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GOVERNMENT OF THE REPUBLIC OF LITHUANIA

LITHUANIA'S CONVERGENCE PROGRAMME OF 2004

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CONTENTS

INTRODUCTION

Convergence Programme is a policy paper provided in the Treaty Establishing the European Community, outlining the Government‘s economic policy commitments aimed at sustainable economic convergence of a Member State towards other EU Member States through the stability of prices and public finances.

The decision of the Government of the Republic of Lithuania to start negotiations for Lithuania’s participation in the Exchange Rate Mechanism II (hereinafter – ERM II) marks the stage of a close economic cooperation between Lithuania and the EU, built on harmonisation of economic policies which is a requisite condition for ensuring a sustainable and deeper integration of Lithuania into the EU single market. Lithuania’s first convergence programme shows that despite the temporary difficulties concerning an extra tensions on the budget, Lithuania is successfully implementing a fiscal and monetary policy leading to the stability of prices and public finances, which helps to maintain a strong confidence in the currency board arrangement and proper preparation for the participation in the ERM II.

Participation in the Economic and Monetary Union is the key goal of the economic policy. The overall programme of reforms is directed towards the development of measures to achieve this goal over the medium term. These measures are as follows:

1) rapid and sustainable economic growth and stable macroeconomic environment;
2) favourable conditions for business development and successful implementation of structural reforms;
3) transparent state governance and political consensus regarding the required reforms;
4) a stable and predictable legal environment; and
5) deeper economic integration to the EU.

The Programme provides an assessment of the conditions for the implementation of the declared economic policy goals. The economic development forecasts given herein are based on the assumption that Lithuania’s external economic environment will, in general, remain stable during the period concerned.

The Programme consists of seven chapters, giving an overview of recent economic developments in Lithuania, a projection of medium-term monetary and fiscal policy, a discussion of the risk of divergence from the assumptions made, an assessment of the quality of public finances, a description of Lithuania’s readiness to overcome the effects of ageing population, and an outline of the main structural reforms planned.

The Lithuanian economy has seen fundamental changes: greater openness, freer movement of capital, a wider role of the private sector, and stronger competition. An important role in the process of modernisation of the national economy is played by foreign investment. The process of economic integration with the EU in both the market for goods and for capital is successfully continued.

As a result of re-pegging the national currency to the euro under the currency board arrangement, inflation remained low, i.e. 0.3% in 2002. In 2003, as the euro appreciated vis-à-vis the U.S. dollar and the competition on the telecommunications market intensified, the average level of prices temporarily fell by 1.2%.

The privatisation process is almost completed. Privatisation proceeds during the period from 1998 to 2003 amounted to LTL 5.36 billion, with the major share of the proceeds coming in the form of foreign investment. A number of new laws, including the Law on Restructuring and the Law on Bankruptcy, were passed in 2001 and now function effectively, ensuring greater transparency of private sector operations, application of international standards and attractiveness to foreign investors.

The structure of the Lithuanian economy has gradually approximated that of the EU Member States. In 2003, the Lithuanian services sector generated 61.9 per cent of the gross value added (GVA), with industry accounting for 25 per cent. The GVA share generated by the agricultural sector fell from 11.3 per cent in 1995 to 6.1 per cent in 2003. Although the employment in the agricultural sector was decreasing rapidly, the number of persons engaged in agriculture in 2003 still accounted for as much as 17.9 per cent of the total employed population (according to the results of an employment survey).

Rapid reforms have inevitably brought about certain economic and social concerns, mitigation of which was not always timely or successful. Firstly, according to the methodology of the International Labour Organisation, unemployment accounted for 12.4 per cent in 2003. Secondly, there is a problem of ageing population, bringing a potential burden of long-term economic and social problems. Further, about one-third of families with three or more children lived below the relative poverty line in 2001. Although the disparities in the standard of living slightly eased in 2003 in comparison with the situation in 2002, the ratio of those living below the relative poverty line remained quite high, i.e. about 16 per cent (cf. 17% in 2002). The aggregate birth-rate (average number of children per mother in her life) was 1.24 in 2002. This low birth-rate does not ensure a demographic balance anymore, and generations do not replace the previous ones. Finally, the current account deficit of Lithuania is primarily financed with foreign capital derived largely from privatisation; however, as privatisation will be completed shortly, further improvement of business and investment conditions, maximum support for investment by statutory measures, and a particularly favourable climate for "green field" investments, all are of critical importance.

Fiscal policy is faced with a new challenge related to future payments to the EU budget and the need to ensure efficient absorption of the EU structural funds, i.e. the necessity to achieve a balance in the rates of growth of the public sector expenditures and revenues, by simultaneously maintaining a low fiscal deficit.

The problem of economic imbalance related to low profitability in the enterprise sector and insufficient domestic investments, a critical issue for a number of years, was significantly eased in the period of 2001 to 2003. According to the quarterly data on corporate financial indicators compiled by the Statistics Department, the profitability in the enterprise sector was 4.9% in 2003. It follows that 1 litas derived from sales produced almost 5 cents of income before taxes. In 2002, this ratio was significantly lower, only 3.6%. Gross capital formation grew by 17.8% in 2001, 11.8% in 2002, and 12.8% in 2003.

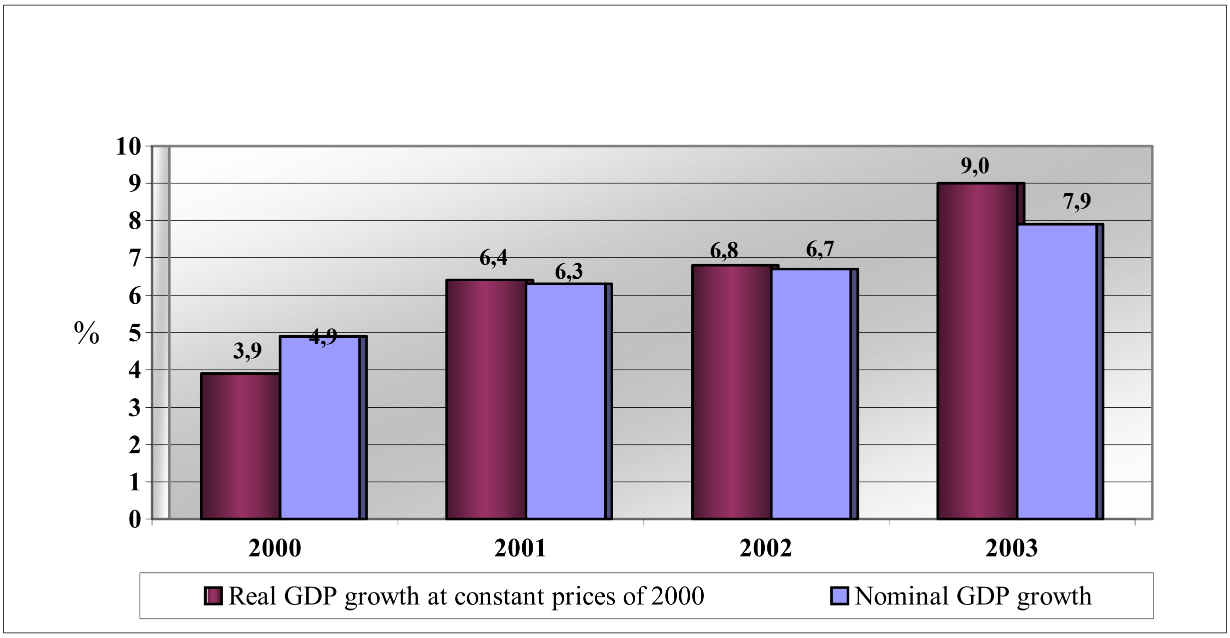
One of the major outcomes of the economic reforms of the past decade was the formation of a flexible market economy in Lithuania. As the effective nominal exchange rate rose, the competitiveness of the economy was maintained thruogh an adequately moderate growth of the nominal wages and salaries, and price stability. The rapid economic growth had positive implications for GDP and brought the level of unemployment down at the highest pace in the EU. The orientation of Lithuania's fiscal policy towards the achievement of the goals of the Stability and Growth Pact has strengthened market expectations regarding the approaching membership in the Economic and Monetary Union and lowered the degree of risks associated with investment in Lithuania. 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 in the short run.

1. OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS

1.1 Real Sector

In recent years, Lithuania's economy has been growing at a gradually increasing pace. In 2003, Lithuania was one of the fastest-growing economies of the world, with its GDP growth of 9 per cent in 2003. This is a proof of the success in implementing structural reforms, effective investment and competitive exports.

Chart 1. Real GDP Growth in 2000 to 2003[1]



In 2003, GDP growth was recorded in almost all economic activities, with the largest share of GDP having been generated in the energy sector (24.8%), constructions (17.1%), processing and mining industries (14.1% and 13.0%, respectively), trade (11.1%), transport and communications (6.8%), and hotels and restaurants (6.5%). Economic growth was furthered by a recovery of the domestic demand. A rapid growth of private borrowing was one of the key factors to promote the growth of investment, household consumption and thus the gross domestic product.

According to the data of the Bank of Lithuania, lending by banks grew by 52.4% or by LTL 12.1 billion, to reach LTL 12.1 billion in 2003. The volume of long-term loans issued by Lithuanian commercial banks to private customers grew by LTL 1.147 billion, which is 2.3 times more than in 2002 and 7.4 times more than in 2001. The better share of these loans, i.e. about 82.4%, consisted in housing loans.

Rapid privatisation has stimulated the development of the private sector. During 1996 to 2003, privatisation proceeds amounted to LTL 5.36 billion, with the better part coming in the form of foreign investment. Proceeds from the sale of enterprises accounted for 1.1% of GDP in 1999, 2% of GDP in 2000, 1% of GDP in 2001, 0.7% of GDP in 2002, and 1.7% of GDP in 2003. The share of the value added generated by the private sector grew to 74% in 2002.

The unemployment has been shrinking in the past two years. The average annual level of unemployment, according to the data of an employment survey, dropped from 13.8% in 2002 to 12.4% in 2003.

[1] The data for this Convergence Programme has been sourced from the Lithuanian Statistics Department under the Government of the Republic of Lithuania, different ministries of the Republic of Lithuania, and Bank of Lithuania.

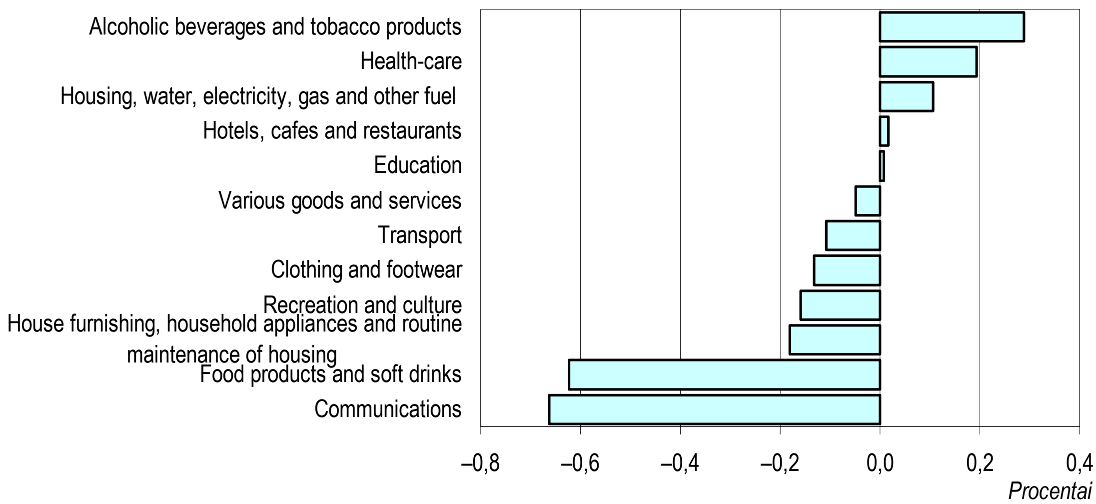
The structural reforms have stimulated a rapid growth of labour productivity. In 2003, productivity of the employed population grew at a rate of 6.5 per cent. With the revival of the economic activity in Lithuania, the structural unemployment has been falling since the beginning of 2002. According to the data of an employment survey, the number of long-term unemployed was about 102 thousand on the average in 2003. The share of long-term unemployed in the total number of unemployed fell from 55% in 2002 to 50% in 2003.

1.2 Inflation

In the past five years, the growth of the nominal litas exchange rate was one of the key factors of disinflation: in 1999, the average nominal litas exchange rate reached its record high of 43.8%, compared to 17% in 2000, 3.8% in 2001, 8.3% in 2002, and 8% in 2003. The average annual inflation dropped from 5.1% in 1998 to an average of 0.4% in the period of 1999 to 2003.

As of the end of 2001, a slight increase in inflation was recorded as a consequence of a poor yield in agriculture. The monthly annual deflation, which started in the other half of 2002 as a result of a higher competition in retail trade, continued in 2003. Although the fall of prices slowed down in the other half of 2003, the increased competition in the telecommunications market forced the average annual deflation to reach 1.2% in 2003 (cf. 1.3% as of year-end).

