, a new unit, Public and Private Partnership Project Management and Coordination Division, was established within the State Treasury Department of the Ministry of Finance with the immediate task of creating the legal base and developing the procedures for the preparation and implementation of PPP projects as part of the overall state budget formation and implementation.

The Ministry of Finance is currently working on the framework conception of developing PPPs in Lithuania, to be approved by a resolution of the Government of the Republic of

Lithuania. The draft version of this Conception has been sent to different ministries and other public authorities for comments and is currently being revised to incorporate such comments and proposals.

76. 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 their strategic activity plans (and programmes, where appropriate) for 2006-2008, not only product but also effect and outcome criteria. This Methodology regulates the preparation of strategic plans directly related with the state budgeting process. With certain amendments, the Methodology integrates into one whole the key national strategic documents (the Single Programming Document, the National Strategy for Sustainable Development), thus contributing to the improvement of strategic planning.

VIII. STRUCTURAL REFORMS

Pension reform

77. *Overview***.** The system of the state social security pensions operates on the pay-as-you-go principle. The budget of the State Social Security Fund is separate from the budget of the Republic of Lithuania.

By 1995, the age limit for the old age pension was 55 years for women and 60 years for men. After 1995, the age limit for the old age pension has been annually increased until the following age limits are reached: 60 years for women (by 2006), 62 years and 6 months for men (by 2003). By 2005 the age limit for the old age pension has reached 59 years for women, 62 years and 6 months for men.

The rate of a pension social security contribution in 2004 was 25.9 per cent of the wage of a person covered by the pension insurance.

78. Reform Goal. The main goal of the pension reform is the setting-up from 2004 of the pillar I tier II pension saving system, providing a possibility for the people of the Republic of Lithuania to privately save a share of their obligatory social security contributions for their retirement.

79. *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:

79.1. the pension reform shall be started on 1 January 2004;

79.2. the employed shall voluntarily decide whether they are willing to save a share of their obligatory social security contributions in a private account with private pension funds;

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

79.4. the general rate of the social security contribution (i. e. 34 %) shall not be raised;

for the purpose of computing the state social security pensions to be paid to the participants in the pension saving pillar for the years of their participation therein the state social security old-age pension (additional share of the old-age pension) shall be reduced proportionately to their saving contributions;

79.5. pension saving schemes shall 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 ownership of the participants in pension saving schemes from the equity of the company operating the scheme, investment requirements). In 2005, 11 enterprises have been engaged in providing the pension saving service.

80. It has been estimated that:

80.1. the functioning of the current pensions system based on the pay-as-you-go principle should be ensured to both current and future pensioners. Over the period of 2003–2005 the new pension saving system was joined by more than 684 000 people covered by social security (54.7 %). Taking into consideration the above number it is estimated that in 2006 approximately LTL 497m will be transferred to the pension saving funds from the state social insurance contributions. It is projected that in 2006 the new pension saving system will be joined by another 10 percent of the insured. As a result of increasing number of the participants and the growing rate of the insurance contributions LTL 665m would be transferred to the pension funds in 2007.

80.2. The increase of expenditure of the State Social Security Fund as a result of the pension reform will be financed from privatisation proceeds, budget of the Republic of Lithuania and other funding sources. It is planned that the loss of the budget income of the State Social Security Fund will be also partially covered by the surplus in the State Social Security Fund's budget that has accrued as a result of the short-term improvement of the demographic situation.

81. *Effects of the Reform***.** Once the pension reform is implemented, a three-pillar pension system will be set up in Lithuania, consisting of a pay-as-you-go pillar, pension saving pillar (where a portion of the obligatory social security contributions is being saved) and a volunteer contributions saving pillar, resulting in the expansion of the long-term saving and investment infrastructure. The pension reform increases the liquidity of financial markets and accelerates the economic development. Although in the short-term a larger fiscal deficit will build up as a result

of the pension reform, the resources accumulated in the pension funds will in the long-term reduce the direct financial commitments of the government towards the future pensioners.

In spite of the fact that the pension reform, i.e. introduction of the pillar I tier II pension saving system, has reduced the impact of ageing on the financial sustainability of the pension system, the problem of the size of replacement pensions remains of concern. Speaking about the strategy of sufficient and stabile pensions the Lithuanian National Report 2005 envisages the measures that would facilitate increasing of the relative size of pensions and ensure financial sustainability of the pensions system. It is estimated that over the period of 2005-2015 the social insurance pensions will be increased to make the replacement rate (gross) increase consistently from 31.3 % to 42 % and over 2012-2026 the retirement age is gradually increased: by 4 months a year for women and by 2 months a year for men until the final retirement age of both women and men reaches 65 years in 2026. As the retirement age is being increased additional employment promotion measures must be introduced to allow the elder persons remain active in the labour market.

