Official translation

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of the Government
of the Republic of Lithuania

CONVERGENCE PROGRAMME FOR LITHUANIA

INTRODUCTION

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

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

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

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

a transparent state governance and a political consensus regarding the reforms to be carried out;

a stable and predictable legal environment; and

a deeper economic integration into the EU.

Despite temporary difficulties related to extra tensions on the budget, Lithuania has undertaken, by adopting the Convergence Programme, to pursue the fiscal and monetary policy that ensures the stability of prices and government finances as to maintain the strong confidence in the continuity of the currency board arrangement in Lithuania and successfully participate in the Exchange Rate Mechanism II (hereinafter the "ERM II").

The Programme consists of seven chapters, giving an overview of recent economic developments in Lithuania, a projection of a medium-term monetary and fiscal policy, an assessment of risks and the quality of government finances, and a description of Lithuania's readiness to overcome the effects of its ageing population, as well as an outline of the main structural reforms underway.

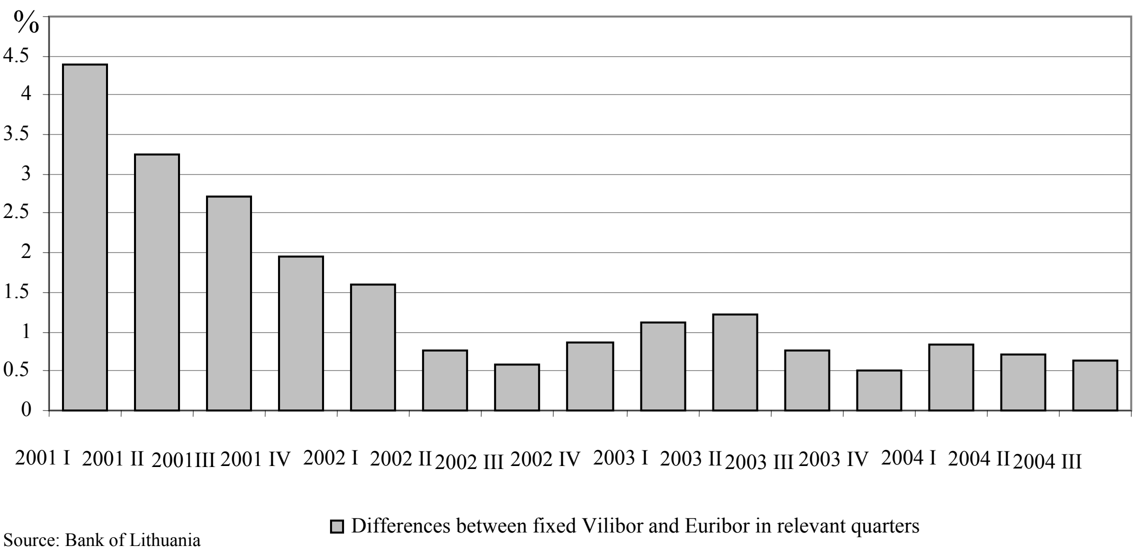
The Programme examines and assesses the preconditions for the achievement of the declared economic policy goals. The economic development projections given herein are based on the assumption that Lithuania's external economic environment will essentially remain stable during the period concerned. Other assumptions used herein are close to those made by the EU Commission. The critical assumption underlying in the projections of economic indicators and the fiscal deficit is that parliamentary parties will sign a framework agreement ensuring the implementation of the measures outlined in the Convergence Programme, which is a requisite for the implementation of the commitments under the Stability and Growth Pact and for the introduction of the euro in 2007.

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, with the appreciation of the euro vis-à-vis the U.S. dollar and the stronger competition in the telecommunications market, the average level of prices temporarily fell by 1.2%. Lithuania's participation in the Exchange Rate Mechanism II marks the stage of a close economic cooperation between Lithuania and the EU, built on harmonisation of economic policies, which is necessary in ensuring a sustainable and deeper integration of Lithuania into the EU single market.

Lithuania has successfully formed a flexible market economy. With the appreciation of the effective nominal exchange rate, the competitiveness of the economy was maintained due to the moderate growth of the nominal wages and the stability of prices. The rapid growth of Lithuania's exports and investment had an upward effect on the GDP and was bringing 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 under the Stability and Growth Pact has strengthened the market players' expectations related to the approaching membership in the Economic and Monetary Union and reduced the degree of risks associated with investment in Lithuania. A rapid growth of investment will ensure Lithuania's long-term competitiveness and increase the import of investment goods and the current account deficit in the short run.

The tight fiscal policy pursued since 2000 and the prudent re-pegging of the litas to the euro in 2002 have aroused market expectations about an early membership in the EMU, thus reducing the gap between interest rates on loans in the litas and in the euro (see Fig. 1) and making euro-denominated-loans more popular. With the drop of interest rates, the private demand financed by the rapidly expanding financial intermediation sector has served to expand production capacities and to improve the utilisation of the existing ones.

Figure 1. Quarterly differences between the annual Vilibor and Euribor



Source: Bank of Lithuania

Changes in Lithuania caused by the membership in the EU will bring about certain economic concerns to be addressed by taking timely precautions. The domestic demand will be boosted, to a record extent, by three factors: firstly, by favourable conditions of borrowing; secondly, by a growth of net inflows from the EU by 4.4 percentage points of GDP; and thirdly, by higher government spending until 2005. Government sector is to allocate additional funding for: growing payments to the EU budget, co-financing of the EU structural policies, the costs of the pension reform, personal income tax reliefs that are increasing in the volume due to the extensive housing lending, and the national expenditure on the support to agriculture approaching the EU average in this area.

The fiscal policy faces the challenge of keeping control over the impact of the changes in the demand on the economy. Price stability in sectors related to construction would help to prevent an unsustainable jump of real estate prices that might have a downward effect on the potential GDP. The rise in agricultural prices after the accession to the EU and after the jump of oil prices imposes a task of maintaining consumer expectations about the stability of prices and a sustainable satisfaction of the price-related convergence criterion. The stabilisation of consumer and housing prices would help to preclude negative social consequences and strengthen the confidence in long-term saving institutions.

The rapid growth of demand under the conditions of a fixed exchange rate of the litas inspires a rapid growth of imports and Lithuania's balance of payments current account deficit. Lithuania's current account deficit was primarily financed by foreign direct investment. Thus, to ensure the continuity of foreign capital inflows, the government should further improve business and investment environment, give maximum support to investment that is promoted statutorily, and create particularly favourable conditions for "green field" investments, as well as maintain the market players' confidence in an early integration of the country into the euro zone.

With a view to preventing any adverse social and economic effects and to weaken cyclical fluctuations of the economy, the Convergence Programme provides for a set of measures aimed at controlling the growth of demand. A number of measures will be taken to increase government revenue, allowing to do without any further expenditure cuts. The expansion of the real estate tax base, the balancing of capital and personal income taxation, and the reduction of the shadow economy will facilitate the implementation of fiscal deficit targets, prevent an unsustainable jump in real estate prices, provide a basis to expect stable consumer prices and interest rates, and help to keep the confidence in macroeconomic stability.

The planned improvement of the tax system will help to achieve a better balance between labour and capital taxation. Efforts will made to continue re-directing a portion of labour taxation over to capital taxation in the medium term.

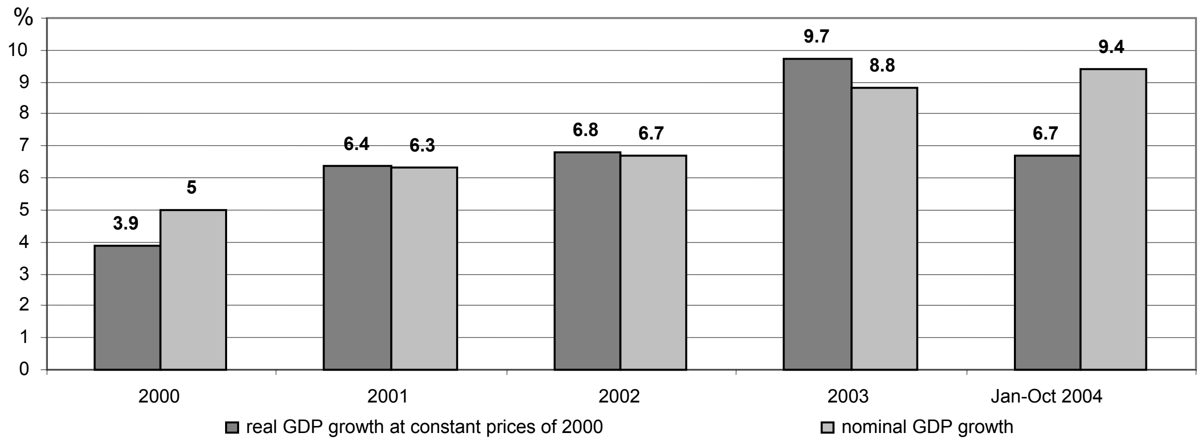
The EU Broad Economic Policy Guidelines set a commitment for Lithuania to use any extra government revenues that might be collected above the plan due to a business cycle or a better collection of taxes, for a further reduction of the fiscal deficit and to refrain from pursuing a pro-cyclical policy. The Convergence Programme reaffirms the commitment to use above-the-plan budget revenue and unspent co-financing monies for the reduction of the fiscal deficit. Strict fiscal policy measures will ensure sustainable private investment and consumption that will speed up the real convergence.

1. OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS

1.1 REAL SECTOR

In recent years, Lithuania's economy has been growing at an increasing pace. In 2003, Lithuania was one of the fastest-growing economies of the world, with its GDP growth of 9.7% during 2003. This is a testimony of success in implementing structural reforms, effective investment, and competitive exports.