Chart 2. Impact of Major Groups of Goods and Services on the CPI Change, as of end-2003



Main internal and external factors of the drop of CPI in 2003:

increasing competition (particularly in telecommunications);

administrative decisions (the reduction of VAT on raw meat from 18 to 5%);

litas appreciation vis-à-vis U.S. dollar (litas appreciation of almost 17% has resulted in the drop of prices of crude oil, oil products and transport services).

1.3 External Sector

Lithuania has chosen a liberal regime for trade and the movement of capital. Since 2001, Lithuania has been a member of the World Trade Organisation. Trade with countries, which have concluded free trade agreements with Lithuania, accounted for 72.6% the total foreign trade in 2002.

On 21 October 2003, the Seimas of the Republic of Lithuania passed a Law on the Denunciation of Free Trade Agreements. As from the date of accession to the European Union, Lithuania will implement the EU *Acquis* on the European Union single market and external trade relations. The Republic of Lithuania has committed to denunciate bilateral and multilateral free trade agreements by signing an Agreement of Accession to the European Union on 16 April 2003.

On 14 October 2003, an Agreement on the Participation of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic in the European Economic Area was signed in Luxembourg and ratified by the Seimas of the Republic of Lithuania on 25 March 2004.

Despite a low demand in the EU local markets and slight changes in the structure of Lithuanian exports, Lithuania's foreign trade has, in the past four years, been oriented towards the present and future EU Member States. Export of goods to the EU, EFTA and CEFTA countries as well as to Estonia and Latvia accounted for 75.2% of Lithuania's total exports and 68.4% of its total imports in 2003.

In 1998 to 2003, the share of exports of Lithuanian products to the EU increased from 38% to 41.9% [2]; exports to CIS countries fell from 35.7% to 16.9% of total exports. Imports (by the country of origin) developed likewise: in 2003, imports from the EU accounted for 44.7%, and imports from CIS countries, 25.5%. Lithuania's exports to the new members accounted for 19.3% of its total exports, and imports from these countries, 11.9 % in 2003.

Lithuania's total export of goods grew by 8.7% in 2003, whereas imports grew by 4.9%. Last year, both exports and imports grew at lower rates than in 2002. However, the faster growth of exports has contributed to the reduction of foreign trade deficit. In 2003, foreign trade developments were largely determined by a higher export of mineral products, plant and machinery, and furniture, and by a higher import of plant and machinery and chemical products. Mineral products excluded, exports of goods grew by 7.5%, and import of goods, by 3.2% in 2003 (January to November). Exports of Lithuanian origin have grown by 14.3% over the same period, which reveals that Lithuanian goods are competitive and exports are well diversified.

Table 1. Lithuanian Foreign Trade
(acc. to the common trade policy)

in LTL million

Indicators	2002	2003	Change, in %
Total volume of trade	48,852.9	52,029.9	6.5
Exports	20,290.7	22,062.4	8.7
of which: of Lithuanian origin	15,511.0	17,731.1	14.3
Imports	28,562.2	29,967.5	4.9
Balance	-8,271.5	-7,905.1	-4.4

Over 2003, the value of exported goods of Lithuanian origin totalled LTL 17,731.1 million, or 80.4% of the total value of Lithuania's exports. The major share of these goods were exported to EU Member States and new members (65.5%) and to EFTA countries (17.2%). The share of Lithuania's total export of goods to the EU and new members accounted for 61.3% of Lithuania's total exports in 2003. One of the key growth factors of the competitiveness of Lithuania's export goods and export performance in recent years has been a higher growth of labour productivity than the growth of wages.

[2] In 2003, the EU share accounted for 42% (cf. 48% in 2002) in the total export of goods, and 49% (cf. 48.8% in 2002) in the total import of goods. The decline of EU exports is associated to the peculiarities of accounting for export of mineral products by country. In the previous years, the main importer of mineral products was the United Kingdom; after the Russian company *Jukos* has taken over the ownership of Mažeikiai Oil Refinery , the status of the main importer has shifted over from UK to Switzerland (although actually oil products are mainly exported to other countries, including EU).

In 2003, foreign trade deficit declined in comparison to 2002; however, due to a substantial increase of the negative balance of income (by over LTL 700 million) and a decrease of the positive balance of services, the current account deficit increased. In 2003, by preliminary estimations, the current account deficit of the balance of payments might increase by almost one-third of the level of 2002, to reach about 6.6% of GDP (cf. 5.2% of GDP in 2002). An exclusive characteristic of the change in the current account balance in 2003 was a significant increase in dividend payments on foreign direct investment, and in reinvestment. This manifests a higher profitability of Lithuanian companies that enjoy foreign direct investment. On the other hand, the increase in dividend payments was influeced by a reduction of the profit tax rate to 15% in 2002 and an introduction of a more favourable dividend taxation regime.

Table 2. Changes in the Current Account Balance and the Constituent Balances, and the Associated Factors

	2003, in M LTL	2002, in M LTL	Change, in %	Contribution to the CAD change, in p.p.
Current account balance	-3,671.62	-2,670.59	37.5	37.5
Balance of trade	-4,905.56	-4,867.76	0.8	1.4
Balance of services	1,838.28	1,987.75	-7.5	5.6
Balance of income	-1,493.93	-642.33	132.6	31.9
Balance of current transfers	889.59	851.75	4.4	-1.4

Source: the Bank of Lithuania

In 2003, the stock of foreign direct investment was reduced by the re-classification of the previous years' investment in the amount of 2% of GDP from FDI into portfolio investment which caused a sharp drop of the net inflow of foreign direct investment in 2003. The volume of re-classification suggests that the inflow of foreign direct investment was higher than that was netted in the balance of payments and accounted for about 2% of GDP. Although the flow of investment was lower than in 2002, when it accounted for about 5% of GDP, Lithuania was still attractive to foreign investors.

By the data as of 31 December 2003, the stock of foreign direct investment in Lithuania reached LTL 13.7 billion (or EUR 3.94 billion). FDI per capita was 3,976 litas (or 1,152 euros) on the average. The growth of foreign direct investment is a precondition for a rapid economic growth in the medium term.

2. MEDIUM-TERM MACROECONOMIC SCENARIO

2.1 Assumptions Underlying the Forecasts

The below forecast of Lithuania's economic development (Table 3) is based on recent trends and assumptions of economic development, such as: sustainable fiscal policy, stable monetary policy, active labour market policy aimed at higher employment and flexible labour market, and investment and business promotion policy stimulating the economic development.

Table 3. GDP Growth and the Associated Factors

	2003	**2004**	**2005**	**2006**	**2007**
GDP growth at constant prices, %	9.0	7.0	7.3	6.6	6.3
GDP at current prices, mill LTL	**55,737**	**59,712**	**65,447**	**71,215**	**77,705**
GDP deflator, change in %	**-0.93**	**0.13**	**2.14**	**2.09**	**2.66**
CPI (average annual), change in %	-1.2	0.9	2.0	2.1	2.5
Employment growth, change in %	2.0	0.7	1.0	0.2	0.2
Unemployment, %	12.4	11.3	10.3	10.0	9.7
Productivity growth, change in %	6.6	6.5	6.2	6.4	4.6
Sources of growth: percentage changes at constant prices					
1. Households consumption expenditure	*11.0*	*6.1*	*7.8*	*5.8*	*5.7*
2. Government consumption expenditure	*5.7*	*7.0*	*-1.0*	*4.0*	*4.0*
3. Gross fixed capital formation	*11.4*	11.3	13.7	11.3	*8.0*
4. Change in inventories and acquisitions less disposals of valuables, % of GDP	*1.2*	*0.8*	*0.8*	*0.8*	*1.0*
5. Exports of goods and services	6.0	10.8	9.6	8.4	7.5
6. Imports of goods and services	8.8	10.7	9.4	8.5	6.9
Contribution to real GDP growth					
7. Domestic demand	**10.97**	**7.67**	**7.82**	**7.24**	**6.40**
8. Change in inventories and acquisitions less disposals of valuables, % of GDP	*1.2*	*0.8*	*0.8*	*0.8*	*1.0*
9. Balance of goods and services	**-2.01**	**-0.68**	**-0.51**	**-0.66**	**-0.12**
Assumptions					
Short-term interest rates	2.4	2.3	2.5	2.9	3.5
Long-term interest rates	5.3	5.0	5.3	5.7	6.1
USD/EUR exchange rates*	1.13	1.25	1.25	1.25	1.25
EU-15 GDP growth, %	0.8	2.0	2.4	2.4	2.4
Global imports (excl. EU), change in %	7.3	9.7	8.5	8.5	8.5
Oil prices (Brent, USD per barrel)**	28.5	28.5	28.5	28.5	28.5

* *technical assumption*
** *the upper limit of OPEC's price corridor*

An important assumption underlying the forecast of the period of 2004 to 2006 is related to the membership in the EU and the absorption of structural funds and other financial assistance from the EU. The assumption regarding the absorption of EU financial support funds was made on the basis of cash flows determined in the negotiations chapter on budgetary and financial provisions. In 2004, the economic growth will be accelerated by positive expectations of market players about Lithuania's membership in the EU.

The key assumptions about the external economic environment in implementing the EU fiscal monitoring procedure and in seeking to ensure the comparability of economic forecasts are in line with external environment assumptions published by the European Commission. It is expected that an improvement of the geopolitical position, favourable financial conditions, flexible macroeconomic policy and implementation of structural reforms will foster a faster EU development in the coming years: the economic growth of the fifteen EU Member States is projected to reach 2% in 2004, and 2.4% in 2005. It is also projected that the global economy (excl. the EU) will grow at a rate of 5.1% in 2004, and 4.7% in 2005. The average economic growth of the ten new EU Member States will reach 4.0% in 2004, and 4.2% in 2005. Another important assumption made in forecasting the economic development over 2004 to 2007 is the stability of exchange rates and oil prices.

The assumptions about the external environment and the data published by the Statistics Department support the projection that Lithuania is capable of maintaining a sustainable annual economic growth of over 6 per cent in the medium term. GDP will grow at a rate of 7% in 2004, 7.3% in 2005, 6.6% in 2006, and 6.3% in 2007.

2.2 Risk-Related Aspects of Economic Development

Macroeconomic projections are based on the assumptions agreed with the EU Commission. Improving trends of the global economic development reduce the degree of risk of the projections made herein.

An early acceptance of Lithuania to ERM II and the euro zone would speed up foreign investment and improve economic indicators.

2.3 Markets for Goods and Services

Increasing competition in the banking system (all banks haven been privatised), improving domestic business perspectives and sustainable fiscal policy will stimulate further growth of lending for the private sector investment and will promote private savings. Low interest rates create favourable conditions for economic entities to finance their investments by borrowing. The rapid growth of credit that started in 2001 particularly accelerated in 2003. The growth of bank lending in the coming years should help stimulate a very rapid growth of corporate investments.

The demand for loans in the beginning of the projected period will grow by reason of favourable interest rates and increasing expectations about Lithuania's membership in the EU, absorption of EU funds, early participation in the ERM II, followed by a full-fledged participation in the Economic and Monetary Union.

In the period of 2004 to 2007, investment and consumption will grow rapidly, and the positive trends in relation to Lithuania's export performance will be maintained. New trends in 2004 suggest that the domestic demand will continue to have a strong impact on economic growth.

Increased domestic lending as well as the EU structural support to investment projects will facilitate a more active investment process. Investment will be furthered by favourable interest rates and the increasing confidence of investors in the stability of the economy. It is projected that investment will account for an increasingly larger share of GDP. The strongest impact of EU financial support will be felt in 2005, when gross capital formation will grow at a rate of 13.7%, to reach 25.5% of GDP as of the end of the projected period.

A new positive impetus for consumption over the projected period will be added by the overall economic boom, decreasing unemployment, increasing income and high expectations by consumers about economic development. Average final consumption rates will account for 5.7% in the period of 2004 to 2007. The rapid growth of the domestic demand will be underpinned by the increasing government consumption expenditure. A moderate increase in government expenditure over the projected period will be conditioned by the expenditure associated with the membership in the EU and by the objective to balance public finances.

Although exports will grow rapidly, the higher domestic demand will increase imports and will postpone the improvement of the current account deficit for later periods. A positive impetus for the current account will be added by the anticipated EU support and higher domestic saving. It is projected that the share of final consumption expenditure will drop from 83.9% of GDP in 2002 to 79.7% of GDP in 2007, thus causing the corresponding increase in the rate of saving and a more extensive drawing on domestic resources to finance investment. Given the fiscal deficit reduction policy and debt-neutral financing of the current account deficit, the medium-term current account deficit would remain stable. It is projected that the current account deficit of the balance of payment will not exceed 6% of GDP in 2007.

Despite the moderate growth of the neighbouring markets and the depreciation of the U.S. dollar, Lithuania’s exports (acc. to the data derived from customs declarations) grew by 8.7% in 2003, with exports of Lithuanian origin growing at an almost double rate in comparison to that in 2002. This is a proof of the capability of Lithuania businesses to compete on foreign markets. These positive trends will continue and will be fostered further by the improvement of trade conditions, the increasing productivity of domestic producers and the expected revival of the global economy. The rapid economic growth will stimulate imports. Yet, the balance of goods and services will remain negative and will account for 5.2% of GDP as of the end of the projected period.