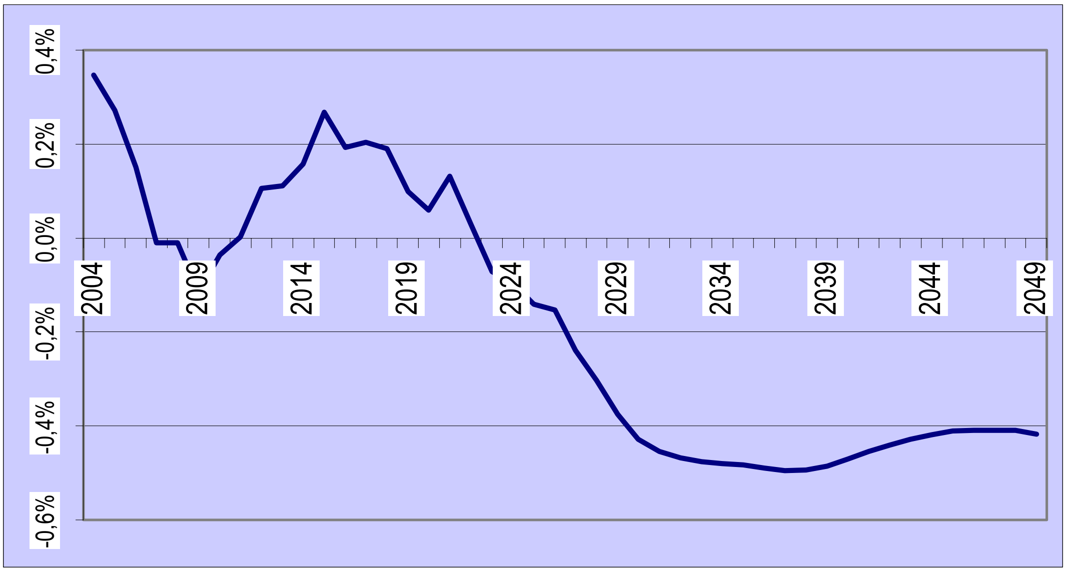
Table 16. Projection of the ratio of pension recipients and contributors

	2004	2010	2020	2030	2050
Ratio of pension recipients and contributors, if the retirement age is 60/62.5 years, %	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

Source: Department of Statistics, Ministry of Finance, Ministry of Social Security and Labour

The pension saving reform and the increasing of the retirement age will allow to achieve a sufficiently well balanced budget of the social security pensions in the long-term (Fig 13).

Fig. 13 Balance of the pensions budget of the Social Security Fund (% of GDP), where the increased pension replacement rate is being combined with the increasing retirement age



Reforms of the health-care sector

82. In order to develop the health-care system that would include health improvement and prevention of diseases, timely diagnosing, treatment, medical and social rehabilitation of the patients and to foster informed opinion of the society on care and improvement of health, as the main precondition for a full-fledged life, the following priorities have been set:

82.1. to implement public health-care reform;

82.2. to promote restructuring of the health-care institutions and services;

82.3. to implement the national pharmaceuticals policy;

82.4. to develop the health insurance system.

83. The reform of the public health system seeks to modernise the infrastructure of the national public health-care system thereby approximating the public health care to the community, to streamline the scope and the structure of the public health-care services, to develop the general framework for personal and public health-care services on the primary health-care level, to efficiently address health risks.

84. The reform of the national health-care sector has two complementary goals:

84.1. to increase efficiency of the health-care sector, to ensure the quality of the services through installing modern medicine technologies in the health-care institutions that employ high-profile medicine specialists;

84.2. to adapt the scope and the structure of the health-care institutions network to the demand and the quality requirements for the health-care services by ensuring availability of health-care services, in particular in country regions.

85. In order to achieve the above goals the Government of the Republic of Lithuania by Resolution No 335 of 18 March 2003 (*Valstybės žinios* (Official Gazette) No. 28-1147, 2003) approved the Healthcare Institutions Restructuring Strategy. The restructuring of the health-care institutions shall be implemented in two stages: stage I – over 2003-2005 and stage II – over 2006-2008. The strategy seeks to ensure a better compliance with the needs for personal health-care services, higher quality, safety of, access to the services and more rational use of the resources, addresses problems related to increasing health-care funding needs. The increase of the funding needs in the future will result from the ageing process, growing prices of medications and treatment means, increasing funding need for renovation of health-care institutions and modernisation of their facilities, the necessity to increase the wages of those employed in the health-care sector. The estimated funding needs to implement the stage II of the Health Care Institutions Restructuring Strategy amounts to LTL 571m (EUR 165.4m).