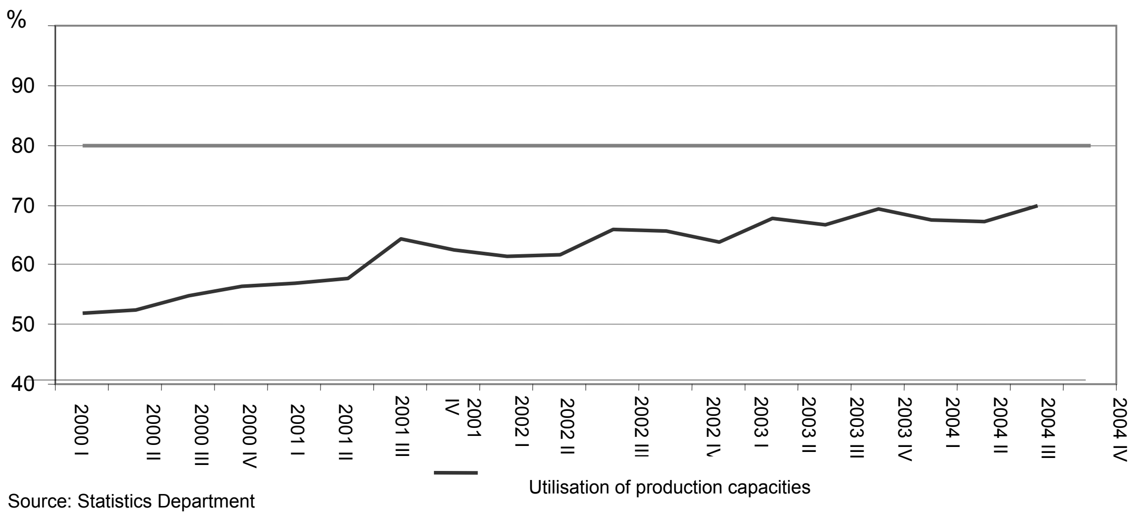
Figure 2. Real GDP growth, 2000-2004 (in %)



Source: Statistics Department

Over the first three quarters of 2004, GDP grew by 6.7%, according to preliminary estimations by the Statistics Department under the Ministry of the Republic of Lithuania (hereinafter – "Statistics Department"). The economic growth was driven by the growth of domestic demand surpassing the growth of GDP and by unused capacities that existed in the economy.

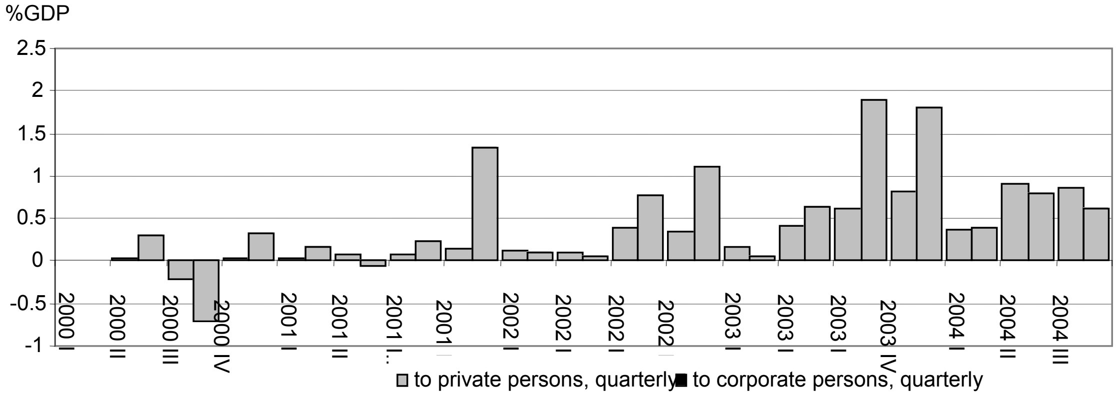
Figure 3. Utilisation of production capacities of the industry (in %)



Source: Statistics Department

Favourable conditions of borrowing were among the key factors that promoted the growth of investment, household consumption, and thus the gross domestic product.

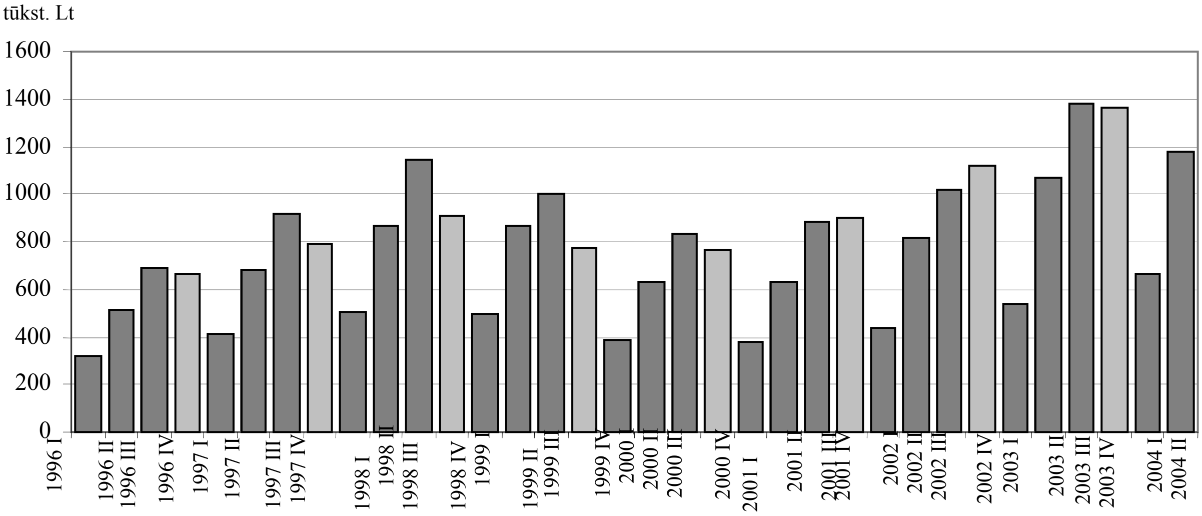
Figure 4. Quarterly growth of loans extended to private and corporate persons (in GDP %)



Source: Bank of Lithuania

According to the data of the Bank of Lithuania, lending by banks grew by 52.4% over 2003. This trend continued in 2004. Over the year since 1 October 2003, lending by banks grew by 50.1% or LTL 5.1bn. Loans to private customers dominated by housing loans remained among the fastest-growing items of banking assets. Over the year since 1 October 2003, bank loans to private customers nearly doubled having grown by LTL 1,913M, of which housing loans alone grew by LTL 1,417M or 91%. This rapid growth in housing loans was driven by lower interest rates and a personal income tax relief effective from 2003 that allowed to reduce taxable income with the interest paid on a housing construction or acquisition loan. Despite the faster growth of real estate prices in viable locations, the growth of construction volumes has contributed to the growth of GDP (see Fig. 5).

Figure 5. Construction volumes at 2000 prices, by quarter and in thou litas



Source: Statistics Department

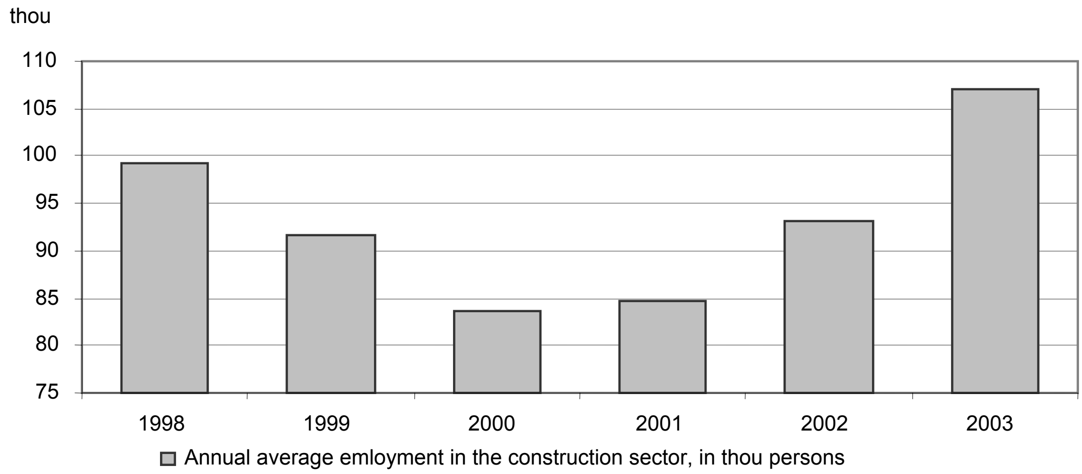
In 2003-2004, a rapid growth of demand and a shortage of production capacities had an upward effect on prices of immovable items (housing, land) and on importation of movable goods and services.

The EU structural support, Lithuania's personal income tax relief on housing construction or acquisition, the EU and national direct payments to agriculture, have all boosted the demand for land and construction capacities and increased the value of the existing property. Lithuania's accession to NATO and the EU inspired the redistribution of property: land and real estate owners had an opportunity to benefit from the appreciation of their property. Bearing in mind that appreciation of property is, to a certain extent, driven by insightful investor expectations, the government plans to propose to expand the real estate tax base, thus pursuing to ensure the sustainable development of real estate market and an evener redistribution of property.

The structural reforms have stimulated a rapid growth of labour productivity. According to calculations made by the Statistics Department which has used such estimates as the gross value added generated in individual types of the economic activity and the number of actual working hours, labour productivity in the economy grew by 22% in 2000 as compared to 2003 and by 4.9% in 2002 as compared to 2003. The fastest growth of productivity and added value was observed in production and consumption sectors. Productivity growth rates were higher in industry, construction and productive services than in overall the economy. The growth of productivity in the past three years exceeded the growth of wages thus enabling to maintain competitiveness under the conditions of appreciation of the nominal litas exchange rate: during 2001-2003, wages grew by 11.5%, and labour productivity grew by over 20%.

Lithuania has, in recent years, witnessed a drop of unemployment. According to the data of an employment survey, the average annual level of unemployment dropped from 13.8% in 2002 to 12.4% in 2003. In the second quarter of 2004, unemployment stood at 11.3%. A particularly high growth of employment was recorded in the construction sector.