Export-intensive industries will remain a key contributor to the economic growth. The overall economic development will also be stimulated by the constructions sector. A more active consumption will facilitate the growth of wholesale and retail trade.

In 2004 to 2006, the development of different sectors of the economy will be promoted by EU structural funds. The primary impact of structural funds would mostly enliven the constructions sector, and industry and education to some extent. New jobs would increase the consumption of intermediate products, which would generate the secondary impact to be most intensively felt in three sectors of services (trade, transportation and warehousing, and communications) and in industry to a certain extent. About 80% of the increase would be shared equally by the following sectors: services to businesses (trade, transportation and warehousing, and communications), constructions, and industry. The remaining share of the increase would mostly be recorded in education and other sectors. The structure of the increase would hardly change over the period of 2004 to 2006. It could only be adjusted by a failure of a certain sector to prepare to absorb structural funds.

2.4 Consumer Prices

The stability of litas exchange rate vis-à-vis the euro and the increase of competition in the telecommunications and retail trade have aroused certain expectations regarding the stability of prices. These factors are likely to have an important impact in the medium term as well. However, due to a lack of information on the effects of the EU membership, consumers might provoke a temporary speculative and misleading change in prices in low competition sectors. Despite this, competition in Lithuania’s market economy will ensure that the overall level of prices will not change rapidly.

In 2004, the level of prices would increase as a result of higher excises on cigarettes and fuel and of a planned abolition of a reduced VAT rate on residential heating. However, given the recent downward trends in prices, only a very slight average annual inflation of the consumer price index is projected for 2004 (0.9%). There is still a risk, however, that once the duties on fuel imported from CIS countries are reduced to the EU level, the stronger competition will bring fuel prices down despite the increase of excises. In the light of Lithuania’s membership in the EU from 1 May 2004, inflation will likely be higher in the other half of 2004; therefore, the annual inflation in December will exceed the average annual inflation and will stand at 1.4%.

In 2005, the average annual change in prices of consumption goods and services will likely account for 2%. Inflation would be strongest among those groups of consumption goods and services in which services account for a relatively higher share. Inflation would stabilise at 2.1% in 2006, and slightly grow to 2.5% in 2007. Low inflation will be maintained thanks to a more effective use of the economic potential and the growth of productivity, which will partly set off the growth of the average monthly wages that will accelerate from 2004 on.

2.5 Labour Market

Over the period of 2004 to 2007, the situation on the labour market will be improving further. The growth of the demand for labour force, the increasing productivity, the optimistic expectations of economic entities and the convergence of prices upon accession to the EU will have positive implications for the growth of wages. It is projected that the average monthly gross wages will grow from 1,056 litas in 2003 to 1,396 litas in 2007.

An increase in the number of the employed population in 2002 and 2003 shows that enterprises have used the available labour force resources in full and will be able to further increase their production volumes by hiring additional staff. Financial support by the EU will stimulate a further growth of employment. The number of the employed population will grow in the entire period covered by the forecast, thus increasingly contributing to the growth of production.

As a result of an increasing demand for labour force and higher flexibility of labour force, the level of unemployment will go down from 12.4% in 2003 to 9.7% in 2007 (by the data of an employment survey).

3. PUBLIC FINANCE

3.1 Policies

3.1.1 Objectives

The key objective of the medium-term fiscal policy is the approximation to a cyclically balanced general government budget by ensuring a successful implementation of economic policy goals. Efforts will be made to limit the general government deficit up to 3 per cent in the period of 2004 to 2007 and to achieve, as soon as possible, a budget balance.

General government budget revenue and expenditure policy measures ensuring the approximation to a cyclically balanced budget are aimed at ensuring a sustainable and rapid economic growth. Structural reforms adding to the competitiveness of the economy speed up the economic convergence with EU Member States.

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

1) to ensure macroeconomic stability by pursuing anti-cyclic fiscal policy;
2) to create favourable conditions for the improvement of labour efficiency, and to improve the competitiveness of the economy;
3) to further stimulate important factors by completing the reforms in energy and agriculture sectors, as well as budget management reforms; and
4) to pursue the fiscal policy in harmony with the priorities of social policy.

Seeking to join the euro-zone in the medium term, Lithuania will be improving, as part of its fiscal policy, the conditions for institutional long-term saving and for higher labour efficiency and will ensure a successful completion of structural reforms, improve tax administration, promote investment, create favourable climate for business and private investment and ensure an effective use of public funds allocated for investment.

Public finance management will be further improved by adopting the methodology applied in the EU Member States for the accounting of public finances and for the assessment and forecasting of financial performance, by improving the technical base and by enhancing labour skills.

3.1.2 Actions Planned

In the period from 2004 to 2007, the following actions are planned:

to complete the transposition to a program-based budgeting;

to restructure general government budgetary expenditures, i.e. to allocate funds by priorities and by the needs for co-financing EU financial support;

to build institutional and administrative capacities to ensure maximum absorption of EU budget allocations;

to improve management of municipal finances;

to improve financial management in the health-care system;

to further develop the Reserve Fund, and to complete the privatisation of state-owned property; and

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.

3.2 Actual Balances and Implications of the Forthcoming Budget on Medium-Term Goals

3.2.1 Overview

The rapid economic development is a proof of the pragmatic 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 2000, the direction of fiscal policy was radically changed with a view of achieving fiscal consolidation. General government budget deficit amounted to 2.5% of GDP in 2000, followed by a drop to 2.1% of GDP in 2001. By preliminary estimations, the general government fiscal deficit accounted for about 1.7% of GDP in 2003. With debt servicing costs of 1.3% of GDP, the primary deficit of 0.4% of GDP was recorded in 2003. The increase of the general government budget deficit in 2003 is explained by higher than expected (0.4 % of GDP) expenditure for savings restitution.

Pursuing the objective to integrate into the euro-zone, Lithuania will make every effort to implement the provisions of the Treaty Establishing the European Community. The medium-term general government budget deficit is projected to shrink from 2.7% of GDP in 2004 to 1.5% of GDP in 2007, without exceeding the 3% limit. During 2004 to 2007, due to the future payments to the EU budget, the expenditures for co-financing the EU structural funds, the costs of the pension reform that is being successfully implemented, and the harmonisation of Lithuania's tax system with that of the EU, the general government finances will change in the structure in comparison to that in 2003. For the period of 2004 to 2007, the following budget indicators are projected:

Table 4. General Government (S13) Budget Projections, for 2004 to 2007 (% of GDP)

% GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending (B9)						
1. General government	S13	-1.7	-2.7	-2.5	-1.7	-1.5
2. Central government	S1311	-2.2	-2.8	-2.6	-1.8	-1.6
3. State government	S1312	-	-	-	-	-
4. Local government	S1313	0.03	0.05	0.02	0.02	0.02
5. Social security funds	S1314	0.5	0.1	0.1	0.1	0.1
General government (S13)						
6. Total receipts	ESA	32.4	34.9	35.3	35.0	34.4
7. Total expenditures	ESA	34.1	37.6	37.8	36.7	35.9
8. Budget balance	B9	-1.7	-2.7	-2.5	-1.7	-1.5
9. Net interest payments	D41	0.4	0.6	0.6	0.5	0.5
10. Primary balance		-0.4	-1.3	-1.2	-0.6	-0.4
Components of revenues						
11. Taxes	D2+D5	20.0	20.4	20.2	20.3	20.4
12. Social contributions	D61	8.7	8.7	8.7	8.7	8.7
13. Interest income	D41	0.9	0.8	0.7	0.7	0.6
14. Other		2.8	4.9	5.7	5.4	4.8

% GDP	ESA code	2003	2004	2005	2006	2007
15. Total receipts	ESA	32.4	34.9	35.3	35.0	34.4
Components of expenditures						
16. Collective consumption	P32	7.9	7.6	7.0	6.7	6.5
17. Social transfers in kind	D63	1.4	1.5	1.5	1.5	1.5
18. Social transfers other than in kind	D62	9.3	9.6	9.4	9.3	9.2
19. Interest payments	D41	1.3	1.4	1.3	1.2	1.1
20. Subsidies	D3	0.8	1.5	1.6	1.6	1.6
21. Gross fixed capital formation	P51	2.9	3.4	3.9	3.6	3.1
22. Other		0.3	1.2	1.5	1.5	1.2
23. Total expenditures	ESS	34.1	37.6	37.8	36.7	35.9

Although expenditure financing priorities have not changed fundamentally, the above projections have been adjusted with update on actual budgets, GDP figures and extra budgetary tenssions. As a result of adoption by the Statistics Department of EUROSTAT methodology for GDP calculations, historic GDP figures increased by nearly two percentage points; therefore, the share of social contributions (as a percentage of GDP) decreased by about 0.2 percentage points in comparison to the respective figure in the previous update. In 2003, the GDP-relative share of social contributions remained on the 2002 level. Despite the higher GDP figure due to the above-mentioned change in the methodology, the GDP-relative share of personal and corporate income taxes receipts has increased by 0.6 percentage points above the 2002 level. The expansion of the profit tax base as an outcome of tax reforms has added about 1% of GDP to general government receipts, despite the reduction of the tax rate by 9 percentage points. In 2003, the reduction of VAT receipts was offset by a better administration of the personal income tax, which helped to maintain tax receipts (as a percentage of GDP) on approximately the same level as in 2002. The VAT share of GDP was higher in 2002 than in 2003 due to higher VAT overpayments (overpayments increased by 0.6 percentage points of GDP). In 2002, the increase in VAT overpayments accounted for about 8% of total VAT receipts. As result of stable VAT overpayments stock in 2003, the inflow of VAT in 2003 remained within the level of 2002. To retain the same level of VAT inflow was difficult because of deflation that prolonged as result of appreciation of national currency. Better administration of VAT has contributed to the reduction of the impact of the drawn-out deflation on revenues. In the light of all these factors, the year 2003 became the first year (since 1998), when the share of tax revenues (adjusted acc. to accrual accounting approach) in the GDP has stepped on the ascending track (despite the reduction of basic tax rates).

In the medium term, general government revenues (as a share of GDP) will grow to 32.4% in 2003, 34.9% in 2004, and 35.3% in 2005. The volumes of the pre-accession aid will decrease in 2006 and will finally stop in 2007; as a result, lower current and capital transfers will bring the general government revenues down to 35% of GDP in 2006 and 34.4% of GDP in 2007. The GDP share of tax revenues will grow throughout the medium-term period, except in 2005, when tax revenues will fall by 0.2% of GDP as a result of abolition of the road tax constituting 0.5% of GDP. Otherwise, tax revenues will grow to 20.4% of GDP in 2004, with a temporary slow-down to 20.2% in 2005, followed by an increase to 20.3% of GDP in 2006 and up to 20.4% of GDP in 2007.

EU commitments that will grow until 2005 will increase current and capital transfers shown in Table 4 above under “Other”. EU payment commitments to Lithuania and payments to the EU budget have been included in the calculations on the basis of cash flows approved in the Copenhagen Council.

As part of fiscal deficit strategy, total general government expenditures were limited to 34.1% of GDP in 2003. Absorption of EU support funds will cause the GDP-relative share of expenditures rise to 37.6% in 2004 and 37.8% in 2005. After the termination of the pre-accession aid, expenditures will shrink to 36.8% of GDP in 2006 and 35.9% GDP in 2007.

General government expenditures include estimated payments to the EU budget, which will account for 0.7% of GDP in 2004 and 1.1% of GDP in the period of 2005 to 2007.

A number of factors, such as payments to the EU budget, co-financing of the EU support, the increase of support to agriculture up to 55% of the EU level, and compensations for real estate and deposits, will call for additional funds. The target to keep the fiscal deficit below 3% of GDP could be achieved by cutting down collective consumption expenditure from 7.9% of GDP in 2003 to 6.5% of GDP in 2007.

The successful implementation of the borrowing policy will lead to the reduction of the GDP-relative share of interest payments from 1.4% in 2004 to 1.1% in 2007.

As result of the pension reform, in the period of 2004 to 2007 part of social insurance contributions will be transferred to private pension funds. Capital transfers to privately-funded pension schemes will increase gradually from 0.3% of GDP in 2004 to 0.8% of GDP in 2007. Favourable demographic structure of employment in the projected period and the increase of the retirement age will result in the reduction of the GDP-relative share of social security payments; however, social benefits that were raised in 2004 will keep this expenditure close to the level of 2003.

Subsidies to agriculture will grow not only because of the future flow of direct payments from the EU, but also because of reallocation of a share of the EU support to agriculture for subsidies. National allocations for subsidies to farmers will be increased by 0.15% of GDP in 2004 and by 0.3% of GDP in 2005. The share of subsidies will double from 0.8% of GDP in 2003 up to 1.6% of GDP in the period of 2005 to 2007. The decision to raise direct payments to farmers to 55% of the EU level was passed after the approval of the Lithuanian Pre-Accession Economic Programme of 2003.