86. In 2004-2006, the Structural Funds assistance for health-care is being provided on the basis of the Single Programming Document of Lithuania 2004-2006 approved by Resolution No. 935 of 2 August 2004 (*Valstybės žinios (*Official Gazette) No. 123-4486, 2004) and endorsed by the European Commission Decision C(2004)2120 of 18 June 2004. The assistance is being provided to two types of activities: strengthening and development of cardiologic health care services through modernisation of health care institutions; and development and modernisation of general practise services infrastructure. The EU Structural Funds assistance of the current programming period amounts to EUR 34.3M. The public capital investments are used to implement continued and new health programmes, to introduce new medical technologies, to renovate health-care institutions, to develop the national e-health system. The Mandatory Health Insurance Fund finances projects on restructuring of health-care institutions on the national and municipal levels.

87. The national pharmaceuticals policy approved by Resolution No. IX-1604 of 5 June 2003 of the Seimas of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No. 56-2488, 2003) aims at ensuring that the Lithuanian market offers only high quality, safe and effective as well as affordable pharmaceuticals. A Pharmacy Law of the Republic of Lithuania has been drafted; the Law has the following main objectives: to streamline pharmaceutical practice and activities, licensing thereof, registration, supply to the market, quality control of pharmaceutical preparations and products for pharmaceutical use, the principles of clinical testing of pharmaceutical preparations being researched and pharmacological vigilance, pricing, advertising of and informing on pharmaceutical preparations. The efforts to ensure rational spending of public funds for reimbursements on medicines and transparency of the reimbursement system aim at facilitating future access to the reimbursable medicines of the maximum number of patients with a maximum range of diseases, supplementing of the list of reimbursable medicines with new preparations needed by the patients.

88. The development of the health insurance system aims at improving the quality of health-care services and accessibility thereof for everybody, increasing the efficiency of the health system, introducing of more efficient forms of use of the available resources.

89. 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 611.1m in 2006, which is 7.2 % more than in 2005 (a contribution per person will increase from LTL 264.2 in 2005 to LTL 304.4 in 2006).

Table 17. The projected budget income and expenditure of the Mandatory Health Insurance Fund, 2005-2008

	2005		2006		2007		2008	
	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %
Income	2360.8	3.4	2870.3	3.8	3056.5	3.8	3234.7	3.6
Expenditur	2360.8	3.4	2870.3	3.8	3056.5	3.8	3234.7	3.6

Source: Ministry of Health

Labour market

90. The key priority of the Lithuanian employment policy set forth in the National Lisbon Strategy Implementation Programme approved by Resolution No. 1270 of 22 November 2005 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No. 139-5019, 2005) (hereinafter referred to as the Programme) is to promote employment and investments into human capital. The Programme envisages that the Government of the Republic of Lithuania taking into consideration the provisions of Article 125 of the EC Treaty and the employment policy guidelines of the member states will in 2005-2008 pursue the employment policy that has the following main objectives:

90.1. Objective 1 – to attract to and maintain in the labour market maximum number of people through ensuring high quality and safe employment and modernisation of the labour market and social security systems;

90.2. Objective 2 – to improve adaptability capacities of the employees and enterprises;

90.3. Objective 3 – to reduce structural unemployment through larger investments into human resources.

91. The Programme sets forth specific employment policy measures that will be undertaken to achieve the above objectives. The estimated funding needs for the implementation of the national measures in the period 2005-2008 amount to LTL 2262.8m, of which

LTL 796.7m is to be funded by the central budget and the municipal budgets, LTL 138.7m – by Employment Fund, LTL 1327.4m – by EU Structural Funds.

92. With the view to achieving full employment, efforts will be made to maintain high level of employment among women and elder people (55-64 years of age) coupled with the implementation of the policy promoting active economic participation and employment among other groups of population. Measures will be taken to approximate the level of employment to 70 %, and to cut unemployment and keep it low, at no more than 6 to –7 % in the nearest 12 to 15 years.