Figure 6. Employment in the construction sector



Source: Statistics Department

1.2 INFLATION

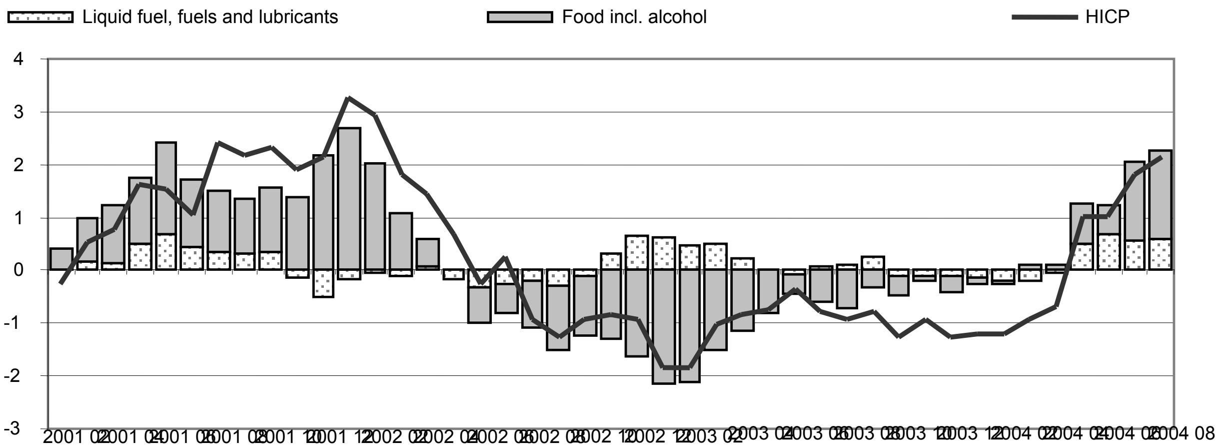
After almost two years of deflation, positive inflation (1%) was recorded in May 2004 and it continued going up to reach 2.2% in August and 3.1% in September, as calculated by using the harmonised index of consumer prices (HICP). These changes in inflationary trends were mainly inspired by skyrocketing world oil prices (in LTL) in April 2004, rising food prices, and changes in administered prices and indirect taxes attributable to the accession to the European Union. The increase of food prices in August 2004 was accountable for the annual inflation of 1.7 percentage points as compared to 0.8 percentage points in May and -0.1 percentage points in January. The increase in prices concurred with the introduction of a tighter trade regime upon accession to the EU and with the rise of fuel prices effected by the lengthy boom of oil prices. The two factors combined have an upward effect on costs, but their individual impact is difficult to assess. It is projected, however, that changes in administered prices and indirect taxation will be accountable for 0.33% of the annual inflation during 2004.

Table 1. Key factors of the HICP change, (in percentage points)

Year and month	2001	2002	2003	2004 01	2004 02	2004 03	2004 04	2004 05	2004 06	2004 07	2004 08
HICP*	1.3	0.4	-1.0	-1.2	-1.2	-0.9	-0.7	1.0	1.0	1.8	2.2
Liquid and other fuel, lubricants	0.2	-0.1	0.2	-0.1	-0.2	-0.2	0.0	0.5	0.7	0.6	0.6
Foodstuffs and alcohol beverages	1.2	-0.1	-0.9	-0.1	-0.1	0.1	0.1	0.8	0.6	1.5	1.7

* Yearly change in per cent.
Sources: Eurostat, Bank of Lithuania‘s calculations.

Figure 7. The HICP (yearly change in per cent) and key factors of the HICP change (in percentage points)



Sources: Eurostat, Bank of Lithuania‘s calculations.

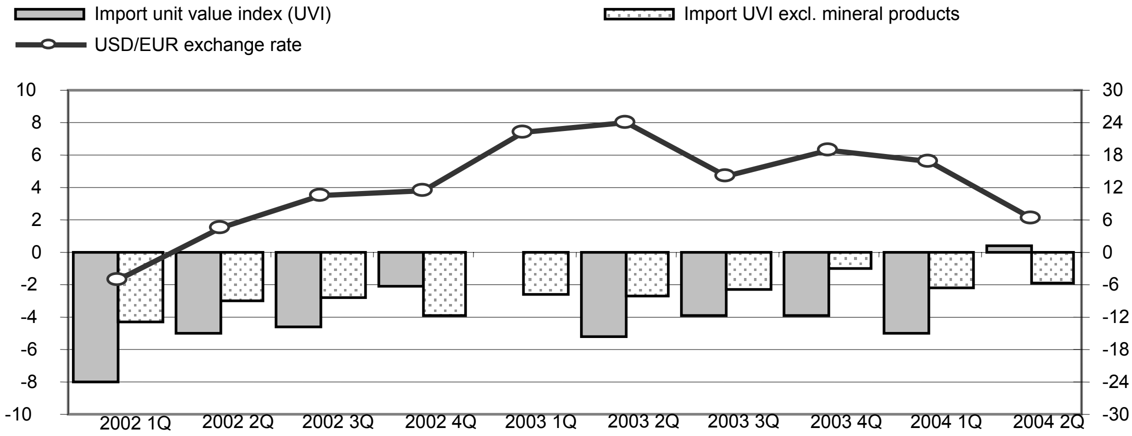
Import prices have been falling in the past three years, mainly as a result of appreciation of the litas. However, the jump of oil prices and the higher stability of the U.S. dollar vis-à-vis the euro reversed this trend in the second quarter of 2004, making the yearly increase of import prices positive (0.4%). A rise of prices of imported mineral products was accountable for 2.0 percentage points of the yearly increase in import prices. The import prices were largely influenced by the fall of prices of imported machinery and equipment which slowed down the yearly increase of import prices by 1.3 percentage points in the second quarter of 2004.

Table 2. Unit value indices of imports and exchange rates, yearly change in per cent

	2001	2002	2003	2004 1Q	2004 2Q
Unit value index of imports (UVII)	-3.3	-4.9	-2.9	-5.0	0.4
UVII, less mineral products	-0.9	-3.9	-2.7	-2.2	-1.9
U.S. dollar rate vis-à-vis the euro	-3.1	5.3	19.8	16.7	6.3

Sources: Statistics Department, Bank of Lithuania, Bank of Lithuania‘s calculations.

Figure 8. Import prices and exchange rates, yearly change in per cent



Sources: Statistics Department, Bank of Lithuania, Bank of Lithuania‘s calculations.

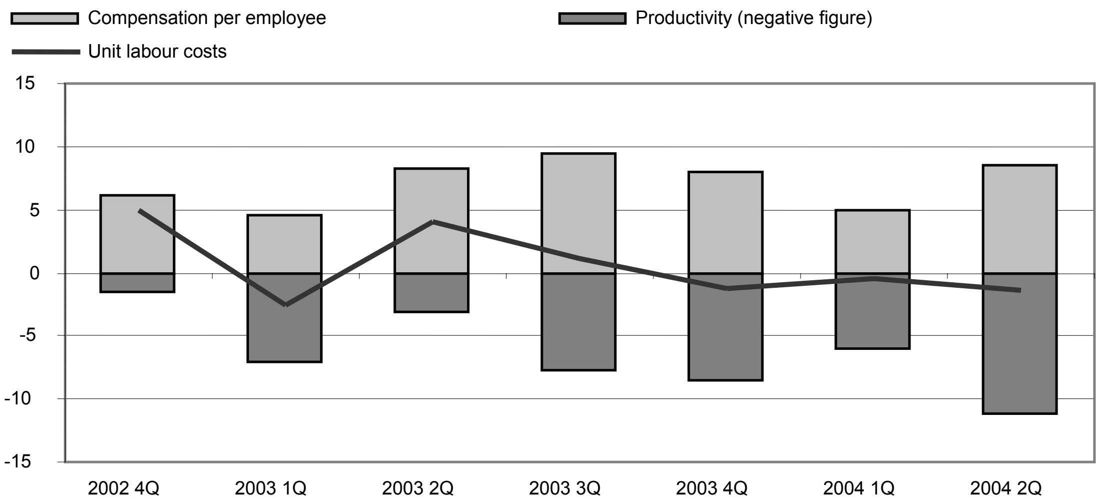
As far as supply trends are concerned, the upward movement of unit labour costs recorded in the past quarters demonstrated similar rates of growth of the cost of labour (compensation per employee) and labour productivity. The yearly increase of compensation per employee accounted for 7.7% in the past four quarters on average, with the increase of productivity accounting for 8.3%. This had a slight downward effect on unit labour costs (1.4%) during the year.

Table 3. Cost of labour, unit labour costs, and productivity, yearly change in per cent

	2001	2002	2003	2004 1Q	2004 2Q
Average monthly wages and salaries	1.2	3.2	4.1	-5.1	6.6
Compensation per employee	4.8	1.7	7.3	4.9	8.5
Productivity	9.9	0.2	6.9	5.4	10.1
Unit labour costs	-4.6	1.4	0.3	-0.5	-1.4

Sources: Statistics Department, Bank of Lithuania‘s calculations.

Figure 9. Cost of labour, unit labour costs, and productivity (negative), yearly change in per cent



Sources: Statistics Department, Bank of Lithuania‘s calculations.

1.3. Monetary and Exchange Rate Policy

The implementation of the fixed exchange rate mechanism supported by a currency board arrangement has played an important role in ensuring a non-inflationary and stable macroeconomic development. This has served to stabilise inflationary expectations, to lower country and currency risk premiums, and to boost confidence in the economic policy of the country.

Note. From 1 April 1994 to 2 February 2002, the litas was pegged to the U.S. dollar. On 2 February 2002, the litas was re-pegged to the euro, chosen as the anchor currency, at the official exchange rate of 3.4528 litas to 1 euro (calculated by multiplying the U.S. dollar exchange rate vis-à-vis the euro (0.8632 US dollar to 1 euro) announced by the European Central Bank on the date of re-pegging (1 February 2002) by 4 (the former official litas exchange rate vis-à-vis the U.S. dollar)), which remained unchanged even after joining the ERM-II on 28 June 2004.

Upon the accession to the EU, Lithuania has committed to replace, in the prescribed manner, the litas with the euro in the future. One of the conditions for this replacement is the participation, at least for two years, in the ERM-II, maintaining a stable exchange rate of the national currency to the euro. In Lithuania's case, a number of economic considerations also spur the introduction of the euro:

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

Lithuania has unilaterally pegged its currency to the euro; however, it does not make full use of the advantages of the single national currency: economic entities suffer exchange losses in converting currencies to/from the euro and pay higher risk premiums, and a deeper integration of trade and finances with the EU is precluded;

the introduction of the euro will speed up Lithuania's economic convergence with EU states.