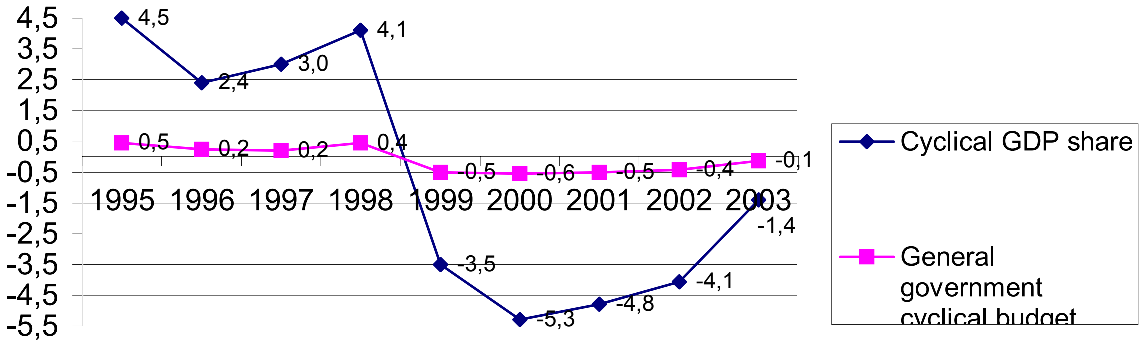
Gross fixed capital formation is expected to grow, due to absorption of EU support, from 2.9% of GDP in 2003 to 3.9% of GDP in 2005. As the pre-accession aid will decrease in 2006 and expire in 2007, gross fixed capital formation will go down to 3.6% of GDP in 2006 and further to 3.1% of GDP in 2007. Support from the EU will account for an increase in capital transfers to the private sector. The rapid growth of investment and capital transfers will, in turn, improve the quality of public finances.

General government budgetary expenditure for restitution of private savings and for compensations for restored ownership of real estate will account of 0.4, 0.5, 0.8 and 1.1% of GDP during 2004 to 2007, respectively. These amounts are subject to change in relation to financial and economic developments.

3.3 Structural Deficit and Sustainability of Fiscal Policy

As shown in Chart 3, the GDP cycle has quite small impact on the deficit. Maximum cyclic fluctuation of general government deficit over 1995 to 2003 was 0.5% of GDP.

Chart 3. Implications of the GDP Cycle on the General Government Cyclical Fiscal Deficit, in per cent



Estimation of the output gap

The GDP cycle was estimated by applying the *Hodrick Prescot* filter. The results of this estimation suggest that Lithuania's economy is currently on the ascending track and will exceed the potential GDP in 2005.

The year 2004 will end the six-year period of a negative output gap. From 2005 on, real economic growth will exceed the potential GDP growth. The output gap will be 1.1% in 2005, 2.1% in 2006, and 3.1% in 2007.

Table 5. Cycles of the Economy

% of GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
1. GDP growth at constant prices	B1g	9.0	7.0	7.3	6.6	6.3
2. Actual balance	B9	-1.7	-2.7	-2.5	-1.8	-1.5
3. Interest payments	D41	-1.3	-1.4	-1.3	-1.2	-1.1
4. Potential GDP growth		6.0	5.9	5.7	5.5	5.3
5. Output gap, HP filter		-1.4	-0.4	1.1	2.1	3.1
6. Cyclical budgetary component		-0.1	0.0	0.1	0.2	0.3
7. Cyclically-adjusted balance (2-6)		-1.5	-2.7	-2.6	-2.0	-1.8
8. Cyclically-adjusted primary balance (7-3)		-0.3	-1.3	-1.3	-0.9	-0.8

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 accurate. Conclusions obtained under the production function approach (based on the *NAIRU* conception) 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 weakness, lying in the fact that it smoothes structural changes even when they show an obvious change 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.

The economy still has unused capacities: industry used only about 70% of its total capacities in 2003. Unemployment is still rather high. Despite the highest rates of GDP growth among European countries, growth-rates of prices and wages are among the slowest ones. These facts suggest that Lithuanian economy has not employed its full potential yet, although the results of the analysis under the production function approach point at a overheating of the economy.

3.4 Budget Sensitivity to GDP Changes

In the period of 1995 to 2003, only one-tenth of the cyclical GDP fluctuation turned into general government deficit. This characteristic of general government finances can be explained by low elasticity of revenues and still lower elasticity of expenditure to GDP fluctuations.

Relying on 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.

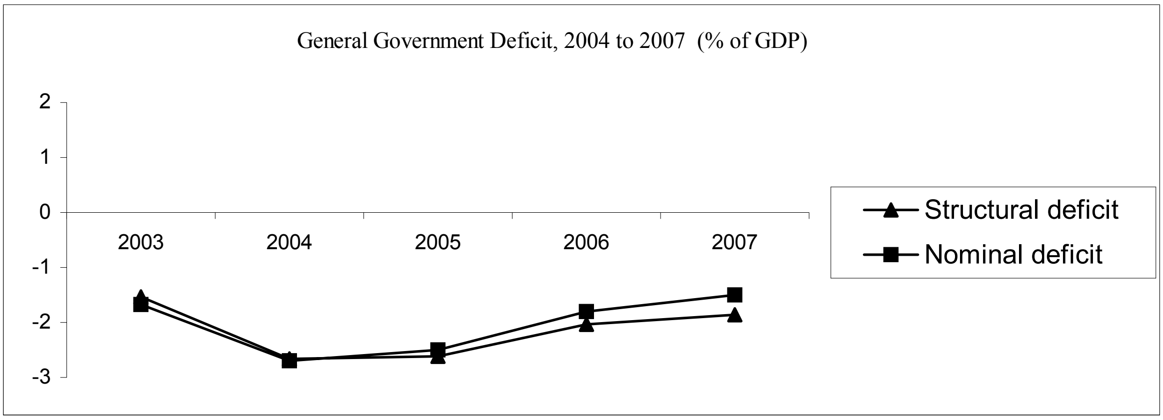
Table 6. Lithuania's General Government Budget Revenue Elasticity Estimates

ESA 95 code		Elasticity estimates
D.212	**Duties**	0.84
D.211	**VAT**	0.97
D.214	**Excise**	1.36
	Of which:	
	on alcohol	1.09
	on tobacco	0.0
	on fuel	1.57
D5	**Income and profit taxes**	1.03
D61	**Social contributions**	0.98
	Current expenditure	0.97

As the Table 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 much sensitive to income fluctuations. These elasticity estimates would have been more accurate, if their quality has not been affected by numerous changes in tax legislation.

Cyclically-Adjusted General Government Balance

Chart 4. The Dynamics of General Government Structural and Cyclical Budget Deficit, 2004 to 2007



Cyclically-adjusted general government deficit has been estimated by relying on macroeconomic and budgetary projections described in this Programme. The results are given in Table 6.

Table 6 shows that the structural deficit [3] would shrink to 0.8% of GDP in 2004 and 0.2% of GDP in 2005, if that euro-integration expenditures and costs of structural reforms were excluded.

Table 6. Projections of General Government Structural and Cyclical Fiscal Deficit and the Additional Financing Requirement Associated with to the EU Accession (in % of GDP)

		2004	2005	2006	2007
1.	**Projected general government fiscal deficit**	**-2.70**	**-2.50**	**-1.80**	**-1.50**
2.	Cyclical fiscal deficit (-)	0.0	0.1	0.2	0.3
3.	**Structural fiscal deficit**	**-2.7**	**-2.6**	**-2.0**	**-1.8**
4.	EU Own Resources	0.75	1.15	1.10	1.10
5.	Co-financing requirement	0.74	0.8	0.6	0.5
6.	One-off effects: loss of revenue due to a new payment procedure of VAT on imports from the EU in 2004; abolition of the road tax.	0.4	0.5	0	0
7.	**Structural deficit reduced by the amount of payments to the EU Own Resources, co-financing requirement and loss of revenue**	**-0.8**	**-0.2**	**-0.3**	**-0.2**

3.5 Stock of Debt and its Dynamics

By preliminary data, general government debt as estimated according to the Excessive Deficit Procedure (EDP) accounted for 21.5% of GDP as of the end of 2003 and was one of the lowest among EU Member States and new members countries.

Table 7. General Government Debt acc. to EDP

	1999	2000	2001	2002	2003
General government debt as of year-end (in M LTL)	9,963.30	10,841.63	11,100.54	11,591.08	11,988.7
% of GDP	23.0	23.8	22.9	22.4	21.5

In the end of 2003, a new version of the Law on the National Debt was passed to regulate national debt accounting in accordance with EDP requirements.

Until 2003, debt in Lithuania has been calculated and debt data published by the conservative approach, i.e. government-guaranteed debt has been included in the total debt. Moreover, the national debt included the total central government debt, but excluded liabilities of certain sub-sectors (such as local governments and social security funds). Since 2004, the total general government debt has been recorded in accordance with the EDP requirements. Pursuant to the above-mentioned new Law on the National Debt, from 2004 on, the national debt will be classified into domestic and foreign debt by resident (previously debt was classified by currency).

[3] Structural deficit shows the difference between general government revenue and expenditure when the actual GDP equals the potential GDP. Structural deficit is estimated by eliminating the effect of the business cycle.

The government borrowing volumes are strictly regulated in the Law on Approval of Financial Indicators of the State and Municipal Budgets, which sets annual limits on net borrowing by the Government and on newly contracted government guarantees. The net borrowing limit for 2004 is set at LTL 1500 million, and no new guarantees are planned at all.

3.5.1 GOAL

The key objective of national debt management is to ensure full and timely financing of public expenditures and timely implementation of debt liabilities at the lowest possible cost and risk, without exceeding the limits placed on the national debt and on new borrowing.

Pursuant to the Medium-Term Borrowing Policy of the Government of the Republic of Lithuania, attempts are made to ensure that the national debt does not exceed 30 per cent and the foreign debt, 25 per cent of GDP. The direct foreign debt nominated in the euro must account for no less than 75 per cent of the total direct foreign debt.

3.5.2 ACTIONS PLANNED

The strategy of financing the government borrowing requirement has not changed from that in the previous year.

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

The Government has accumulated over LTL 1.4 billion in the Stabilisation Fund. In case of unfavourable developments in financial markets, the Government will be able to draw on these resources to cover its liabilities.

In the medium term, the Government has envisaged to implement the following borrowing policy measures:

- to increase borrowing in the national currency, to prolong maturity of securities (bonds), and to boost liquidity of government securities in the secondary market;
- to gradually reduce government liabilities in foreign currencies;
- to seek that government securities denominated in foreign currencies accounted for an increasingly larger share of the direct foreign debt portfolio;
- in foreign markets, to borrow in the euro or other foreign currencies to be converted to the euro through derivatives;
- to reduce volumes of new government guarantees or to extend no guarantees at all.

3.5.3 General government Debt Projections

It is projected that because of large fiscal deficit the general government debt (acc. to EDP) (S.13) will increase, in 2004, by almost 1% of the projected GDP. This increase will likely to be followed by a downward trend. In the medium term, the stock of general government debt should settle at 21% of GDP.

One of the Government's medium-term borrowing policies is the reduction of volumes of new guarantees (in 2004, no government guarantees will be extended for new investment projects at all), thus seeking to create equal business and borrowing opportunities for all economic entities and to promote the activity of commercial banks in financing promising investment projects.

As of the end of 2003, government-guaranteed loan portfolio accounted for 2.6% of GDP. This figure is expected to drop to 1.4% of GDP over the medium term.

Table 8. General Government Debt Projections

% of GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
National debt as of year-end		21.5	22.4	22.2	21.4	21.0
Change of national debt		-0.9	0.9	-0.2	-0.8	-0.4
Factors Influencing the Change of National Debt						
Primary balance	B9	0.4	1.3	1.2	0.6	0.4
Interest	D41	1.3	1.4	1.3	1.2	1.1
Nominal GDP growth	B1g	-1.7	-1.6	-2.1	-1.9	-1.9
Other factors influencing the debt ratio		-0.9	-0.2	-0.6	-0.6	0.1
Of which: privatisation receipts (-) positive proceeds (+) negative proceeds		-1.5	-0.7	-0.8	-0.2	-0.2
p.m. implicit interest rate on debt (%)		5.5	5.2	5.3	5.4	5.4

3.5.4 ECONOMIC IMPACT

In the end of 2003 and the beginning of 2004, three leading rating agencies raised credit ratings for Lithuania on account of positive dynamics of Lithuania's macroeconomic indicators and tight fiscal policy of the state. Over the medium term, the Government expects to further improve its sovereign credit ratings, which would not only contribute to lower government borrowing costs, but would also have a positive impact on borrowing by the private sector.

3.6 Balance by Sub-Sectors of General Government

In 2003, budgets of social security funds ran surpluses: a preliminary surplus of 0.5% of GDP was recorded. Social security funds have fully cleared their budget arrears over 2003.

Better administration of collection of municipal revenues and the reduction of budget arrears as well as strict control over municipal borrowing, all led to a slight overall surplus of municipal budgets in 2003 (about 0.03% of GDP).