93. Objective assessment of the main employment problems, important strategic documents adopted, programmes, recommendations of the EU Council to Lithuania, has resulted in the following medium-term objectives for the period 2005-2008 in Lithuania:

Table 18. Main employment goals in 2005-2008 (%)

Indicator	2005	2006	2007	2008
Employment level: population of 15-64 years of age	62.5	64.0	65.0	66.0
women	58.4	58.8	59.2	59.7
population of 55-64 years of age	47.2	47.5	48.0	48.5

Source: Ministry of Finance, Ministry of Social Security and Labour

94. It has been also planned:

94.1. to facilitate creating of at least 150 000 new jobs over the period 2005-2008;

94.2. by 2010, to reduce unemployment of young people by 15 %, long-term unemployment – by 3.5 %, and to limit the unemployment to 8 %;

94.3. by 2013, to ensure that unemployment in any region of Lithuania does not exceed the average national unemployment level by more than 35 %.

Education, research and development

95. In order to provide equal environment for businesses to make use of the results of education, research and development and to invest into this activity themselves, thereby promoting public sector's capacities in this area, the following key objectives of the macroeconomic policy have been set:

95.1. to set priority areas of economy, research and development policy;

95.2. to more actively support the research and development works undertaken by businesses, to promote a closer cooperation of businesses with research and development institutions and competence networks;

95.3. to increase efficiency of the high education system, to improve the supply of high-profile specialists, meeting the requirements of the modern industry and business.

95.4. to increase efficiency of the operations of the education and studies system related to education, research and development, and compliance thereof with the needs of the economy;

96. The Government of the Republic of Lithuania by Resolution No 1646 of 22 December 2003 (*Valstybės žinios* (Official Gazette) No 12-5489, 2003) approved the Long-Term Research and Development Strategy and the Program for the Implementation of the White Paper on Science and Technology in Lithuania. The programme for implementing stage II of the Long-Term Research and Development Strategy is currently under preparation.

97. To achieve the goals of the Lisbon Strategy and the National Education Strategy the Government of the Republic of Lithuania by Resolution No 82 of 24 January 2005 (*Valstybės žinios* (Official Gazette) No 12-391, 2005) approved the Programme for Implementation of the National Education Strategy 2003-2012. The Programme has the following main objectives: targeted and efficient investments, life-long-learning guarantees, providing of socially just studying opportunities, education quality complying with the needs of the civil society and market economy that would contribute to employment guarantees. The implementation of the Programme includes modification of management and funding ways, increasing of wages in the education sector, introduction of new education services, modernisation of the contents of education and studies as well as enhancement of qualification of the staff in the education sector.

Small and medium business

98. The Government of the Republic of Lithuania by Resolution No 1104 of 19 October 2005 (*Valstybės žinios* (Official Gazette)No 126-4491, 2005) approved Strategic Directions for Small and Medium Business Development until 2008 and the Measures for Development of Small and Medium Enterprises (hereinafter referred to as SME) in 2005-2008 that set forth medium-term SME development priorities of the Government and the measures to achieve these priorities. It is planned to improve legal and economic framework of SMEs, financial assistance to SMEs, to foster entrepreneurship in the regions, to promote competitiveness of SMEs.

It is also admitted that in order to maintain the current growth tendencies of the Lithuanian economy the innovative and technological development processes should be encouraged both in SMEs and large companies operating both in the industry and services sectors.

As Lithuania has few companies in the high technology industry it is vital to involve research institutions in the development of this industry. In order to promote growth of the sectors in the industry of high and medium technologies as well as to develop the innovative potential in traditional sectors, the strengthening of the national innovations system and improvement of its efficiency is of crucial importance.

99. The key principles of the Lithuanian Innovations Policy are set as part of the measures to implement the Business Innovations Programme and Business Investment Programme in 2003-2006 as approved by Government Resolution No 911 of 15 July 2003 (*Valstybės žinios* (Official Gazette) No 71-3225, 2003). The Programme aims at increasing competitiveness of the Lithuanian industry and business through facilitating renovations of the operating companies and setting-up of new modern companies as well through providing opportunities to the companies to make better use of the scientific potential in order to achieve high value added and be able to compete in the world markets.

To ensure growth of the number of innovative companies, the funding needs for the services promoting innovations, creation of favourable environment, applied researches by companies, technologic development and innovative projects will remain high. In addition to the national funds, SMEs will be able to apply for support from the EU Structural Funds from 2004. For the period of 2004 to 2006, over EUR 100m has been allocated, as direct support for businesses, for enterprise development, modernisation, innovation, tourism and other projects. In 2004 and 2005 over EUR 57M have already been granted to projects of companies. Taking into consideration the current and the planned amount of the Structural Funds assistance to innovations and research, a rather high positive effect of this assistance could be expected both to development of research institutions, promotion of innovations infrastructure and to growth of competitiveness of companies and economy.