Lithuania is successfully participating in the ERM-II, with a unilateral commitment of maintaining the existing fixed exchange rate regime and a fixed national currency exchange rate vis-à-vis the euro until the introduction of the latter. Accordingly, litas-denominated liabilities of the Bank of Lithuania must be fully backed by foreign reserves (as of 30 September 2004, they were backed by over 150 per cent).

Pursuing a disciplined fiscal policy and having eliminated legal unconformities set out in convergence reports by the Commission of the European Union and the European Central Bank, Lithuania seeks to be ready for the introduction of the euro in early 2007.

Table 4. Interest rates, 1996-2003 (in per cent)

	1996	1997	1998	1999	2000	2001	2002	2003	2004 I half
Average interest on bank loans in litas	21.3	13.9	12.0	13.0	11.9	9.3	6.6	5.8	5.7
Average interest on litas deposits with banks *	13.8	8.2	6.7	7.7	7.3	5.3	3.2	2.5	2.3

* Average interest on deposits with maturity of over 1 month
Source: Bank of Lithuania.

Table 5. Interpolated yield of RoL euro-denominated euro-bonds and the difference between the latter and the basic euro yield*
(end of period)

	Time before redemption									
	Y1		Y2		Y3		Y5		Y10	
	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference
2001-12	-	-	5.0	+1.3	5.3	+1.4	5.6	+1.2	-	-
2002-12	2.9	+0.3	3.2	+0.5	3.5	+0.6	4.2	+0.8	5.1	+0.9
2003-12	2.5	+0.3	2.9	+0.3	3.2	+0.4	3.9	+0.3	4.8	+0.5
2004-06	2.4	+0.2	2.8	+0.1	3.2	+0.1	3.8	+0.2	4.6	+0.3
2004-09	2.4	+0.1	2.7	+0.2	3.0	+0.2	3.5	+0.1	4.4	+0.3

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

Table 6. Yield of RoL government securities and the difference between the latter and the interpolated yield of RoL euro-denominated euro-bonds*
(end of period)

	Time before redemption									
	Y1		Y2		Y3		Y5		Y10	
	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference	Yield	Difference
2001-12	4.8	-	5.4	+0.4	5.7	+0.4	6.0	+0.3	-	-
2002-12	3.2	+0.2	3.8	+0.6	4.0	+0.5	4.7	+0.5	5.2	+0.1
2003-12	2.3	-0.2	3.4	+0.5	3.7	+0.5	4.1	+0.3	4.9	+0.1
2004-06	2.2	-0.2	2.9	+0.1	3.3	+0.1	3.6	-0.2	4.7	+0.0
2004-09	2.3	-0.2	2.8	+0.1	3.3	+0.3	3.8	+0.3	4.6	+0.2

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

1.4 EXTERNAL SECTOR

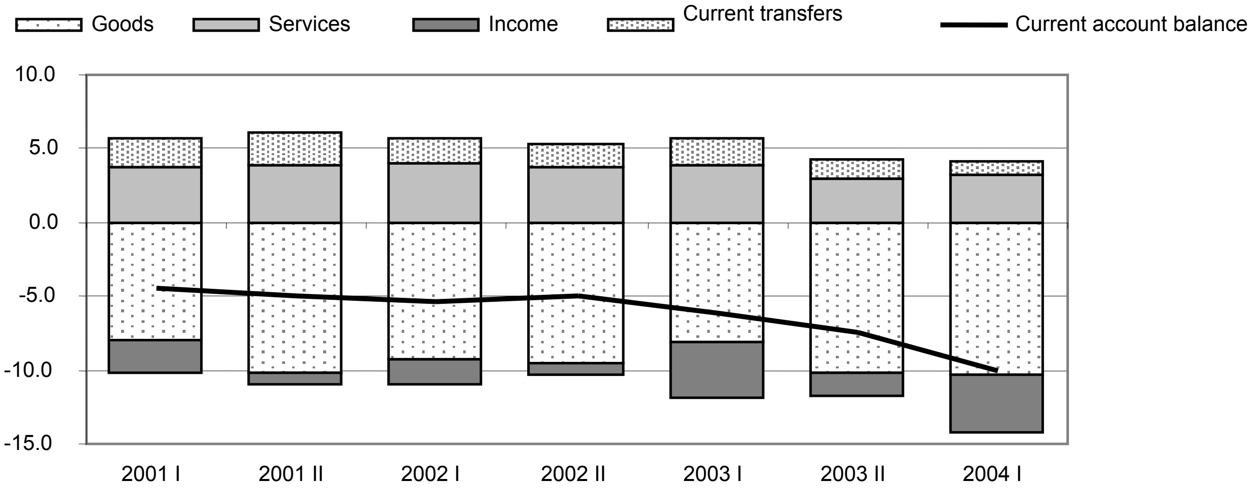
In the first half of 2004, the current account deficit was increasing further, to reach 9.9% relative to GDP, compared to 6.2 per cent in the corresponding period of 2003. This change in the volume of the current account deficit was largely caused by the increase of foreign trade deficit by up to 10.3% relative to GDP.

Table 7. Components of the current account balance, relative to GDP(in per cent)

	2001	2002	2003	2004 1 st half
Current account balance	-4.7	-5.2	-6.9	-9.9
Goods	-9.2	-9.4	-9.2	-10.3
Services	3.8	3.8	3.4	3.2
Income	-1.5	-1.2	-2.7	-3.9
Current transfers	2.1	1.6	1.6	1

Sources: Bank of Lithuania.

Figure 10. Components of the current account balance, relative to GDP (in per cent)



Sources: Bank of Lithuania.

In the first half of 2004, Lithuania's total export and import of goods increased by 16.2% and 15.6%, respectively, as compared to the corresponding period of 2003. Lithuania's foreign trade was further oriented towards EU countries (including the new Member States). In the first half of 2004, export and import of goods to the EU (hereinafter – "EU - 25") increased by 15.1% and 13.6%, respectively, as compared to the corresponding period of 2003. The share of export of Lithuanian goods to the EU accounted for 62.4% of total exports (cf. 61.3% in 2003); and imports, for 64.5% of total imports (cf. 56.3% in 2003). Export of Lithuanian goods to Commonwealth of Independent States (hereinafter – "CIS countries") fell from 17% to 15.7% of total exports in the first half of 2004, while the share of imports (by the country of origin) hardly changed and accounted for 25.3% of total imports.

Table 8. Changes in exports and imports of the main categories of goods, and factors causing the changes in the first half of 2004 as compared to the first half of 2003, in per cent.

	Exports		Imports	
	Change	**Impact of factors**	**Change**	**Impact of factors**
All goods	16.2	16.2	15.6	15.6
Investment goods	-18.6	-2.3	13.6	2.6
Interim consumption goods	21.6	10.7	17.2	9.7
Consumption goods	16.0	4.4	24.2	4.0
Petrol	83.7	4.5	28.9	0.0
Cars	-22.2	-1.1	-0.6	0.1
Other goods	30.0	0.0	-45.9	-0.8

Sources: Statistics Department, Bank of Lithuania's calculations.

The largest increase in exports over of the period concerned was recorded in the machinery and equipment sector (43.7%). Driven by a continuous supply of crude oil and an uninterrupted operation of AB "*Mažeikių Nafta*" (Oil Refinery Company) as well as the rise of oil prices in international markets, export of mineral products grew rapidly (a growth of 41.1% was recorded over the period concerned), with its share growing from 19.2 to 23.3% of total exports. A very slight drop was recorded in the volumes of export of textiles and textile articles; its share in the total export, however, fell from 14.8 to 12.7%.

The growth of import of goods was driven by the growing domestic demand. In the first half of 2004 as compared to the corresponding period of 2003, the largest growth was recorded in the import of consumption goods (24.2%), of which the import of long-term consumption goods (household appliances, TV-sets, refrigerators, etc.) increased by as much as 51% over the period concerned. The growth of import of these goods was attributable to a more extensive borrowing prompted by more favourable borrowing conditions. It is evidenced by an almost threefold increase in the volume of bank loans to natural persons for the acquisition of consumption goods. The removal of customs duties on foodstuffs and alcohol beverages imported from the EU significantly reduced the prices of these products and increased their consumption in the second quarter of the year. In the second quarter of 2004 the rapid growth of construction volumes entailed a growth of import of certain goods (paints and other finishing materials, plumbing equipment).

The higher domestic demand also had an impact on the balance of services. In the first half of 2004 as compared to the corresponding period of 2003, export and import of services to EU-25 grew by 11.9% and 25.5%, respectively. The total positive balance of services amounted to LTL 910.1M (cf. LTL 1bn in the first half of 2003). The change in the total export and import of services was determined by the developments in the transport and travel services.

In the total exports of services, the share of exports to EU countries (25 states) accounted for 48.3%, and that to CIS countries, 43.3%. Export of transport services to EU countries accounted for 50.5%, and that to CIS countries, 42.7% of the total export of transport services. Export of travel services to the EU accounted for 44.1%, and export of other services, 62.3%.

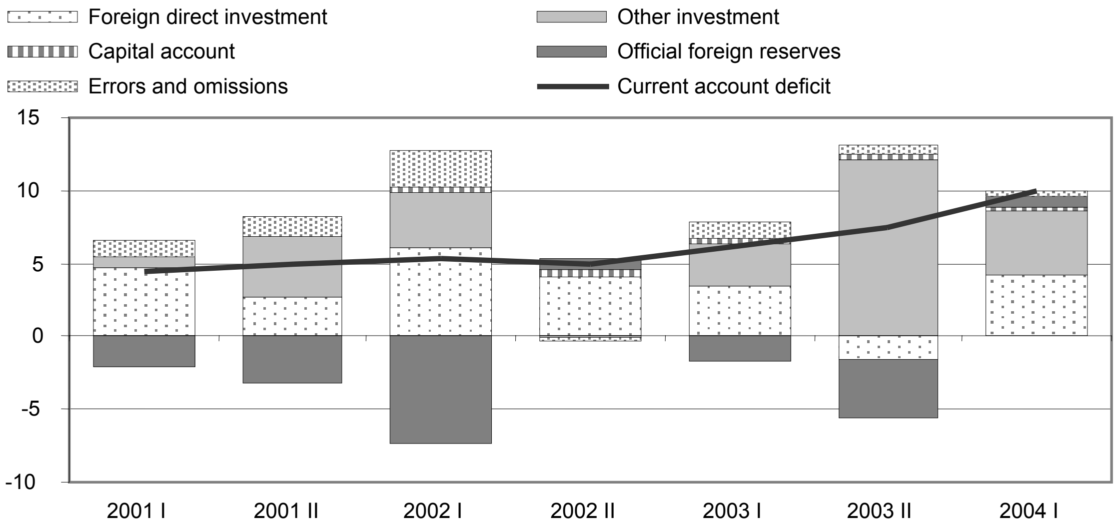
As far as the current account deficit is concerned, foreign direct investment remained its main source of financing, which in the first half of 2004 accounted for 42.1% relative to the CAD, or 4.2% relative to GDP. Privatisation proceeds classified as foreign direct investment accounted for below 10% of the total flows of direct investment in Lithuania. This ratio reveals a weak sensitivity of FDI flows in Lithuania to the privatisation process and thus a low risk of the drop in FDI after the completion of the privatisation process.