As a result of structural and tax reforms carried out in recent years, the central government budget deficit accounted for a major share of the total deficit in 2003, i.e. 2.2% of GDP (LTL 1.228,3 million).

It is projected that 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 budget of social security funds will run a surplus that will grow slowly and account for a stable share of GDP, i.e. about 0.1% of GDP. The deficit of the central government sub-sector equals the total deficit of the general government budget. Therefore, the deficit of the central government sub-sector and the general government deficit will be decreasing by the same amounts in the medium term, which is shown in Table 4.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Sensitivity and Risk Assessment

The degree of sensitivity of the general government budget deficit to GDP fluctuations is rather low. In the period of 1995 to 2003, only one-tenth of cyclical fluctuations in GDP would convert to a change in the general government balance. This feature of the general government finances can be explained by a low elasticity of income and still lower elasticity of expenditure with respect to GDP fluctuations.

A medium-term growth of variable and fixed market interest rates by one percentage point would add 0.04% of GDP (LTL 22 million), 0.09% of GDP (LTL 60.9 million), 0.11% of GDP (LTL 80 million), and 0.12% of GDP (LTL 93.7 million) to the amount of interest payable on the central government debt in 2004 to 2007, respectively (including new borrowing).

Sensitivity of Budgetary Projections to Different Assumptions

Assumptions made in forecasting macroeconomic indicators are close to those made by the EU Commission in forecasting the spring environment. However, Lithuania's real GDP is estimated at the prices of 2000, whereas the EU Commission uses the prices of 1995; therefore, different structure of real GDP causes differences in the growth of real GDP.

Lithuanian forecasts are based on the assumption that EU support will be absorbed as per the cash flows approved by the Copenhagen Council. Lower absorption of EU support would mean a 1 % lower GDP growth. Almost 100% absorption of the EU pre-accession support allows to expect that the amount absorbed will exceed payment commitments, thus creating the conditions for GDP to grow at a higher pace than that projected in this Convergence Programme.

Comparison with the Previous Update

Successful implementation of euro-integration programmes in 2003 and of a number of on-going reforms as well as the update of actual data have adjusted general government deficit projections.

The projections below have been made according to ESA'95.

Table 9. Dynamics of General Government Fiscal Deficit and Debt Projections (% of GDP)

% of GDP	ESA code	2003	2004	2005	2006	2007
GDP growth **Previous update**	B1g	6.8	6.2	6.5	6.0	-
Latest update		9.0	7.0	7.3	6.6	6.3
Difference		2.2	0.8	0.8	0.6	-
Actual budget balance **Previous update**	B9	-2.4	-2.9	-2.5	-1.8	-
Latest update		-1.7	-2.7	-2.5	-1.7	-1.5
Difference		0.7	0.2	0.0	0.1	-
General government debt **Previous update**		22.9	22.7	23.2	23.3	-
Latest update		21.5	22.4	22.2	21.4	21.0
Difference		-1.4	-0.3	-1.0	-1.9	-

In 2003, the preliminary actual general government deficit was lower than in the previous projection for the following reasons:

- the surplus in social security funds was 0.5% of GDP above the planned level;
- the improved tax administration and the tax reform raised the receipts from the profit tax and personal income tax by 0.8% of GDP above the planned level;
- the improved management of municipal finances resulted in the overall surplus of municipal budgets;
- higher rates of GDP growth changed the GDP by 0.03%.

Since the deficit was lower than expected, as explained above, 0.5% of GDP was paid out to individuals as a compensation of their savings in 2003.

The use of ESA'95 methodology for recording direct payments by the EU to agriculture has reduced the general government deficit forecast from 2.9% to 2.7% of GDP in 2004 and pulled it off the Maastricht criterion of 3%.

5. QUALITY OF GENERAL GOVERNMENT FINANCES

Policy Strategy

As part of the budgeting reform, off-budgetary funds have been incorporated into the state budget and a number of legal amendments were passed to enable the accumulation of 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 emergencies so as to ensure a smooth functioning of the economy. As of 1 April 2004, the Reserve (Stabilisation) Fund had LTL 1,410.5 million (2.4% of GDP).

5.1 General Government Expenditure

General Government Expenditure Policy

Overview

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

Table 10. General Government Expenditure in 1998 to 2003, by ESA 95 (% of GDP)*

Indicators	Code	1999	2000	2001	2002	2003
Total expenditure	**ESA**	**42.9**	**38.4**	**35.1**	**34.3**	**34.1**
Collective consumption expenditure	P32	8.7	9.5	8.0	7.8	7.9
Private consumption expenditure	P31	13.5	12.1	11.8	11.6	10.9
Capital depreciation	K1	-2.0	-2.0	-1.8	-1.5	-1.4
Social transfers other than in kind	D62	11.4	10.7	10.6	9.3	9.3
Interest payments	D41	1.5	1.7	1.7	1.6	1.3
Subsidies	D3	1.1	0.8	0.9	0.8	0.8
Gross fixed capital formation	P51	2.6	2.4	2.2	2.8	2.9
Other		6.1	3.2	1.7	1.9	2.4
Budget balance	**B9**	**-5.6**	**-2.4**	**-2.1**	**-1.5**	**-1.7**

*data from the Statistics Department

Over the period of 1999 to 2003, the GDP-relative share of general government expenditure has been continuously falling: from 42.9% of GDP in 1999 to 34.1% of GDP in 2003 (by preliminary data reported by the Statistics Department). This downward trend was the outcome of the strict budget 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 13.5% of GDP in 1999 to 10.9% of GDP in 2003) and in collective consumption expenditure and social transfers (from 11.4% of GDP in 1999 to 9.3% of GDP in 2003). Decreasing interest rates on government securities and favourable conditions on the international securities market are reflected in the reduction of interest payments on general government debt. Government subsidies stayed at around 0.9% of GDP during 1999 to 2003 and continued to be on a downward track.

General government expenditure on gross fixed capital formation that has been demonstrating a decline since 1999 reached its bottom of 2.2% of GDP in 2001, followed by an increase in 2002 to reach 2.9% of GDP in 2003.

With a view to improving public finance management, a number of legal acts were passed in the period of 2000 to 2003 to define the principle of budget publicity, essential principles of strategic planning, and the inclusion of most off-budgetary funds into the budget.

The municipal budgeting procedure has been reformed. Efforts are being made to ensure equal and stable financial opportunities for municipalities to form their own budgets in accordance with statutory limits on long-term revenue. From 2002, municipalities receive funding from the state budget for the implementation of functions delegated to them by the central government and for the “student’s basket”. This has helped to significantly consolidate municipal finances and create real conditions for municipalities to reduce their budget arrears.

As part of the budget reform, a strategic planning and program-based budgeting mechanism was introduced. It has created possibilities to direct the activities of appropriation managers towards the achievement of the priorities set by the Government. The strategic planning of the government budget is in line with the principles applied in the EU.

With a view to ensuring efficient use of EU support, the Law on Approval of Financial Indicators of the Sate and Municipal Budgets for 2004 gives the right to the Government, or an authority authorised by the Government, to reallocate the EU support and national co-financing funds allocated for programs and projects, among appropriation managers, areas of investment, governmental functions and items of economic classification, and to cover a temporary shortage, if any, of funds for EU co-financed programs with state budget operating funds or borrowed resources. The Law also allows to reallocate the balance of allocations that remained unused (as planned) for EU-financed programs and projects as of the end of 2003 and to use it for co-financed projects as unused funds of special programs, as well as to use the balance of allocations approved for 2004 in excess of the appropriations approved by the above mentioned Law.

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 programs, 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.

Upon accession to the EU, Lithuania will be 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 EU Structural Funds and the Cohesion Fund are financial instruments of the EU structural policy that are employed to co-finance projects in priority areas 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, whereas the strategy of use and the projects of the Cohesion Fund and the respective national co-financing is defined in the Cohesion Funds Strategy for 2004-2006.

Goals

In Lithuania, budgetary expenditure targets and priorities are defined in a number of policy papers that are interrelated and form a single integrated framework. The key national budget expenditure targets and priorities are defined in the Government Long-Term Development Strategy, the Single Programming Document (SPD), the Government Program, regional development plans, and the documents on accession to the EU and NATO. The medium-term budget for the period until

2007 is planned and relevant programs are prepared in line with the following strategic goals (priorities) approved by the Government of the Republic of Lithuania[4]:

- to strengthen Lithuania's say in forming the economic policy of the European Union and in making decisions on issues relevant to the country;
- to develop the national defence system as a part of NATO's collective security and defence system;
- to seek sustainable development, ensure further improvement of the conditions for business development, and boost the development of a competitive agricultural sector;
- to reduce unemployment and poverty;
- to ensure the development of education, science and national culture, and the promotion of healthy life-style;
- to develop information and knowledge society;
- to ensure public security and public order; and
- to ensure the development of public transport infrastructure.

The expenditure policy is strongly influenced by the EU integration process. From 2000 on, expenditure necessitated by the EU integration has become a priority. Every effort is being made to ensure maximum implementation of EU-related projects. In the post-accession period, this policy direction will be pursued with still stronger effort. The key directions of this policy are agriculture, the development of transport and environmental protection, business promotion, investment not only in infrastructure but also in the development of human resources.

Actions Planned

As part of the budget reform, the scheme of integrating budgetary resources with the EU support is being improved. The integration covers preparation of the NDP, the budget cycle, and planning of investments.

A new amendment to the Law on the Budget Structure was passed in December 2003. The Law now defines new budgetary aspects necessitated by the membership in the European Union. Lithuanian's membership in the EU is reflected in the amended Law on Budget Structure in two aspects: firstly, the commitment of the Republic of Lithuania to ensure an effective and efficient use of the European Union financial support funds and payments to the European Union budget; secondly, implementation of the European Union system of accounts in administrating national budgetary funds and cash flows.

Starting with 2004, the state budget channels large cash flows both to co-finance the EU support programs and to make payments to the EU budget.

5.2 General Government Revenue

Government budget revenues declined from 37.3% of GDP in 1999 to 32.4% of GDP in 2003. The decrease was conditioned in part by lower income from levies, assets, dividends, interest and other income, which is by nature related to assets possessed or government operations. The decline was also stimulated by the implementation of the tax reform (a number of tax benefits and exemptions on receipts from the corporate profit tax and personal income tax): tax revenues fell from 23% of GDP in 1999 to 20% of GDP in 2003. Despite the fact that tax collection in 2003 exceeded the plan, general government revenues accounted for an increasingly lower share of GDP due to the rapid GDP growth.

[4] Resolution No. 330 of the Government of the Republic of Lithuania, dated 18 March 2003, "On the Strategic Goals (Priorities) of the Government of the Republic of Lithuania".

Table 11. General Government Revenue in 1999 to 2003, by ESA'95 (% of GDP)*

	ESA code	1999	2000	2001	2002	2003
Total revenue and grants	**ESS**	**37.3**	**36.0**	**33.1**	**32.8**	**32.4**
Taxes	D2+D5	23.0	21.0	20.1	20.1	20.0
Social contributions	D61	9.3	9.4	9.0	8.7	8.7
Other receipts and grants		5.0	5.5	4.0	4.0	3.7

*data from the Statistics Department

From 1 January 2003, a new Law on Personal Income Tax came into force. The new Law sets two rates of the personal income tax: 15 and 33 per cent. From 2003, individuals enjoy a higher non-taxable rate on all income received (raised from 250 to 290 Litas per month). The Law also allows a 25 per cent reduction of the taxable personal income (for the purpose of calculating the taxable income, the total income may be reduced with life insurance contributions, contributions to pension funds established in the Republic of Lithuania, interest paid to banks and other credit institutions on loans taken for construction or acquisition of housing, tuition fees for studies at a university-level institution).

The Law on Personal Income Tax also establishes that parents with one or two children may enjoy an additional tax-exemption, i.e. 29 Litas per child. The disabled, families with three and more children, single parents as well as people employed in farmers' farms and agricultural entities are entitled to still higher tax exemptions determined individually.

The Law also introduces a full-scale declaration of income and income tax.

On 13 April 2004, the Seimas of the Republic of Lithuania passed a new Law on Tax Administration to improve regulation of legal aspects of tax administration. The Law defines basic principles of legal regulation of taxation applicable to all tax legislation; regulates, with higher precision and consistency and in more detail, taxation procedures on the statutory level, by using the best experience of foreign states; adjusts the focus of activities of the tax administer, by attaching a priority to the promotion of voluntary payment of taxes and to all possible assistance to the taxpayer in the field of legal compliance.

In 2003, the Seimas of the Republic of Lithuania passed a Law on the Provision of Assistance to and the Receiving of Assistance from Institutions of the European Union Member States for the Recovery of Claims Relating to Certain Levies, Duties, Taxes and Other Measures, which creates legal preconditions for the effective co-operation between Lithuania and other EU Member States in the field of recovery of tax debts.

To facilitate the fulfilment of taxpayers' obligations, tax administrators have taken over certain functions of administration of social security contributions from 1 January 2004.