To promote business, innovations and advanced technologies Lithuania is developing infrastructure of public services to businesses that includes all types of non-profit organisations performing functions related to economic development, business promotion, development of technologies and innovations. By the middle of 2005 Lithuania had 6 science and technologies parks, Lithuanian Innovations Centre, 42 business information centres, 7 business incubators, etc. operating. The development of this infrastructure of public services to business started rather recently and the majority of its establishments are only starting their operations and so far have mainly concentrated on the development of their physical infrastructure, strengthening of the technical base, enhancement of competence, preparation to provide high-quality services, making contacts with other organisations and winning of public recognition.

To provide better financing possibilities to small and medium enterprises, the private limited liability company “Investicijų ir verslo garantijos” (Investment and Business Guarantees*)* issues guarantees in favour of banks on a portion (up to 80) of loans taken by small and medium business entities and covers up to 50 of interest on the guaranteed loans. In 2004 the regulations on guarantees have been amended to provide for a possibility to small and medium business entities to take loans with sovereign guarantee to implement projects co-financed by the European Union Structural Funds; the size of the guaranteed loans and the available guarantees has been increased. Thereby the small and medium business entities were given the opportunity to obtain EU Structural Funds assistance more successfully, increasing the business development possibilities.

Moreover, in Quarter I of 2004 the agreement with the European Investment Fund (EIF) was signed on re-guarantees of liabilities undertaken by he private limited liability company “Investicijų ir verslo garantijos”, which encouraged to issue more guarantees on loans granted to small and medium business entities.

The demand for the services of the private limited company “Investicijų ir verslo garantijos” has been growing: over the nine months of 2005 it has issued 169 guarantees on LTL 59.7m worth of loans to small and medium business entities, which was by 36 % (guarantees) and by 82.5 % (loans) more than over the corresponding period of 2004. The implementation of business projects for which loans have been issued under the guarantees of the private limited company “Investicijų ir verslo garantijos” during this nine-month period of 2005 will serve to create about 798 new jobs, i.e. by 11.9 % more than in the corresponding period of 2004.

100. Lithuania is an active participant in the EC Multi-Annual Program for Enterprises (in particular for small and medium-sized businesses) and Entrepreneurship and is continuing dialogue with the European Investment Fund on the measures for expansion of SME funding possibilities.

Agriculture, food industry and rural development

101**.** Although the gross value added generated in the agricultural and food industry has been constantly falling with regard to the national value added, manufacturing and productivity of the agricultural output has increased in this sector in the recent three years. To ensure the implementation of the EU common agricultural policy, to develop competitive agricultural and food sectors, and to promote sustainable economic and social development in rural areas, the following measures are being implemented:

101.1. measures aimed at securing income for entities engaged in agricultural activities, and market regulation measures (direct payments in accordance with the simplified scheme, systems of quotas, interventional procurement, private storage, import/export mechanisms, standards for supply of products to the market, etc.);

101.2. measures set forth in the General Provisions of the Rural Development Plan 2004-2006 as approved by Resolution No. 1317 of 22 October 2003 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 101-4550, 2003) (early retirement from commercial farming, less favoured areas and areas with environmental restrictions, forestation of agricultural land, environmentally friendly agricultural methods, support to semi-subsistence farms being restructured, meeting of EU standards);

101.3. measures under the “Rural Development and Fisheries” priority of the Single Programming Document of Lithuania 2004-2006 (investment in agricultural holdings, setting up of young farmers, improving processing and marketing of agricultural products, promoting adaptation and development of rural areas, forestry, LEADER+ type measure, training and three measures for fisheries);

101.4. application of state aid measures (state support for the development of production of high quality products, for the development and implementation of the quality testing system, for the acquisition of breeding animals, for the acquisition of the certified reproduction material of plants, for farmer's training and consultation services and other measures);

101.5. the process of restitution of ownership rights to land, forest and water bodies is approaching the end, to be followed by the next stage of land management process related to promotion of a rational use of land, by preserving the ecologic stability of the landscape and by developing the required rural infrastructure. The issue of selling agricultural land to Lithuanian legal persons and foreign citizens has been solved as well;

101.6. promotion of the development of a competitive food industry, restructuring of the food sector, ensuring that only safe food is supplied to the market and food control in the whole chain from “the field to the table”.

101.7. improvement of administrative capacities in order to ensure implementation of the EU common agricultural policy.