Table 9. Sources of financing of the current account deficit, relative to GDP(in per cent)

	2001	2002	2003	2004 1st half
Foreign direct investment	3.6	5.0	0.8	4.2
Other investment	2.5	1.8	7.8	4.4
Capital account	0.0	0.4	0.4	0.1
Official international reserves	-2.7	-3.1	-2.9	0.8
Errors and omissions	1.3	1.1	0.9	0.4

Sources: Bank of Lithuania.

Figure 11. Sources of financing of the current account deficit, relative to GDP(in per cent).



Sources: Bank of Lithuania.

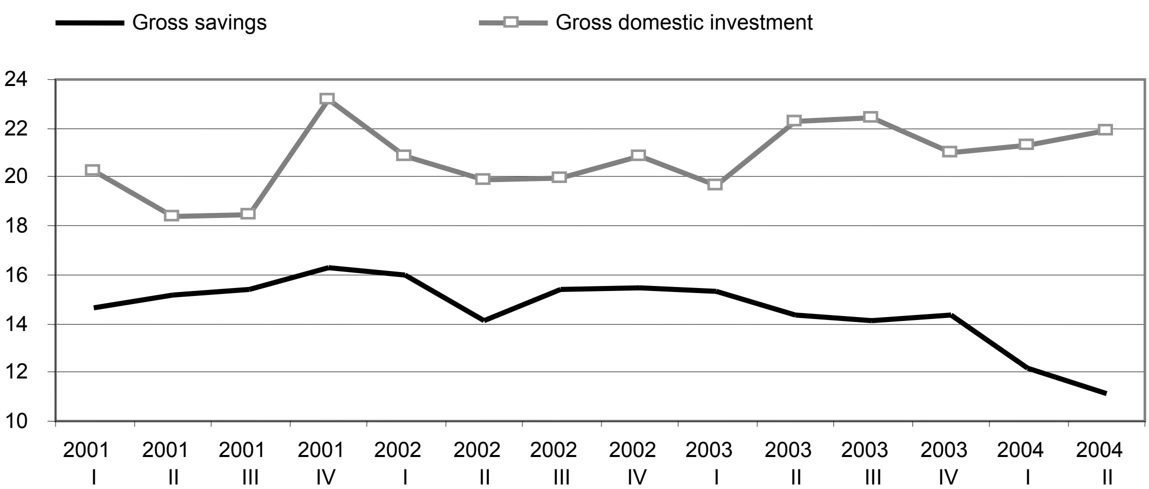
Analysis of the current account factors according to the balance of savings and investment reveals that the widening of the current account deficit was largely caused by the declining share of savings that accounted for 11.6% relative to GDP in the first half of 2004 as compared to the average of 14.7% relative to GDP in the period from 2000 to 2003.

Table 10. Gross savings and gross domestic investment relative to GDP (in per cent)

	2002 I	2002 II	2002 III	2002 IV	2003 I	2003 II	2003 III	2003 IV	2004 I	2004 II
Gross savings	16.0	14.2	15.4	15.5	15.4	14.4	14.1	14.3	12.2	11.1
Gross domestic investment	20.9	19.9	19.9	20.8	19.7	22.3	22.4	21.0	21.3	21.9

The season adjusted data.
Sources: Statistics Department, Bank of Lithuania's calculations.

Figure 12. Gross savings and gross domestic investment relative to GDP(in per cent)*



*The season adjusted data.
Sources: Statistics Department, Bank of Lithuania's calculations

To be sure about the medium- and long-term development and sustainability of the external sector, it is important to analyse the level and dynamics of the total foreign debt. As of 30 June 2004, Lithuania's total debt to foreign entities accounted for 43% of GDP. Its upward movement is not a concern: the total debt to foreign entities accounted for 43.6% of GDP in the end of 2001, and 41% of GDP in the end of 2003.

2. MEDIUM-TERM MACROECONOMIC SCENARIO

2.1 ASSUMPTIONS UNDERLYING THE FORECASTS

The below forecast of Lithuania's economic development (see Table 11) is based on the recent trends of economic development and assumptions of economic growth, most important of which are a stable monetary and fiscal policy, an active labour market policy aimed at a higher employment and a flexible labour market, and an investment and business promotion policy favourable for the economic development.

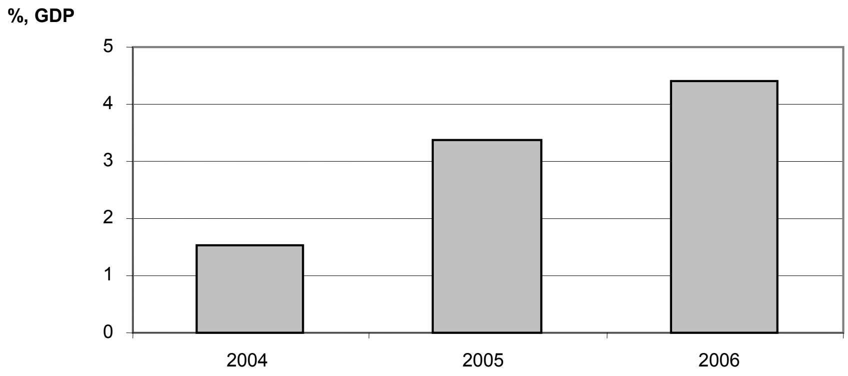
Table 11. GDP growth and growth factors

	2003	**2004**	**2005**	**2006**	**2007**
GDP growth at constant prices, %	9.7	6.5	6.5	6.2	6.0
GDP at current prices, LTL M	**56179**	**61027**	**66526**	**72424**	**78686**
GDP deflator, change in %	**-0.83**	**2.02**	**2.31**	**2.51**	**2.50**
CPI (average annual), change in %	-1.2	1.2	2.9	2.5	2.9
Growth of employment, change in %	2.2	1.5	0.5	0.5	0.6
Productivity growth, change in %	9.8	6.1	6.1	6.3	6.0
Sources of growth: change in % (at constant prices)					
1. Household consumption expenditure	12.4	8.5	6.9	6.6	6.7
2. Government consumption expenditure	4.0	9.4	3.7	3.0	2.5
3. Gross fixed capital formation	14.0	10.5	16.7	13.2	6.5
4. Change in inventories and acquisitions less disposals of valuables, % of GDP	2.2	1.8	2.0	1.9	1.5
5. Export of goods and services	6.9	9.8	8.8	8.6	7.5
6. Import of goods and services	10.2	13.2	11.6	10.0	6.7
Contribution to real GDP growth					
7. Final domestic demand	**11.5**	**9.5**	**9.0**	**8.2**	**6.6**
8. Change in inventories and acquisitions less disposals of valuables, % of GDP	0.6	-0.2	0.3	0.0	-0.3
9. Balance of goods and services	**-2.40**	**-2.79**	**-2.69**	**-1.97**	**-0.30**
Assumptions					
Short-term interest rates	2.4	2.3	2.5	3.2	3.6
Long-term interest rates	5.3	4.6	5.1	5.7	6.0
USD/EUR exchange rates	1.13	1.23	1.24	1.24	1.24
EU-25 GDP growth, %	1.0	2.5	2.3	2.4	2.4
Global imports (excl. EU-25), change in %	4.2	5.7	4.8	4.6	4.6
Oil prices (Brent, USD per barrel)	28.5	39.3	45.1	40.1	40.1

An important assumption underlying in the forecast of the period of 2004 to 2006 is related to the membership in the EU and the use of structural funds and other financial assistance from the EU.

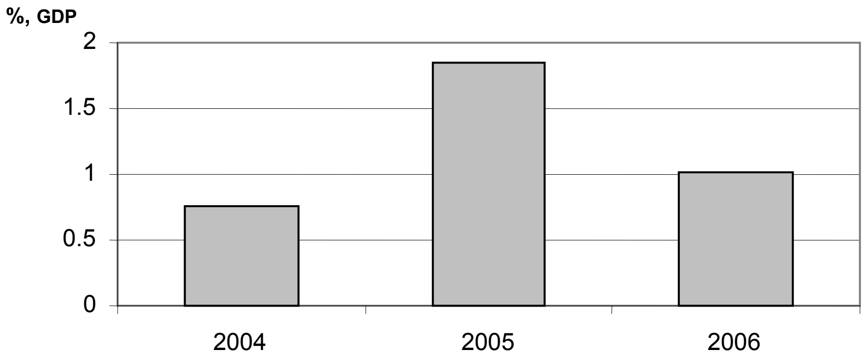
The assumption regarding the absorption of EU financial support was made on the basis of a historical average level of absorption of such funds in the European Union.

Figure 13. EU net support (in % of GDP)



Source: Bank of Lithuania

Figure 14. Annual increase of EU net support compared to previous years(% of GDP)



Source: Bank of Lithuania

The key assumptions about the external economic environment in implementing the EU fiscal monitoring procedure and in seeking to ensure the comparability of economic forecasts correspond to the external environment assumptions announced by the European Commission (EC's Autumn 2004 Forecast). It is expected that the improved geopolitical position, favourable financial conditions, the flexible macroeconomic policy and the implementation of structural reforms will foster a faster development in the EU in the coming years: the economic growth of the 25 EU Member States is projected to reach 2.5% in 2004, 2.3% in 2005, and 2.4% in 2006. It is also projected that the global economy (excl. EU-25) will grow at a rate of 5.7% in 2004, 4.8% in 2005, and 4.6% in 2006. The average economic growth in the euro zone will reach 2.1% in 2004, 2% in 2005, and 2.2% in 2006. Another important assumption underlying the forecasts of economic development for 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, in the medium term, a sustainable annual economic growth of about 6 per cent. GDP would grow at a rate of 6.5% in 2004, 6.5% in 2005, 6.2% in 2006, and 6% in 2007.