From 1 May 2004, no VAT on imports will be collected on the Lithuanian-EU border. It has been estimated that the budget will lose VAT receipts in the amount of 0.4% of GDP in 2004.

Measures to Improve the Tax Reform

The tax system will be further improved with a view to guaranteeing stable budgetary inflows, fair and proportionate distribution of taxes, and fair competition, and to ensuring that tax legislation implements general principles of taxation in line with requirements of the EU *acquis* and taking account of the output of the European Commission working groups and the world's best practice.

The near future plans include the improvement of a number of draft legal acts necessary for the implementation of the new version of the Law on Tax Administration, by taking account of the EU practices in this field, with an aim to strictly regulate rights and responsibilities of the tax administrator towards taxpayers, and of a number of secondary legislation, which, together with the new Law on Tax Administration, will implement the provisions of the EU Council Directive on taxation of savings income in the form of interest payments.

The preparation of a set of legal acts on the implementation of the Law on the Provision of Assistance to and the Receiving of Assistance from Institutions of the European Union Member States for the Recovery of Claims Relating to Certain Levies, Duties, Taxes and Other Measures will be completed shortly.

In April 2004, a set of secondary legislation was adopted to implement certain measures aimed at ensuring the implementation of the provisions of the Republic of Lithuania Law on Profit Tax and the Law on Personal Income Tax that oblige taxpayers to transact at arm's length and, in the failure to do so, authorise the tax administrator to adjust transaction values, as outlined in the European Union and OECD guidelines.

Moreover, the provisions of the EU Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states should be implemented from 1 May 2004; for this purpose, an appropriate amendment to the Law of Profit Tax has been drafted.

As part of the real estate taxation reform, there are plans to introduce a market value approach in valuating real estate for tax purposes.

In 2004, two new pieces of legislation were passed: an amendment to the Law on Value Added Tax and a new version of the Law on Excise Duties, which will come into force on 1 May 2004, followed by a number of other legal acts on the implementation of the two laws. This new set of legislation will implement the provisions necessary for the actual membership in the EU, i.e. establish, in line with the EU *acquis*, the rules of taxation of transactions between economic entities of different EU states.

From 1 May 2004, excise rates applicable in Lithuania will be adjusted to match the minimum EU rates, except the excises on the products for which Lithuania has been given or expects to be given a transitional period (such as petrol, gasoline, coke, lignite, electricity, orimulsion, and cigarettes).

There are intentions to eliminate the deductions from gross corporate income for the Road Program with a view to replacing them with alternative sources of income.

Financing

It is projected that the implementation of new tax legislation and the envisaged measures will have the following direct impact on the general government budget:

the provisions of the new Law on Personal Income Tax that came into force in 2003 will bring revenue losses to the general government budget in the amount of around 0.23% of GDP in 2004;

as a result of harmonisation of the VAT Law with the EU requirements, the state budget will receive additional revenue in the amount of around 0.16% of GDP in 2004; however, the change in the procedure for payment of VAT on imports will cause a loss of revenue in the amount of around 0.31% of GDP in 2004;

the increase of excise rates on tobacco in 2004 (increase of the special rate to LTL 47.5 per 1000 cigarettes, and the *ad valorem* rate up to 15%), on engine petrol (to LTL 1318 per tonne) and on gasoline (to LTL 1002 per tonne) will bring additional revenues to the state budget in the amount of about LTL 0.24% of GDP; in 2005, the respective additional receipts will account for around 0.03% of GDP, due to a scheduled increase of excise on the above-listed products.

Economic Impact

Once the new tax laws are implemented, a share of the tax burden will be shifted over from labour to capital taxation.

The application of higher non-taxable share of personal income and the possibility to reduce the taxable income with expenses on education, interest on housing loans, life insurance contributions and payments to pension funds will reduce the amount of taxes to be paid by individuals by up to 3 per cent, depending on the individual deductions applied. The expansion of the profit tax base has already yielded additional revenue in the amount of around 1 percentage point of GDP.

6. SUSTAINABILITY OF PUBLIC FINANCES

6.1 Ageing Population: Fiscal and Economic Aspects

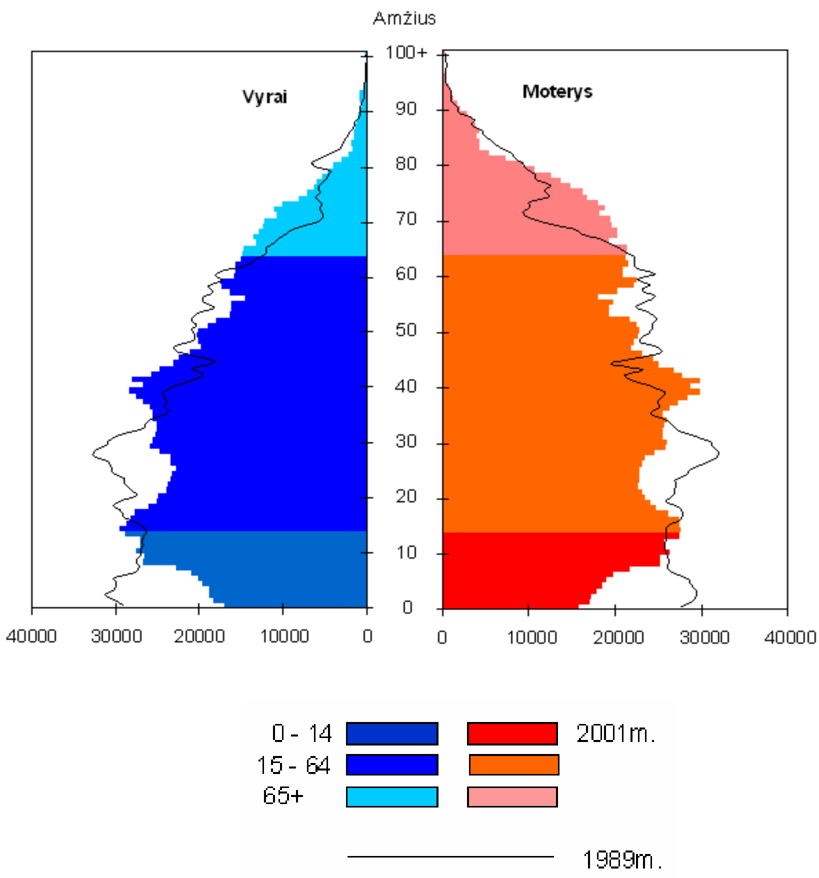
6.1.1 Overview

According to the results of the population census of 2001, the average age of the population has reached 37 years: 34.6 for men and 39.2 for women. Since the previous population census in 1989, the average age has increased by 2.1 years: 1.9 for men and 2.2 for women.

Over the period from 1989 to 2001, the number of children under 10 years of age (as a share of the total population) has decreased from 15.5 to 11.6 per cent, whereas the share of the population over 60 years of age has increased from 15.7 to 19.3 per cent. The structure of the population in terms of sex and age, and its dynamics after 1989, is illustrated in Chart 5 below. Highest birth-rates were recorded in the periods 1958-1962 and 1985-1987. In recent years, the birth-rate rate has sharply declined.

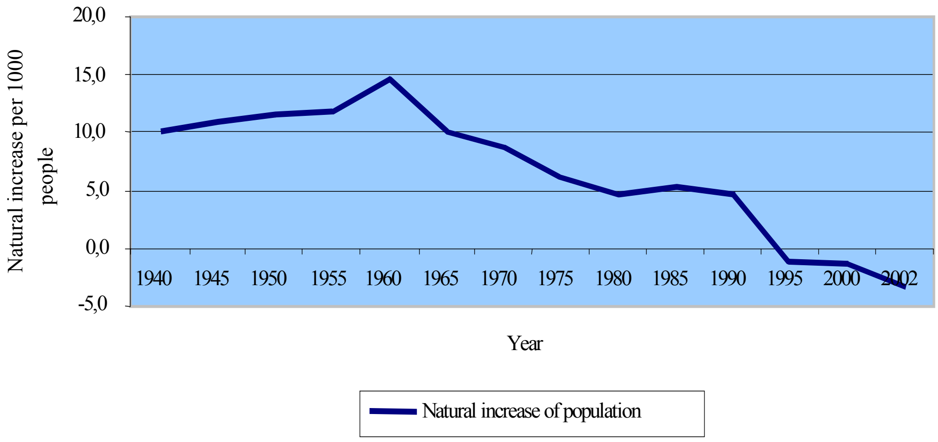
According to the forecast of the number of population in the period of 2005 to 2030 made by the Statistics Department, the number of population over 60 years of age will account for 27.3% in 2030 in Lithuania.

Chart 5. Population by Sex and Age in 1989 and 2001



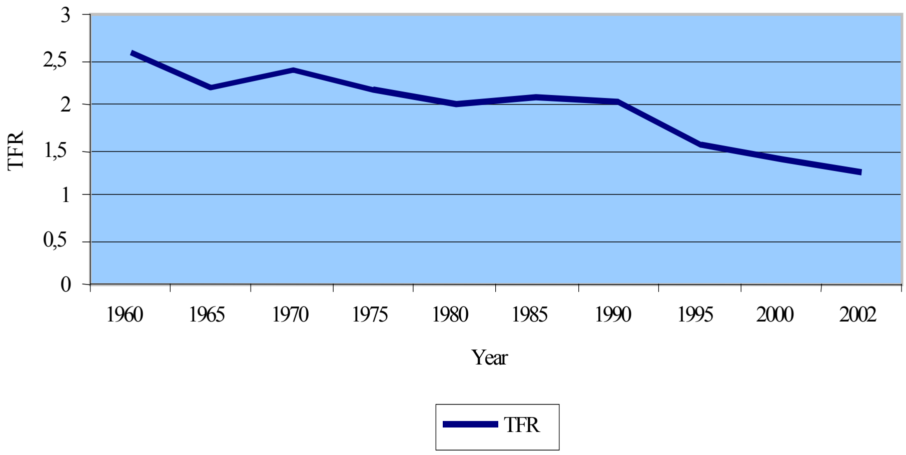
The natural increase of population has been declining since 1960, until the number of births dropped below the number of deaths in 1994: the number of births was 11.6 per 1000 population and the number of deaths was 12.7 per 1000 population (thus the natural increase of population was -1.1). In 2002, the natural increase of population was also negative, i.e.–3.2 (see Chart 6).

Chart 6. Natural Increase of Population in 1940 to 2002



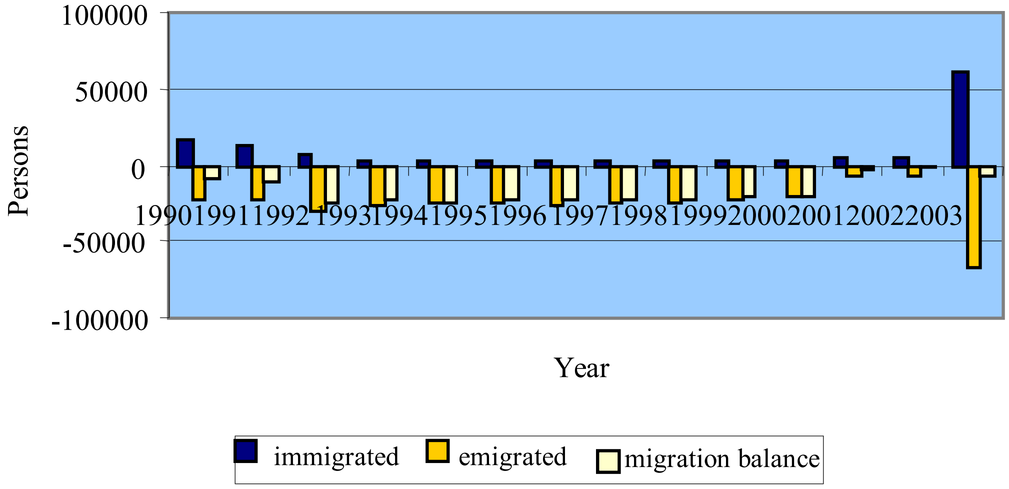
In 1960, the total fertility rate was 2.59. Over the past four decades, this indicator has shrunk more than twice. In 2002, there were only 1.24 births per 1000 women of 15 to 49 years of age (see Chart 7).

Chart 7. Total Fertility Rate, 1960 to 2002



Shrinkage of the population was stimulated, inter alia, by migration. By the data of the Statistics Department, in the period from 1990 to 2003, there were 236 thousand more emigrants than immigrants. In 2003, emigration exceeded immigration by 6304 persons (cf. 1976 in 2002) (see Chart 8).

Chart 8. International Migration, 1990 to 2003



The average life expectancy has been growing. Over the period from 1958 to 2002, it has grown by 3 years: 1.34 for men and 6 for women. In 2002, the average life expectancy was 72 years: 66 for men and 78 for women.

The Statistics Department reports that the average number of members in a family was 2.6 in 2002 (elderly families had 1.8 members on the average).

Largest families are characteristic of the lowest-income segment (Decile I), i.e. 3.6 members in a family, and vice versa, smallest families are recorded in the highest-income segment (Decile X), i.e. 1.9 members in a family.