Table 19. Projected measured to achieve strategic goals of the agricultural policy

Measure	Funding							
	2005		2006		2007		2008	
	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %
1. Implementation of the measures of the Common Agricultural Policy								
B. Net direct effect on the budget	-195.8	*-0.3*	-289.1	*-0.4*	-277.5	*-0.3*	-572.4	*-0.6*
B.1. Income	521.8	*0.8*	599.1	*0.8*	704.5	*0.9*	758.2	*0.9*
B.2. Expenditure	717.6	*1.0*	888.2	*1.2*	982.0	*1.2*	1330.6	*1.5*
2. Restructuring of the agricultural and fisheries sectors								
B. Net direct effect on the budget	-94.4	*-0.1*	-112.1	*-0.1*	-110.8	*-0.1*	-104.1	*-0.1*
B.1. Income	0.5	*0.0*	0.7	*0.0*	0.7	*0.0*	0.7	*0.0*
B.2. Expenditure	94.9	*0.1*	112.8	*0.1*	111.6	*0.1*	104.9	*0.1*
3. Land management and administration								
B. Net direct effect on the budget	-158.3	*-0.2*	-187.4	*-0.2*	-178.9	*-0.2*	-353.4	*-0.4*
B.1. Income	0.09	*0.0*	0.06	*0.0*	0.04	*0.0*	0.04	*0.0*
B.2. Expenditure	158.4	*0.2*	187.5	*0.2*	179	*0.2*	353.5	*0.4*
4. Strengthening of institutional and administrative capacities								
B. Net direct effect on the budget	-79.9	*-0.1*	-90.1	*-0.1*	-75.5	*-0.1*	-74.8	*-0.1*
B.1. Income	6	*0.0*	7.1	*0.0*	7.1	*0.0*	7.1	*0.0*
B.2. Expenditure	85.9	*0.1*	97.1	*0.1*	82.6	*0.1*	81.9	*0.1*
5. SAPARD								
B. Net direct effect on the budget	-36.9	*-0.1*	-	-	-	-	-	-
B.1. Income	111.1	*0.2*	-	-	-	-	-	-
B.2. Expenditure	147.9	*0.2*	-	-	-	-	-	-
6. Structural assistance and rural development measures*								
B. Net direct effect on the budget	-208.5	*-0.3*	-233.2	*-0.3*	-	-	-	-
B.1. Income	725.1	*1.1*	801.4	*1.1*	-	-	-	-
B.2. Expenditure	933.6	*1.4*	1034.7	*1.4*	-	-	-	-
7. Total direct effect on the budget								
B. Net direct effect on the budget	-773.7	*-1.1*	-911.9	*-1.2*	-642.8	*-0.8*	-1104.8	*-1.2*
B.1. Income	1364.5	*2.0*	1408.4	*1.9*	712.4	*0.9*	766.1	*0.9*
B.2. Expenditure	2138.2	*3.1*	2320.3	*3.1*	1355.2	*1.7*	1870.9	*2.1*

*The sums indicated here are the sums specified in he Single Programming Document of Lithuania 2004-2006 (Priority "Rural development and Fisheries") and Rural Development Plan 2004-2006 for the respective years. The calculations do not include the funds to be provided to rural development and fishery under 2007-2013 financial perspective as the negotiations are still ongoing.

Source: Ministry of Agriculture

102. In order to achieve strategic goals of the agricultural policy and participation in the EU market on equal terms it is planned that the central budget of the Republic of Lithuania will continue to finance national premiums of direct payments the rate of which is set by the Government of the Republic of Lithuania on an annual basis (following the principle that the share of premiums of the direct payments payable from the central budget may not increase), state aid to agricultural measures agreed with the Commission of the European Union (within the limits of appropriations assigned for this aid under the Rural Support Programme), land reform, land improvement, market development, infrastructure, quality management, science and education, information and other needs, and that the co-financing of structural assistance and rural development measures will be ensured.

103. Preparation of the new Rural Development Plan 2007-2013 has started; the new plan will serve as the basis to absorb the funds of the European Agricultural Fund for Rural Development.

104. Implementation of the rural development policy in 2007-2013 will aim at achievement of three main goals – to increase competitiveness of the agriculture and forestry sector, to foster environment and landscape through assistance to management of land resources, to promote improvement of life quality and diversification of economic activities in rural areas.

Other structural reforms of the service and supply markets

105. Other structural reforms that affect sustainability of public finance in the medium and long-term are being continued.

106. *Environmental policy***.** To ensure good quality of water in all water reservoirs of Lithuania by 2015, the reform of state regulation of protection of water resources is being continued; once this reform is completed water resources will be managed on the basis regions of river basins. To ensure consistency and efficiency of development of water supply and waste management sector in all regions of the country, a law on drinking water and waste management (water management) has been drafted. The fundamental reform of the water sector is to be implemented through modifying management of water services – facilitation of growth in size of water suppliers coupled with implementation of "cost recovery" and "polluter pays" principles.