The assumption underlying in the projections of economic indicators and the fiscal deficit is that parliamentary parties will sign a framework agreement ensuring the implementation of the measures outlined in the Convergence Programme, which is a requisite for the implementation of the commitments under the Stability and Growth Pact and for the introduction of the euro in 2007.

2.2 RISK-RELATED ASPECTS OF ECONOMIC DEVELOPMENT

The accession to NATO and the EU has strengthened the expectation that direct foreign investment per capita will reach the level of other EU Member States and that the growth of GDP will accelerate, meaning, unfortunately, a correspondingly higher current account deficit.

The highest threat for the growth in the short run would be posed by a potential decline of national disposable income and solvent demand, owing to persistently high oil prices. According to the European Commission's calculations, a rise of oil prices by 10 dollars would mean a slowdown of GDP growth in a developed economy by 0.4 percentage points. A rise of oil prices by 50% would slow down GDP growth of the euro zone by 0.6 percentage points in the first year, 0.2 percentage points in the second year, and 0.1 percentage points in the third year. Given the fact that Lithuania's economy consumes over six times more energy to generate GDP than developed economies, the impact would be higher for Lithuania. However, the depreciation of the U.S. dollar and the ongoing growth of the volumes of consumption loans in 2004 have, in part, compensated the impact of changes in oil prices and keep the growth of GDP on a fast track.

A number of structural reforms are implemented to tackle the issue of dependency on imported energy sources: a set of legal acts passed in 2004 will speed up the process of housing renovation, enabling households to cut their expenses on heating by 25 to 70 per cent. At the end of the medium-term period, economic indicators will not be so much sensitive to energy product prices.

A higher than expected growth of consumer credits and wages in the period of 2004 to 2005 would serve to boost consumption and import of interim and final consumption goods, and would accordingly influence the growth of GDP, Lithuania's balance of payments current account deficit, and the consumer price index. The continued rise in oil prices would slow down the growth of GDP, and unreasonable consumer expectations about the overall price boom are likely to affect consumer behaviour and procyclically affect the economy, thus accelerating the growth of the nominal GDP. Automatic stabilisers will hopefully handle the increasing demand for loans and the accelerating inflation: interest rates will rise, real GDP growth will approximate the potential GDP growth, and the current account deficit will be stabilised. The fiscal deficit reduction scheme laid out in Lithuania's Convergence Programme is aimed at securing confidence in the macroeconomic stability of the country.

The decommissioning of Unit I of the Ignalina Nuclear Power Plant in 2005 will mean a loss of one-third of energy generated by the Plant, which will result in the drop of exports by about 1 percentage point and a slowdown of GDP growth by about 0.3 percentage points.

A successful absorption of EU support is a sufficient means to offset the factors that slow down the GDP growth: higher expenditure on oil, loss of revenue as a result of the decommissioning of Unit I of the Ignalina Nuclear Power Plant, and a cyclical fluctuation of the economy after the record-high growth of credits. In the period of 2004 to 2007, EU support-driven demand will increase the GDP by over 3 percentage points. DGP growth will additionally be stimulated by the improved economic infrastructure and production capacities. The average growth of GDP over the period concerned will remain on the fast track, accounting for over 6 per cent.

The forecasts of the rapid growth of GDP are based on the assumption that Lithuania will phase out its national currency and introduce the euro in 2007. To make this assumption true, corresponding fiscal policy goals have been formulated.

2.3 MARKETS FOR GOODS AND SERVICES

Over the period of 2004 to 2007, a rapid growth in investment and consumption is projected, and Lithuania's export performance will remain on a positive track. New trends in 2003-2004 suggest that the domestic demand will continue to have a heavy impact on the economic growth.

The demand for loans in the beginning of the projected period will be driven up by favourable interest rates and expectations about a rapid growth of income associated with Lithuania's membership in the EU, a successful absorption of EU funds, an early participation in the ERM-II, and integration into the euro zone.

New opportunities for domestic lending as well as EU structural support to investment projects will facilitate a more active investment process. Investment will be furthered by the increasing investor confidence in the stability of the economy. It is projected that investment will grow at a higher rate than GDP and account for an increasingly larger share of GDP. The largest impact of EU financial support will be felt in 2005, when gross capital formation will grow at a rate of 16.5%, to reach 26.1% of GDP in the end of the projected period.

In the period of 2004 to 2006, the development of different sectors of the economy will be supported by EU structural funds. The primary impact of structural funds would primarily enliven the constructions sector, as well as industry and education to a certain extent. New jobs would serve to increase the consumption of interim products, which would have a 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 this 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 be spread between education and other sectors. The structure of the increase would hardly change over the entire period of 2004 to 2006. Changes might occur only if a certain sector fails to absorb structural funds in full.

A new positive impetus to consumption in the projected period will be provided by the overall economic upswing, decreasing unemployment, opening EU labour markets, increasing income and positive consumer expectations about the economic development. Average final consumption rates will account for 6.6% in the period of 2004 to 2007. The rapid growth of the domestic demand will be underpinned by a moderate increase in government consumption expenditure. This moderate increase in government expenditure over the projected period is attributable to higher expenditure associated with the membership in the EU and by the objective to balance public finances.

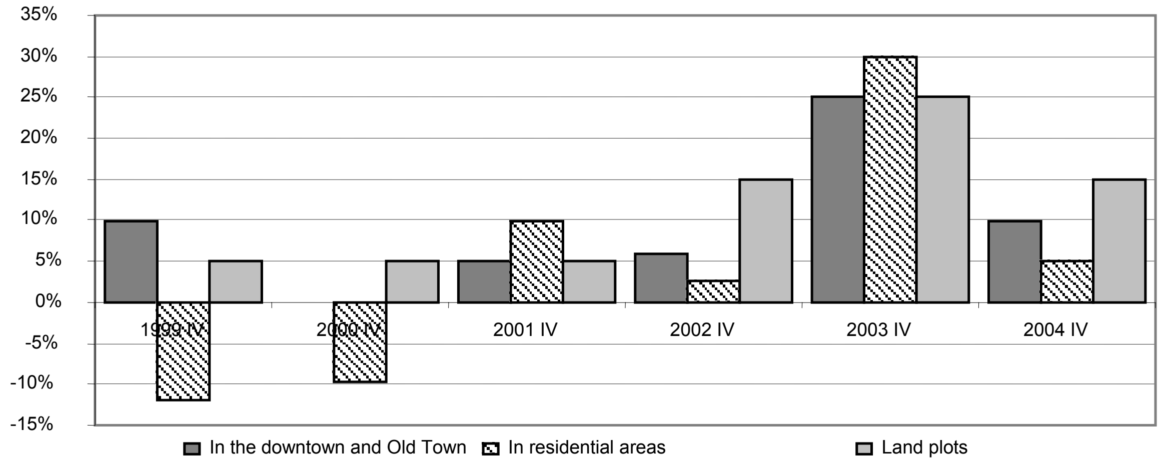
Export-intensive industries will remain the key contributor to the long-term economic growth. The overall economic development will mostly be stimulated by the construction sector. A more active consumption will facilitate the growth of wholesale and retail trade.

2.4 STABILITY OF PRICES

The macroeconomic impact of inflation in 2004 will be revealed by the average annual inflation ratio: the drop of prices in the communications sector due to the higher competition in the beginning of the year have partially offset the increase in prices of foodstuffs, and transport and health-care services recorded in May and June; thus, the general price level will go up by about 1.2 per cent on average in 2004. The 2004 December inflation of 2.9% anticipates trends that will prevail in 2005 when the annual inflation will average at 2.9%. The upward movement of prices associated with the accession to the EU is likely to fade in 2005, resulting in a slowdown of the rise in prices in 2006.

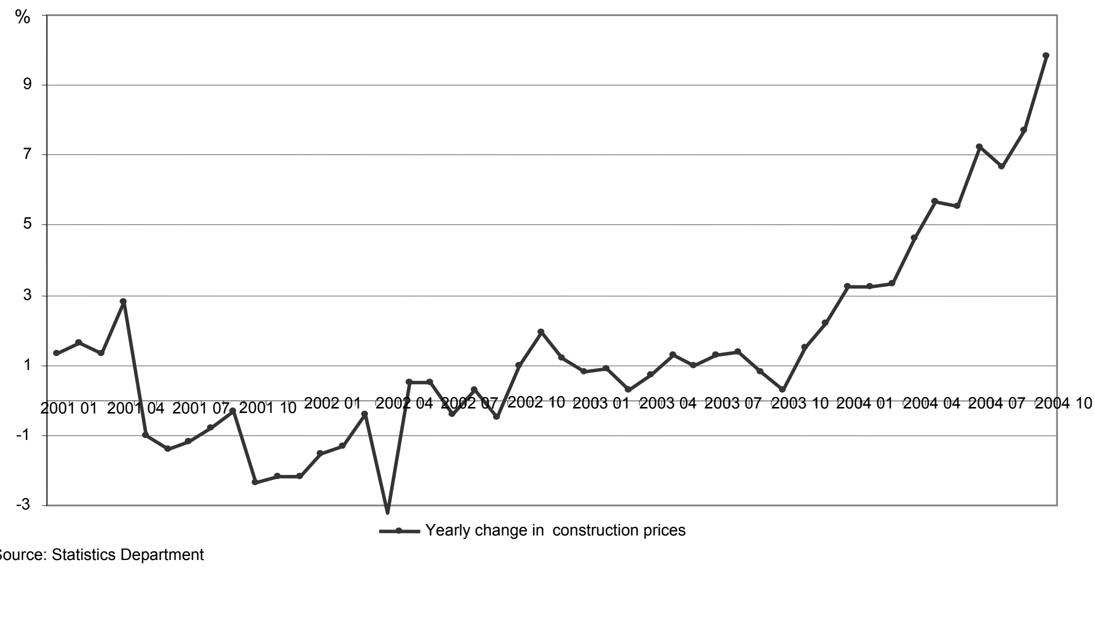
There is a threat, however, that price changes in the construction and food-exporting sectors will distort the expectations about Consumer Price Index (hereinafter –"CPI") inflation in 2005 and 2006. In 2003, real estate prices started to swell (see Fig. 15). The second and third quarter of 2004 witnessed a rapid increase in the export deflator, the construction price index, and the consumer price index (see Fig. 16 to 18). The boom of consumer and construction prices, the rise in oil prices, and the anticipation that the accession to the EU will entail an indefinite increase of inflation might cause a sudden jump of inflation in the future.