As part of the birth promotion policy pursued in the country, families and children are paid welfare benefits and given social guarantees and privileges. Certain benefits are paid regardless of the family's income such as a one-off child birth grant, maternity benefit for studying women, family benefit, benefit for children of military conscripts, benefit for families with 4 or more children, foster care benefit, orphan stipend, settlement grant for orphans and foster children. There are also income-tested benefits for low-income families: social benefit, benefit for families with 3 children, compensation for heating and hot and cold water. School-age children of low-income families are also entitled to free-of-charge meals at their general education schools. Moreover, there are maternity and maternity (paternity) benefits that are paid from the budget of the State Social Security Fund. Yearly allocation for social transfers and social guarantees and privileges stays at around 1.3% of GDP.

One of the goals of the ongoing tax policy is the increase of the real income of families with children by granting tax benefits to them. From 2003, a new provision of the Law on Personal Income Tax came into force, whereunder the non-taxable share of income has been increased by LTL 29 per child for families with one or two children, this amount being divided to both parents (stepparents) equally, and raised to LTL 430 for families with 3 or more children (stepchildren) under 18 years of age or older, provided that the latter are full-time students in general schools, and increased further by LTL 46 for the fourth and each successive child (stepchild). Application of tax benefits to families with children fixed in the Law on Personal Income Tax cost the general government budget about 0.2% of GDP annually.

To help infertile families and to boost natality in Lithuania, artificial impregnation is allowed to married women.

Further efforts will be made to slow down the reduction of the share of employed population in the total number of population. Today, the number of older people, particularly people in the 55-59 age group, accounts for a significantly lower share of the employed population than other age groups.

Yet, having assessed the situation based on the data reported by the Statistics Department, we can make the conclusion that the recent social policy has had a positive effect on the degree of participation of these people on the labour market. In 2000 to 2002, the participation (total labour force divided by the number of people in the respective age group) of the labour force (employed population plus job-seekers) in this age group grew at the highest rate of 3%, whereas the respective figure related to the working age population was only 0.6%.

Furthermore, preventive and social rehabilitation measures will be continued with respect to the population of social risk groups (alcohol and drugs addicts, homeless, criminally inclined, post-convicted, etc). The planned allocation for the implementation of the programme for the convicted and post-convicted is LTL 2.4 million in 2004, to be financed by the state budget and the EU structural funds.

The Government supports the exiles of the occupation period who come back to Lithuania. The Genocide and Resistance Research Centre of Lithuania reports that about 300 to 500 thousand Lithuanians were illegally exiled in the occupation period. Political refugees, expatriates and their successors who have returned to Lithuania for permanent residence are entitled to the compensation of travel costs and to a one-off settlement benefit (up to LTL 3500 per adult member of the family and LTL 2500 per underage child), to a compensation of expenses on vocational training and re-training (up to LTL 2000), and a possibility to acquire housing in Lithuania on soft terms, etc. The 2004 allocation for the programme of repatriation of prisoners and exiles and their families to Lithuania and their housing and employment is LTL 3.9 million from the state budget and LTL 8 million of the loan from the Council of Europe Development Bank.

The problem of emigration of young high-qualification specialists to other states is very painful in Lithuania. In the negotiations on the chapter on free movement of persons, Lithuania has agreed to the EU initiative to provide a 7-year (2+3+2) transitional period in the field of free movement of workforce.

Lithuanian pension system has been operated on the PAYG principle, whereby the major burden of payments fell on the employer (the rate of contribution: 31+3). From 1 January 2004, a reformed pension system is in place. The share of PAYG contributions that is transferred to privately-funded pensions funds will be increasing year-on-year.

The National Strategy for Mitigating the Consequences of the Population Ageing is underway, to be followed by an action plan for the implementation thereof. The Strategy requires the consideration of ageing factors in every policy area, with a view to coordinating the economic and social development with demographic changes and to mitigating social-economic consequences of ageing.

6.1.2 Reform Goals and Objectives

The reform aims at slowing down the ageing of the Lithuanian population, thus reducing the social-economic burden on future generations.

Key objectives:

- boosting natality;
- preventing the reduction of the share of the employed population in the total number of population;
- achieving better migration balance;
- modernising the pension system and guaranteeing its financial stability.

6.1.3 Actions Planned

With a view to creating better conditions for families, especially the young ones, to raise loans for housing acquisition or renovation, natural persons will be allowed to deduct, in 2004, the interest paid on housing loans from the taxable share of their income received in 2003.

From 1 March 2004, the size of the maternity (paternity) benefit was raised from 60 to 70% of the reference salary.

With an aim to improving the financial position of families with dependent children, the Government tabled a proposal to the Seimas to introduce, from July 2004, a child benefit (0.4 minimum subsistence level or 50 litas) per child under 7 years of age.

Efforts are focussed on the promotion of economic activity of older population and the enhancement of their qualifications, re-training or acquisition of new skills to adapt to the changing requirements on the labour market. In the end of 2003, the Labour Exchange of Lithuania started the implementation of the 55+ Employment Support Programme targeted at the unemployed population of older age. The goal of the Programme is the improvement of their employability and the retention of employment.

The share of the employed population is being expanded by increasing the retirement age. The retirement age is being increased by six month a year both for men and women, until it reaches 60 years for women and 62.5 years for men. Men reached this retirement age in 2003, whereas women will reach it in 2006. One of the measures that could slow down the reduction of the share of the employed population in the total population is setting the retirement age at 65 years without distinction between men and women.

The pension reform that was started on 1 January 2004 is being implemented consistently, with the outcome being the creation of a system integrating the pay-as-you-go principle with the privately-funded pension principle.

6.1.4 Financing

The provision allowing to deduct the interest paid on loans for housing construction or acquisition will bring revenue losses in the amount of about LTL 11 million to the national budget and about LTL 5 million to the Mandatory Health Insurance Fund in 2004.

The allocation in the State Social Security Fund for the increase of the maternity (paternity) benefit from 60 to 70% of the reference salary will amount to LTL 15.7 million in 2004. Benefits to families with children under 7 years of age will require about LTL 36 million in 2004. The 55+ Employment Support Programme targeted at the older population is financed from the Employment Fund. The planned allocation in the general government budget of 2004 for the pension reform accounts for around 0.3% of GDP.

6.1.5 Economic Impact

The tax benefit allowing the deduction of interest paid on bank loans for construction or acquisition of housing from the taxable share of personal income will create more favourable conditions for young families with higher and highest income (Deciles VII to X) to procure housing earlier, thus improving children raising conditions.

It is expected that the increase of the maternity (paternity) benefit will boost natality.

Non-income tested child benefits payable for each child under 7 years of age in a family will bring additional real income to families with children and will hopefully boost natality.

The effective functioning of the lifelong learning system targeted at older people will encourage their effort to adapt to the changing requirements on the labour market and to acquire appropriate skills.

The increase of the retirement age to 65 years will ease the financial burden on the employed population who are contributors to social security funds. If the retirement age were not increased, there would be 8 pensioners per 10 social security contributors in 2025, and 11 pensioners in 2050 (see Table 12). It is projected that there will be 7 pensioners per 10 social security contributors in 2025, and 9 pensioners in 2050, and that spending on old-age pensions will be below 7 per cent of GDP in 2050.

Table 12. Projection of the Ratio of Pension Recipients and Contributors

	2002	2025	2050

Population, in thou (beginning of year)	3475	3202	2555
Ratio of the number of residents of 60+ and 18-59 age groups, in %	34.1	46.3	74.6
Ratio of pension recipients and contributors, if retirement age is 60/62.5 years, in %	86.1	81.3	113.1
Ratio of pension recipients and contributors, if retirement age is increased to 65/65 years, in %	86.1	65.3	88.5

The pension reform will contribute to the reduction of direct financial liabilities of the government towards future pensioners, thus helping to prevent the collapse of the pension system in the long run due to demographic developments.

Table 13. Long-Term Sustainability of Public Finances

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	38.4	37.8	37.4	37.4	37.4	37.4	37.4
Old-age pensions*	5.3	5.3	5.3	5.3	6.0	7.0	7.0
Healthcare (including care for the elderly)	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Interest payments	1.7	1.3	1.1	0.9	0.7	0.6	0.5
Total revenues	36.0	35.3	37.4	37.4	37.4	37.4	37.4
Of which: from pensions contributions	5.1	5.3	6.1	6.2	5.4	5.1	4.4
National pension fund assets	–	0.8	N/A	N/A	N/A	N/A	N/A
Assumptions							
Labour productivity growth	8.3	6.2	5.0	4.7	4.5	4.2	4.0
Real GDP growth	3.9	7.3	6.1	4.2	3.5	3.5	2.7
Participation rate males (aged 20–64)	82.1	83.3	88.2	89.0	90.0	90.1	90.2
Participation rate females (aged 20–64)	74.2	74.5	76.7	79.0	79.5	79.8	80.0
Total participation rates (aged 20–64)	77.9	78.4	82.0	83.9	84.6	84.8	85.0
Unemployment rate (ILO definition)	16.4	10.3	9.2	7.4	6.3	6.2	6.0

* On the assumption that the increase of the pension age to 65 years will start in 2010.

6.2 Pension Reform

6.2.1 Overview

The state social security pension system put in place in 1991-1995 operates on the pay-as-you-go (PAYG) principle. The system is administrated by the Board of the State Social Security Fund (SSSF) that has its own budget, separate from the state budget.

Before 1995, the retirement age was 55 years for women and 60 years for men. After 1995, the retirement age has been annually increased by 4 months for women and 2 months for men. Since 1 January 2001, the retirement age both for women and men has been and will be increased by 6 months a year until the targeted retirement age is reached, which is 60 year for women (by 2006) and 62 years and 6 months for men (by 2003). In 2004, the age limit for the retirement pension is 59 years for women and 62 years and 6 months for men. The rate of the pension insurance contribution is 25.9 per cent of the wages of the person covered by the pension insurance scheme. The State Social Security Fund budget expenditure on pensions accounted for 6.4 per cent of GDP in 2003.

6.2.2 Reform Goal

The main goal of the pension reform is the establishment of the first pillar of the privately-funded pension system, thus providing a possibility for the Lithuanian population to privately save funds for their old-age pensions.

6.2.3 Reform Measures

On 3 December 2002, the Seimas passed a Law on Pension Reform setting forth the following measures:

the pension reform is scheduled to start on 1 January 2004;

participation in privately-funded pension scheme~~s~~ is on a volunteer basis;

contributions to privately-funded pension scheme~~s~~ amounts to 5.5 per cent the participants' income on which state social security contributions are payable (2.5 per cent in 2004, 3.5 per cent in 2005, 4.5 per cent in 2006, and 5.5 per cent in 2007). This share of the pay-as-you-go contributions will be transferred to the privately-funded pension scheme~~s~~;

the general rate of contributions (i.e. 34 per cent) to the State Social Security Fund will not be raised;

the size of the state social security pension to be paid to participants in the privately-funded pensions schemes for the years of their participation therein will be reduced proportionately to their contributions to the privately-funded pensions schemes;

pension schemes will be operated by life insurance companies and management companies. They will be subject, by law, to additional requirements (licensing, size of capital, liquidity of equity, separation of the ownership of participants in privately-funded pension schemes from the equity of the company operating the scheme, requirements as to investment). In 2004, 10 enterprises are engaged in providing the pension saving service.

6.2.4 Financing

It is envisaged that accessibility to the current pension~~s~~ system based on the pay-as-you-go principle should be ensured to both current and future pensioners. In 2003, over 441 thou people covered by social security (36.6%) joined the new pension system, i.e. privately-funded pension scheme. It has been estimated on the basis of this figure that the share of social security contributions that will be transferred to privately-funded pension funds in 2004 will amount to around LTL 155 million. It is expected that 15% of those covered by social security will additionally join the system in 2004, and another 10% in 2005, thus injecting to the privately-funded pension schemes LTL 305 million in 2005 and LTL 460 million in 2006. The increase of expenditure of the State Social Security Fund as a result of the pension reform will be financed from privatisation receipts, state budget and other sources. A portion of this expenditure will also be financed with the surplus in the budget of the State Social Security Fund that has accrued as a result of the short-term improvement of the demographic situation.

6.2.5 Economic Impact of the Reform

It had been estimated that:

once the pension reform is implemented, Lithuania will operate a three-pillar pension system consisting of the pay-as-you-go pillar, mandatory privately-funded (when a portion of a social security contribution is transferred to the privately-funded pension scheme) and volunteer privately-funded pension pillars, resulting in the expansion of the long-term saving and investment infrastructure;

the pension reform will increase the liquidity of financial markets and accelerate the economic development. Although a larger fiscal deficit will build up as a result of the reform, the resources accumulated in pension funds will reduce the stock of direct financial commitments of the government towards future pensioners.

7. IMPLICATIONS OF STRUCTURAL REFORMS ON PUBLIC FINANCES

7.1 Labour Market

7.1.1 Employment Policy

Employment policy in Lithuania is formulated in line with he EU employment strategies. According to the commitments undertaken in the Accession Agreement, Lithuania's post-accession employment policies will be fully harmonised with respective EU policies, and actions plans for the promotion of employment in the country will be developed accordingly.