To establish an efficiently operating consumption waste management system in Lithuania 10 regional waste management systems will be created; the establishment and development of these systems will be mainly financed by EU Cohesion Fund. It is planned that by 2010 there will be 11 regional landfills established and more than 800 landfills that are currently functioning but do not meet environmental and public health care requirements closed. The establishment of water and waste management systems on a regional level will allow to reduce the investment needs, make maintenance of the systems cheaper and reduce the service prices, as well as to increase competitiveness of problematic territories.

In order to save energy and raw materials, separate collection and preparation of the flows of secondary raw materials and consumption waste (waste of electric and electronic equipment, construction waste generated by households, large size waste (furniture, etc.), used tires, hazardous consumption waste) are being developed.

In order to ensure efficient management of hazardous waste it is planned that by 2009 the investment project on hazardous waste management will be implemented in Lithuania, i.e. hazardous waste combustion facilities will be constructed, landfill of hazardous waste constructed and leather industry landfill closed in Aukštatrakiai.

Implementing Kyoto Protocol and EU requirements to reduce emissions with greenhouse effect, the National Plan for Distribution of Operational Pollution Permits 2005-2007 was prepared in 2004 and approved by Order No D1-686 of 27 December 2004 of the Minister of Environment (*Valstybės žinios* (Official Gazette) No 6-166, 2005); Order No D1-231 of 29 April 2004 of the Minister of Environment (*Valstybės žinios* (Official Gazette) No 78-2764, 2004; No 137-4948, 2005) approved the Rules of Procedures for issue of and trade in operating permits for pollution with greenhouse gas that basically enforces the system of trade in greenhouse gas operating permits.

Adhering to the principle "polluter pays", from 2003 a tax on pollution of the environment with production and packing waste has been introduced under the Law of the Republic of Lithuania on Environmental Pollution. This tax is charged on all types of primary filled-in packages and certain products; the Law clearly specified liability of manufacturers and importers for management of packing waste. As the Law amending Articles 2, 5, 7 and Annexes 3, 4 of the Law on Environmental Pollution has been adopted (*Valstybės žinios* (Official Gazette) No 47-1560, 2005), from 2006 all packages will be taxed. From 2004 the Programme for Management of Production and Packing Waste has been started; the main purpose of the Programme is to finance projects on development of waste collection and processing systems.

Table 20. Projected pollution tax income of the national budget in 2005-2008

Tax	**2005**	**2006**	**2007**	**2008**
Water pollution tax, mLTL	11	11.5	12	12.5
Tax on products and packages, mLTL	8.3	6	5	5
Air pollution tax, mLTL	22	23	24	25
Total mLTL GDP %	41.3 0.1	40.5 0.1	41 0.1	42.5 0.1

Source: Ministry of Environment

The rates of tax on emissions from stationery pollution sources to the atmosphere and water set in the Law on Environmental Pollution of the Republic of Lithuania for 2005-2009 will remain in this period the same as in 2004; the respective tax to mobile pollution sources has been reduced from 2005 by 10 %. Business expenditure and prices of goods and services hence should not increase in the above period.

107. *Transport sector.* The Long-term Strategy (until 2025) for Development of the Lithuanian Transport System approved by Resolution No 692 of 23 June 2005 of the Government of the Republic of Lithuania (*Valstybės žinios* (Official Gazette) No 79-2860, 2005) establishes the key priority areas of transport development that should be achieved through the following two main priority objectives of the Lithuanian transport sector:

107.1. to modernize Trans-European network infrastructure within the territory of Lithuania (roads, railways, water transport and civil aviation);

107.2. to reconstruct local and regional transport infrastructure.

The restructuring and opening for competition of the railway transport infrastructure must take into consideration the specifics of the national markets of EU member states, in order to ensure economic as well as political and security interests of the individual member states and the European Union as a whole. Development of infrastructure in the north-south axis of the infrastructure is a very important priority to Lithuania. That would provide realistic technical opportunities for integration to EU railway network and railway transport services network as well as provide proper environment for competition and emerging of new carriers. In this context, the key project of transport infrastructure is the construction of the European track railway "Rail Baltica" (Warsaw-Kaunas-Riga-Tallinn-Helsinki) that will connect the Baltic states with the western Europe through Poland. Smooth functioning of railway transport can not be ensured currently due to different width of tracks in the West European states and the Russian tracks in the Baltic states, therefore construction of a modern railway ensuring rapid and convenient connection between administrative, economic and cultural centres of the Baltic states and the West Europe is of vital importance. Taking into consideration large project implementation costs it is planned to attract private capital investments.