Figure 15. Yearly changes in real estate prices in Vilnius



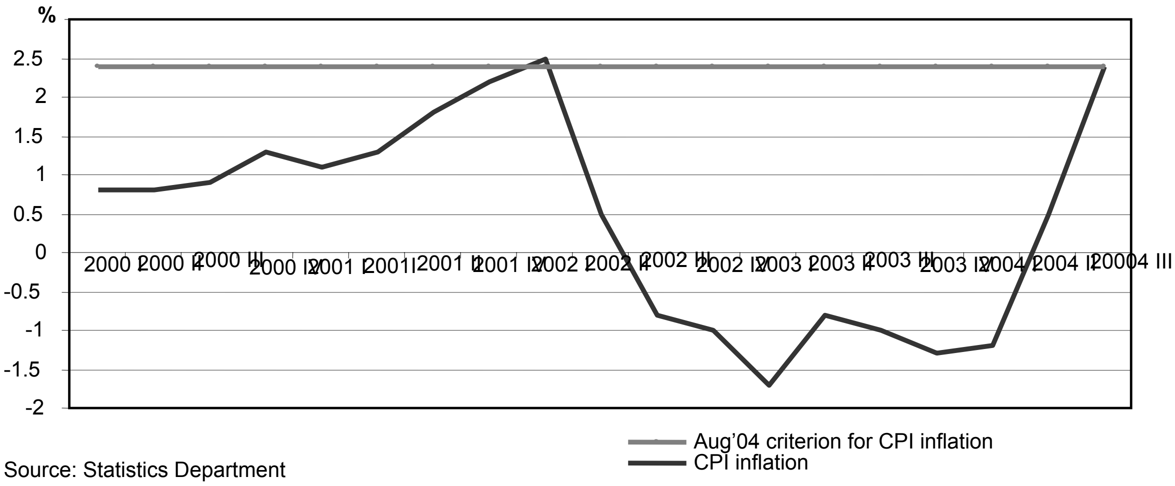
Source: Ober Haus Real Estate Company

Figure 16. Yearly change in construction prices



Source: Statistics Department

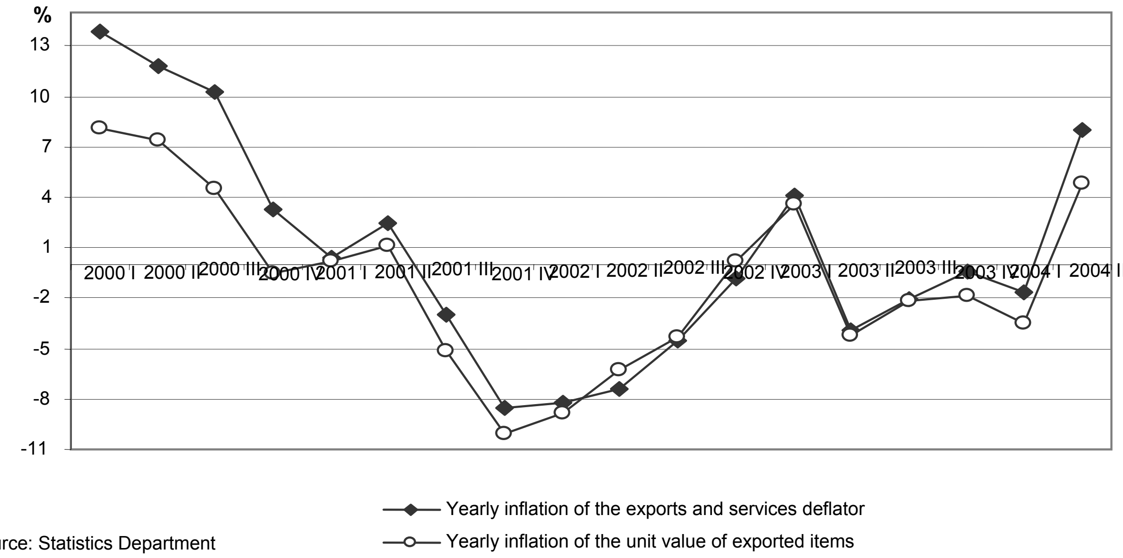
Figure 17. CPI inflation



Source: Statistics Department

The liberalisation of the trade in foodstuffs with the EU has allowed to raise meat and dairy export prices and to import certain goods more cheaply, free of duties.

Figure 18. Inflation of the exports and services deflator and of the unit value of exported items



Source: Statistics Department

The appreciation of the litas that has continued for several years, the stronger competition in the telecommunications sector, and the continued fall of food, clothing and footwear prices, have all served to form certain expectations about price stability. These factors are likely to exert quite an effect in the medium term, too. Competition in the market economy of Lithuania and consumer awareness will bring inflation performance well within the Maastricht criteria.

Inflation would be the strongest in those groups of consumption goods and services where services account for a relatively higher share. The annual inflation would average at 2.5% in 2006 and 2.9% in 2007. 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, will subdue the rise in prices.

2.5 LABOUR MARKET

Over the period of 2004 to 2007, the situation in the labour market is set to be improving further. The 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 have to hire additional staff to be able to further increase their production volumes. Financial support from the EU will stimulate a further growth of employment. The number of the employed population will grow in the entire period covered by the forecast, thus increasingly contributing to the growth of production.

The growth of foreign direct investment will contribute to higher productivity and mitigate the impact of the growth of wages on the remuneration for work. Corporate profits that have demonstrated a growth in recent years will also have an upward effect on wages, without losing competitiveness. A moderate growth in wages (up from a relatively low level) will contribute to the sustainability of the current account.

2.6. THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

The current account deficit is set to shrink in the second half of 2004, acted on by several factors. Firstly, EU advance payments to be transferred to the treasury will have an upward effect on the positive balance of current transfers. In the second quarter of 2004, the balance of current transfers fell owing to the fact that Lithuania had to contribute to the EU European Communities (hereinafter – “EC”) Own Resources before receiving the EU support as an advance. In the first quarter of the year, before the EU duty regime became applicable, use was made of the opportunity to import raw materials more cheaply (this process particularly boomed in April); therefore, the import of these raw materials is likely to drop in the second half of the year. The deficit of the first half-year additionally broadened owing to unreasonable consumer expectations about a rapid growth of prices, leading to a buying rush and higher volumes of import of consumption goods. The abolition of duties on foodstuffs and alcohol beverages imported from the EU significantly reduced their prices and increased their consumption in the second quarter of 2004. The excitement about imported goods that have so suddenly became cheaper will fade eventually and normalize. In this context, the growth of imports is likely to slow down. Since non-resident investment income (paid in the form of dividends) is typically higher in the first half-year, the negative balance of income will shrink in the second half-year. With all these factors in mind, the current account deficit is set to stand at 8.4% of GDP in 2004.

The stability of the real effective litas exchange rate and the recovery of the EU domestic demand are likely to secure positive export performance for Lithuania. Exports grow at a high pace, thus testifying the continued competitiveness of Lithuania’s economy. The long-term outlook suggesting the improvement of productivity and export performance is an assurance of the sustainability of Lithuania’s current account of the balance of payments: in the coming years, more plant and machinery will be imported so as to ensure a rapid growth of exports and productivity in later years.

However, the EU support and higher foreign investment in the first half of 2004 that will keep consumption and investment at a high level will promote the importation of goods and services, which will worsen the current account deficit. The buoyant domestic demand will serve to increase imports and postpone the improvement of trade and current account deficit to later periods. On the other hand, the medium-term growth of demand might be subdued by potentially deteriorating terms of borrowing and fiscal policy measures aimed at achieving a balanced structural budget. Therefore, it is expected that these trends will serve to stabilise the current account deficit in the medium term.

Clear perspectives about the integration into the euro zone stimulate consumers to spend a portion of their future income today. The rapid expansion of financial markets create favourable conditions for borrowing and spending before the money is earned. The tight fiscal policy is adjusted so as to respond to market players' expectations and ensure the sustainability of the current account.

The fiscal deficit reduction policy is set to sustain the current account deficit at a healthy level in the medium term. A positive impetus to the current account will be provided by the future EU current transfers and the projected growth of domestic savings. The current account deficit would be mainly financed from debt-neutral sources such as foreign direct investment and EU transfers. The GDP-relative share of final consumption expenditure is projected to shrink from 83.4% in 2003 to 82.2% in 2007, meaning a corresponding growth of the savings rate and a more extensive financing of investment by domestic resources.

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

Higher volumes of cash transferred by Lithuanian residents working abroad can improve the position of the current account of the balance of payments to a larger extent than projected so far.

The stable flow of foreign direct investment in Lithuania in recent years and the favourable external and internal environment support the expectation that the flow of foreign direct investment in Lithuania will not go off track in the period of 2005 to 2007 and will be drawn on to finance up to 50% of the current account deficit. The EU support is another stable source of financing of the current account deficit of the balance of payments. A successful absorption of EU support funds will be equally important for the current account deficit as foreign direct investment: funds to be transferred by the EU are projected to account for 3.6% of GDP in 2007.

3. PUBLIC FINANCES

3.1 POLICIES

3.1.1 Objective

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 sustain the general government deficit below 3% of GDP in the period of 2004 to 2007 and to adhere to the balance deficit.