Priority in Lithuania is attached to active measures of unemployment reduction. According to the Republic of Lithuania Employment Increasing Program for 2001-2004 which is in line with the European Union employment strategies, the employment policy will be geared towards the following five directions:

Development of the new jobs creation system:

- the improvement of the new jobs promotion system (promotion of small and medium businesses and investments);
- promotion of local employment initiatives.

Improvement of employment support:

- a more active implementation of labour market policies: reform of the unemployment insurance system and active labour market polices; expansion of active labour market programs by organising training and implementing other measures aimed at permanent employment;
- increasing the employability of long-term unemployed and those starting their working life;
- improvement of vocational training;
- strengthening the cohesion between the employment and social policy (reform of the unemployment benefit and social support to the unemployed with a view to increasing the social coverage and promoting active job-seeking rather than passive receiving of a benefit);

Improvement of adaptability to changes:

- the development of flexible forms of labour organisation and remuneration.
- the remuneration policy will be adjusted to the situation in the labour market and changes in labour productivity, with safeguards against new sectoral and regional imbalances.
- the enhancement of qualifications (development and implementation of the national lifelong learning strategy);
- the mitigation of adverse implications of structural changes.

Enhancement of equal opportunities in the labour market:

- the formation of the labour market open to everybody;
- the assurance of equal opportunities of men and women in the labour market (further improvement of the legislation on equal opportunities);
- the promotion of employment of the disabled.

Enhancement of integrity of the employment policy:

- the improvement of employment and labour market management system;
- the restructuring and strengthening of labour market institutional system;
- the formation of an open labour market;
- the development of the network of private employment agencies.

The first four directions listed above are in line with the EU employment policies, with efforts being focussed on the preparation for participation in the EU employment policy co-ordination process, whereas the fifth one is aimed at the necessity to strengthen the co-operation between employment and labour market management institutions and the co-ordination of their activities.

The situation in the labour market will be largely determined by the economic development, business and investments climate, and the degree of flexibility of the labour market.

The promotion of employment, active labour market and social integration measures are also included in Lithuania's Single Programming Document for 2004-2006 as a priority direction of investment of the EU structural support funds in the human capital.

7.1.2 Reform of the Unemployment Insurance System

The Law on Unemployment Insurance that was passed on 16 December 2003 and that will come into force from 2005:

- ensures the application of insurance principles in paying unemployment benefits;
- reorganizes the financing system of unemployment insurance (both active and passive labour market policy measures will be financed from a single source, the State Social Security Fund);
- guarantees at least minimum social protection in case of unemployment, in accordance with the Revised European Social Charter and Social Security Code of Europe.

The Law shortens the mandatory minimum period of insurance entitling to the unemployment benefit, sets new eligibility criteria for the unemployment benefit, and links the size of the unemployment benefit to the previous wages of the jobless in question. The new methodology of determining the unemployment benefit is advantageous to the unemployed as it provides for higher benefits.

The Law on Unemployment Insurance provides for a gradual, distributed in a 5-year period (starting with 2005), shift over to active labour market policy measures and to financing labour market institutions (such as the Labour Exchange of Lithuania and the Lithuanian Labour Market Training Service) from the state budget. Unemployment insurance funds will be used to finance unemployment benefits only.

7.2 Small and Medium-Sized Business

The new version of the Law on Small and Medium-Sized Business which came into force on 1 January 2003 revised the definition of small and medium enterprises; as a result, the share of small and medium enterprises (SME) in the total number of operating enterprises reached 99.5 per cent.

The major effort in the promotion and development of SME's in Lithuania is geared towards the development and strengthening of the financial support to SME, the development of business infrastructure, and support of SME's through business incubators and business information centers.

To provide SME with better possibilities to raise financing from external sources, the operations of INVEGA* will be expanded further: SME financial support instruments will be applied more extensively. International programs and government support will be draw on to make available the financing of SME projects on soft terms. Through the participation in the EU Multi-Annual Program for Enterprise and Entrepreneurship, particularly for small and medium businesses, Lithuania intends to make use of financial instruments of the European Investment Fund, e.g. SME guarantee instrument, thus expanding the activities of INVEGA.

To ensure access for entrepreneurs to the necessary information, consultations and training in Lithuania, the network of institutions providing services to SME will be developed further, and new institutions to provide services to SME will be established and strengthened. With a view to improving the quality of services to businesses, it is planned to further improve the activities of the Lithuanian Small and Medium Business Development Agency, business information centres and business incubators, and the supervision of activities of business information centres and business incubators, and to strengthen the capacities of the network institutions to apply for the support from the EU structural funds.

* The private company *Investment and Business Guarantees,* which issues government guarantees in favour of banks on loans to SMEs and finances a portion of interest on guaranteed loans.

With the view to being ready to absorb EU structural support funds, administrative structures that will be in charge of managing structural support for business development are being strengthened, the new Lithuanian Business Support Agency first of all.

In reaction to the entrepreneurs' opinion polled and their proposals put forward during the poll, SME development strategies and SME development promotion measures will be renewed.

Accession to the EU will open new possibilities to use structural support funds for industries and business development. State support to businesses will be allocated through state support schemes. Support to businesses will be available not only in the form of technical assistance, but also directly in the from of grants for investment in business development.

With a view to improving business climate by creating attractive conditions for private and public investment, including foreign direct "greenfield" investment, Lithuania will shortly start implementing a PHARE ESC 2003 project "Support to Development of Greenfield Investment in Lithuania" approved by the European Commission.

The above mentioned project pursues an objective to enhance institutional capacities in the field of development and promotion of greenfield investment, to identify best practices of present and new Member States of the EU, to produce a methodology for the development of greenfield investment, including the strategy for marketing of the greenfield sites, to describe the criteria and attractiveness of greenfield sites, to draw up a tentative list of potential greenfield sites, and to prepare feasibility studies and full technical documentation for 3 to 4 sites in order to be able to apply for the support from the Structural Funds.

7.3 Health-Care

In 2003, the Government approved a Health-Care Institutions Restructuring Strategy, pursuant to which health-care institutions undergo restructuring. With a view to ensuring most effective and efficient use of the available resources and to meeting the demand for health-care services and the requirements as to the quality of the services, the personal health-care network is being streamlined in terms of its coverage, structure and layout, and the quality of and accessibility to health-care services is being improved. Priority is attached to the following areas:

the development of the primary health-care and ambulatory services;

the improvement of medical nursing and long-term sustaining treatment services;

the streamlining of in-patient services and the development of alternative forms of activities;

the preservation and improvement of children's and youth's health.

The health insurance system is being improved and the principle of justice in health relations is being enforced by taking account of the needs of different regions and social groups. The resources of the Mandatory Health Insurance Fund are distributed according to the statistical demographic indicators, i.e. with reference to the number, sex and age of the population of the respective region. Patients are given the right to select a medical institutional they prefer, thus the competition among medical institutions is promoted. For the purpose of implementing health insurance principles, prices of services are revised annually.

Once the pharmacy sector is restructured in line with the EU requirements, the quality of its pharmaceutical services will be improved. Authorities responsible for the management and control of pharmaceutical activities ensure, through effective official control of pharmaceutical activities and the quality of medicines, that only safe and high-quality medicines are circulated on the market; and the system of compensation for medicines is being further improved.

The goals of the health reform will be achieved through the implementation of the following measures:

strengthening of public health-care as part of the implementation of the EU policy in this field: to strengthen public health-care by enhancing disease prevention and control; to educate the society on healthy lifestyle and health-care in line with the requirements of the EU legal acts; to reduce the morbidity and mortality rate; to ensure the development of health education and information systems and the assessment of health implications of risks factors; to promote the professional perfection of those working in the public health system;

assurance of the quality of personal health-care: the goal is to ensure accessible, high-quality and safe health-care, by improving the activities of health-care institutions. Given the increasing socio-medical expenditure as a result of different social and demographic factors, efforts are being made to create equal opportunities for everybody to receive the required health-care services, to ensure access to everybody to a high-quality ambulatory and in-patient aid, to monitor and assess the morbidity and mortality trends and reasons, to put in place an effective network of central, regional and local health-care institutions. To ensure compliance with the EU requirements and to improve the quality of services, new medical technologies are implemented and personnel skills are enhanced.

implementation of the national pharmaceuticals policy: the goal is to ensure that Lithuanian market offers only high quality, safe and effective as well as affordable pharmaceuticals, in line with the EU requirements. Registration of pharmaceuticals has been adjusted to the EU requirements. The rational application of pharmaceutical pricing and compensation principles ensure economically justified prices of medicines;

development of health-care system: efforts will be made to ensure effective health-care, by improving the administration and financing of the health-care system. Through the implementation of scientific research and investment programs pertaining to health-care monitoring, new state-of-the-art treatment methods are being introduced and the very treatment process is being improved;

development of health insurance system: efforts are made to improve the quality of health-care services and the accessibility for everybody to these services, to increase the efficiency of the health system, and to search for and implement more efficient forms of use of the available resources.

According to the results of an assessment of the Mandatory Health Insurance Funds budgetary implications of the implementation of the European Council Regulations (EEC) No. 1408/71 and No. 574/72 and in the light of free movement of persons, funds will be allocated to compensate for the actual health-care services received in other Member States of the European Union by persons covered by the mandatory health insurance.

7.4 Other Structural Reforms in Goods and Services Markets

A number of other structural reforms affecting the sustainability of public finances in the medium and long term are continued.

Efforts are made to create the conditions and to promote the development of the information society, to help the society to integrate in the world's information society and to exploit the opportunities that it offers. This goal is being pursued by enhancing competences of Lithuanian population and through social cohesion, by upgrading public administration, by speeding-up the development of knowledge economy and electronic business, and by cherishing the Lithuanian culture and preserving the Lithuanian language with the help of IT tools.

In making preparations to apply EC competition rules and work in the EU legal environment upon accession, efforts are focused on the following priorities: to ensure further approximation of Lithuanian competition legislation with the EC legislation; to establish the procedure of cooperation with the Commission and competition authorities of Members States in the field of investigation of cases and competition policies; to ensure efficient enforcement of competition rules; and to intensify the education on issues related to the competition law and application thereof. As part of the consistent monitoring of state aid, attention is focussed on the state aid provided for rehabilitation and restructuring of enterprises and for regional development.

From 1 January 2003, the telecommunications (electronic communications) market is completely liberalised. In the electronic communications and postal sectors, efforts are geared towards further strengthening of competition and the creation of favourable conditions for the development of infrastructure and for the implementation of new technologies as well as for further diversification of services. With a view to harmonising legal acts of the Republic of Lithuania with the Council directives forming the new system of regulation of the European Union electronic communications (telecommunications) and postal activities, the Republic of Lithuania Law on Electronic Communications (Telecommunications) and the Postal Law were amended effective from 1 May 2004. In January 2004, a Strategy for the Development the Postal Sector of Lithuania for 2004-2008 was approved, the implementation whereof will ensure optimal liberalisation of the postal services market, accessibility of universal postal services, competitiveness and better quality of services, the development of new services to meet market needs, and a new status of the public post.

To ensure successful implementation of the EU single market organization and rural development measures, further efforts are being made to strengthen the administrative capacities, to implement the EU Common Agricultural Policy measures (in 2004, rural development policy measures were launched and structural support applied), to implement the Integrated Administration and Control System, to restructure and upgrade veterinary and phyto-sanitary border control posts with the aim of ensuring the compliance with veterinary and phyto-sanitary requirements and the quality and safety of food, to complete the restitution of ownership of land, forest and water bodies, and to make the necessary preparations for the next stage of land administration consisting in the formation of efficient use of land (as of 1 January 2004, the actual restitution of ownership of land, forest and water area accounted for 87.54% of the total area claimed). The implementation of these measures will accelerate the development of a more competitive agriculture, ensure the compliance of agricultural and food products with the EU safety and quality requirements and standards, expand the export and import geography, and optimise the number of those employed in agricultural production and alternative fields of activity. It is also expected that current investment in agriculture will be exploited more efficiently, and agricultural producers will have better earnings.

In the period until 2010, the required investment in the public sector for the implementation of the planned environmental measures is estimated at LTL 3 billion. These investments will be mainly used to construct or reconstruct water treatment plants and wastewater collection systems, to construct drinking water treatment plant and distribution system, and to install household and hazardous waste treatment systems (equipment for the removal of hazardous waste, regional landfills for household waste, collection of materials for recycling). It is projected that many profitable companies (the large ones, in particular) will be interested in investing in environmental projects, as pollution taxes may have direct impact on their competitiveness in the future. Companies, which will not have implemented environmental measures and will not have reached the imposed standards by the set time, will have to pay 20 per cent higher pollution taxes than the currently applied ones, while the companies, which will have implemented the necessary environmental measures resulting in the reduction of pollution to the established standard, will benefit from lower pollution taxes.

A more detailed description of the implementation of structural reforms in goods, services and capital markets will be given in the national Structural Reforms Report that is scheduled in October 2004.