Table 21. Projected values of the priority objectives of the transport sector, mLTL

Measure	**2005**		**2006**		**2007**		**2008**	
	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %
1. To modernise Trans-European transport network infrastructure in the territory of Lithuania (roads, railways, water transport and civil aviation)								
B. Net direct effect on the budget	-81.1	*-0.1*	-56.8	*-0.1*	-43.5	*-0.1*	-94.2	*-0.1*
B.1. Income	374.3	*0.5*	356.7	*0.5*	493.9	*0.6*	563.0	*0.6*

B.2. Expenditure	455.4	*0.7*	413.4	*0.5*	537.4	*0.7*	657.2	*0.7*
2. To reconstruct local and regional transport infrastructure								
B. Net direct effect on the budget	-107.6	*-0.2*	-154.6	*-0.2*	-123	*-0.2*	-110	*-0.1*
B.1. Income	100.7	*0.1*	200	*0.3*	100	*0.1*	47	*0.1*
B.2. Expenditure	208.2	*0.3*	354.6	*0.5*	223	*0.3*	157	*0.2*
Total direct effect on the budget								
Income	475.0	*0.7*	556.7	*0.7*	593.9	*0.7*	610.0	*0.7*
Expenditure	663.7	*1.0*	768.1	*1.0*	760.4	*0.9*	814.2	*0.9*

Source: Ministry of Transport

108. *Energy sector*. Currently the energy system in Lithuania is functioning in parallel to the Latvian, Estonian, Byelorussian and Russian energy systems. In order to integrate in the single EU electricity market the electricity networks connection works are being continued. A feasibility study on connection of Lithuanian-Polish electricity systems has been prepared. The price of the project estimated by the study comprises EUR 434m. To ensure economical viability of the project EUR 267m of EU financial assistance would be required. As an alternative to the project on connection of the Lithuanian and Polish electricity networks another project on connection of the Lithuanian and Swedish electricity networks is being developed. This project would enable to create "small Baltic ring" and the Baltic states would be integrated to the single EU market through Nordpool system. This would strengthen the reliability of energy supply in the Baltic states after decommissioning of Ignalina NPP. In 2004, the joint project of Lithuania, Latvia, Estonia, Finland on connection of electricity networks was started; as a result of the project the Baltic energy market will be integrated with the Scandinavian electricity market.

To implement the Directive No 2003/55/EC of 26 June 2003 of the European Parliament and Council concerning Common Rules for the Internal Market in Gas, a new law on natural gas of the Republic of Lithuania has been drafted. Before decommissioning of the first reactor of Ignalina NPP (in 2005) the total gas consumption in Lithuania was growing by 2-3 % annually; it is projected that the gas consumption in 2006 will amount to 3.5 billion m^3, in 2007 – to around 3.8-4.0 billion m^3. Taking into consideration that Lithuania's gas supply network is not connected with the gas networks of the Western Europe and alternative gas supply is not available, opportunities to integrate the Lithuanian gas networks with the gas networks of the Western Europe and to develop transit gas supply systems are being sought.

Approximately 88 % of the national demand of oil products is met by AB Mažeikių Nafta, while import of oil production comprises only 12 %. In the recent years approximately 75 % of the production by AB Mažeikių Nafta has been exported. The total consumption volume of petrol and dieseline in the recent 3 years has increased by 6 per cent, while the consumption of boiler oil decreased as a result of increased price and tighter environmental requirements for its consumption. Therefore the consumption of a "cleaner" fuel, i.e. natural gas, has increased.

In order to ensure reliable supply of oil to the national market, a 90 days' reserve of oil products and oil is being generated. By 31 December 2004 the country already had the 67 days' reserve of oil products generated. The funding needs for the purpose of generation and maintenance of the oil products reserve in 2006-2009 will amount to LTL 185m, of which for reconstruction of the reservoirs to store the reserve oil products – LTL 16m in 2006-2009.

Table 22. Values of projected measures

Measure	2005		2006		2007		2008	
	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %	mLTL	GDP %
1. Storage and management of the mandatory stock of oil products								
B.2. Income	21.0	0.03	53.0	0.07	58.0	0.07	58.0	0.07
2. Reconstruction of fuel containers								
B.2. Expenditure	-	-	8.0	0.01	4.0	0.01	4.0	0.01
Total direct effect on the budget								
Expenditure	21.0	0.03	61.0	0.08	62.0	0.08	62.0	0.07

Source: Ministry of Economy