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

to ensure macroeconomic stability by pursuing an anti-cyclic fiscal policy: to seek to maintain low risk premiums above the benchmark interest rate, and a low inflation;

to create favourable conditions for the improvement of labour efficiency and to improve the competitiveness of the economy: to attract more foreign direct investment and to successfully implement EU structural policies;

to further stimulate important factors in continuing energy, agriculture, and budget management reforms;

to continue the pension reform ensuring a long-term general government financial sustainability;

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

Seeking to join the euro zone with the first wave of enlargement, Lithuania will improve, as part of its fiscal policy, the institutional conditions for a long-term saving and for a higher labour efficiency, and will ensure a successful completion of structural reforms, improve tax administration, promote investment, create favourable business and private investment environment, and ensure an effective use of public funds allocated for investment. Through the use of tax measures, Lithuania will try to balance the too-high growth of the demand that is currently financed by bank loans and by the increasing EU support. Any additional general government revenue or unspent expenditure allocations will be used for the implementation of fiscal deficit plans or for a further reduction of the deficit. By introducing new taxes, the government will seek to cut speculative investment and to ensure sustainability of the current account.

3.1.2 ACTIONS PLANNED FOR 2004 TO 2007

By way of implementing the new tax legislation, a share of the tax burden has been shifted over from labour to capital. In the medium term, efforts will be made to ensure the continuance of this trend. The government also seeks to introduce a real estate tax chargeable on residents, by taking measures to protect socially vulnerable groups of population from additional taxation and slowing down the rise of housing and land prices, and to suggest to increase indirect taxation of capital, by raising land and real estate taxes chargeable on companies. If housing prices stabilise as a result of a change in the economic environment and if fiscal deficit targets are secured by other measures, the introduction of a real estate tax for residents will be postponed to a later period. Efforts will also be made to promote an efficient use of property, in particular land, by discouraging speculative investment and barring unsustainable rises in real estate and land prices. Furthermore, a set of tax measures will be suggested aiming to partially offset revenue losses associated with the abolition of the turnover tax on the use of roads: several options of an additional tax on vehicles are being considered.

A better balance between taxation of capital and employment-related income will be sought in the medium term, by reducing the burden of personal income tax and streamlining capital taxation and by promoting the development of labour-intensive sectors of the economy and the creation of new jobs. Efforts will be made to make sure that the balance between labour and capital taxation is achieved without adding to the fiscal deficit, that it promotes a sustainable economic development and creates conditions for businesses to enhance their competitiveness and profitability.

The government is considering to put forward the following proposals:

to use general government revenues collected in excess of the plan owing to a business cycle or a better collection of taxes, for the reduction of fiscal deficit;

to re-allocate general government budget allocations that might remain unspent due to delays in co-financing the EU support or for other reasons, for the reduction of fiscal deficit;

to amend the Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets to ensure the achievement of the fiscal deficit target by cutting down expenditure, should it emerge in the second half of 2005 that co-financing will require more funds than allocated in the state budget for this purpose.

Further effort will be made to improve public financial management and the quality of general government finances.

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 to achieving fiscal consolidation. General government budget deficit amounted to 2.5% of GDP in 2000, followed by a drop to 2% of GDP in 2001. The 2003 general government fiscal deficit accounted for 1.9% of GDP. With debt servicing costs of 1.3% of GDP, the primary deficit of 0.6% of GDP was recorded in 2003. The increase of the general government budget deficit in 2003 is attributable to higher than expected (0.4 p.p. of GDP) expenditure for the restitution of depreciated savings.

On account of the carry-forward to 2005 of the unspent funds that had been allocated for co-financing the EU support in 2004 and a faster growth of the nominal GDP, general government deficit is expected to fall below the target (2.7% of GDP) and to account for 2.5% of GDP.

As the budget burden imposed by the membership in the EU eases over the medium term, efforts will be made to reduce general government deficit from 2.5% of GDP in 2004 to 1.5% of GDP in 2007, thus keeping it below the ceiling of 3%. General government finances will change in the structure during 2004 to 2007 compared to that in 2003, mainly due to the payments to the EC Own Resources and the co-financing of the EU support funds, the costs of the pension reform that is being successfully implemented, and the harmonisation of taxation with relevant EU polices. The following budget indicators are projected for the period of 2004 to 2007:

Table 12. General government budget (S13) projections, for 2004 to 2007 (% of GDP)

% GDP	ESA code	2003	2004	2005	2006	2007
Net borrowing (B9)						
1. General government*	S13	-1.9	-2.5	-2.5	-1.8	-1.5
2. Central government	S1311	-2.38	-2.69	-2.55	-1.82	-1.51
3. State government	S1312					
4. Local government	S1313	0.03	0.05	0.02	0.02	0.02

% GDP	ESA code	2003	2004	2005	2006	2007
5. Social security funds	S1314	0.50	0.11	0.03	0.00	0.00
General government budget (S13)						
6. Total receipts	ESA	32,29	32,95	34,41	34,70	34,48
7. Total expenditures	ESA	34,14	35,49	36,91	36,50	35,98
8. Budget balance	B9	-1.9	-2.5	-2.5	-1.8	-1.5
9. Net interest	D41	0.4	0.5	0.6	0.6	0.6
10. Primary balance		-0.6	-1.5	-1.4	-0.8	-0.5
Components of revenues						
11. Taxes	D2+D5	19.9	19.8	20.4	20.4	20.5
12. Social security contributions	D61	8.7	8.7	8.6	8.5	8.4
13. Interest income	D41	0.9	0.6	0.5	0.4	0.4
14. Other		2.8	3.8	4.9	5.4	5.2
15. Total receipts	ESA	32,29	32,95	34,41	34,70	34,48
Components of expenditures						
16. Collective consumption	P32	7.9	7.1	7.1	6.6	6.3
17. Social transfers in kind	D63	10.8	10.8	10.8	10.3	9.9
18. Social transfers other than in kind	D62	9.2	9.3	9.2	9.2	9.0
19. Interest payments	D41	1.3	1.1	1.1	1.0	1.0
20. Subsidies	D3	0.8	0.9	0.9	0.9	0.8
21. Gross fixed capital formation*	P51	3.0	3.4	4.9	5.2	5.0
22. Other		1.1	2.9	2.9	3.4	3.8
23. Total expenditures	ESS	34,14	35,49	36,91	36,50	35,98

* ESA – European System of Accounts

** Figures marked with the asterisk will be lower if EU support is absorbed more slowly than assumed.

As a result of the carry-forward to 2005 of the unspent funds that had been allocated for co-financing the EU support in 2004, the 2004 fiscal deficit could be 0.3 percentage points lower than that given in the Table 12 above.

The updated Convergence Programme fundamentally changes general government financial projections due to the following five factors: more funds allocated for the formation of fixed capital; Eurostat general recommendations for the disclosure of the EU support; a faster growth of GDP causing the "base effect"; assumptions adjusting the co-financing of the EU support; and tax measures aimed to control the cyclical growth of the economy..

In the medium term, general government revenues (as a percentage of GDP) that accounted for 32.3% of GDP in 2003 will grow to 32.9% in 2004, 34.4% in 2005, and 34.7% of GDP in 2006. The pre-accession aid will be finished in 2007; as a result, lower current and capital transfers will bring the general government revenues down to 34.5% of GDP in 2007. As recommended by Eurostat, the updated Convergence Programme excludes the EU support to the private sector from the category of general government revenues.

The GDP share of tax revenues will grow throughout the medium-term period. Although the abolition of the road tax in 2005 will bring revenue losses of around 0.4% of GDP, additional tax measures will serve to increase tax revenues by about 0.6 p.p. of GDP to 20.4-20.5% of GDP.

The updated assumptions about co-financing of the EU support suggest that EU commitments will continuously increase, until 2006, current and capital transfers shown in Table 12 under "Other".

EU payment commitments to Lithuania have been included in the calculations not on the basis of cash flows approved by the Copenhagen Council but on the basis of historic average rates of absorption of the EU support in the new Member States.

By way of implementing the fiscal deficit strategy, total general government expenditures were brought down to 34.1% of GDP in 2003. Absorption of the EU support funds resulted in a rise in the GDP-relative share of expenditures to 35.5% in 2004 and will further grow to 36.9% in 2005. To be able to implement fiscal policy objectives matched to the economic cycles, general government expenditure should shrink to 36.5% of GDP in 2006. General government consumption efficiency and the phasing-out of the pre-accession aid will bring general government expenditure down to 36% of GDP in 2007. The contraction of general government expenditure will not essentially affect the projection in the updated Convergence Programme about a rise in expenditure on investment by about 2 percentage points of GDP. The implementation of the commitment under the Stability and Growth Pact to achieve a budget balance should help to improve the quality of government finances.

General government expenditures include estimated payments to the EU budget, which will account for 0.7% of GDP in 2004, 1.2% of GDP in 2005, and 1.1% of GDP in 2006 and 2007.

A number of factors, such as payments to the EU budget, the need to co-finance the EU support, the increase of support to agriculture to 55% of the EU level in 2004 (to 60% in 2005), and compensations for real estate and private savings restituted, will call for additional funds. The target to keep the fiscal deficit below 3% of GDP would be achieved by cutting down collective consumption expenditure from 7.9% of GDP in 2003 to 6.3% of GDP in 2007. Support to agriculture financed from national resources that is set to be increased from 40 to 55% of the EU average accounted for over 0.3% of GDP in 2004 and is set to account for over 0.5% of GDP in 2005. The Programme lowers the amount of subsidies by 0.6 percentage points of GDP, as direct payments to agriculture are attributed, according to the new Eurostat methodology, to the private sector rather than to the general government sector. The decision to top up towards the EU level in making direct payments to agriculture was adopted by Resolution No. 1391 of 8 November 2004 of the Government of the Republic of Lithuania on the directs payments to the agricultural entities of Lithuania in 2005 (*Valstybės žinios* (Official Gazette) 2004, No 164-5982), which sets that direct payment to agriculture for agricultural holdings shall reach 60% of the EU average in 2005.

The successful implementation of the borrowing policy will lead to the reduction of the GDP-relative share of interest payments from 1.3% in 2003 to 1% in 2007.

As part of the pension reform in the period of 2004 to 2007, a part of social security contributions are being transferred to privately-funded pension schemes. Capital transfers to privately-funded pension schemes will be increasing gradually from 0.3% of GDP in 2004 to 0.7% of GDP in 2007. Due to the favourable demographic structure of employment in the projected period and the increase of the retirement age, social security payments will account for an increasingly lower share of GDP; however, social benefits that were raised in 2004 will keep this expenditure close to the level of 2003.

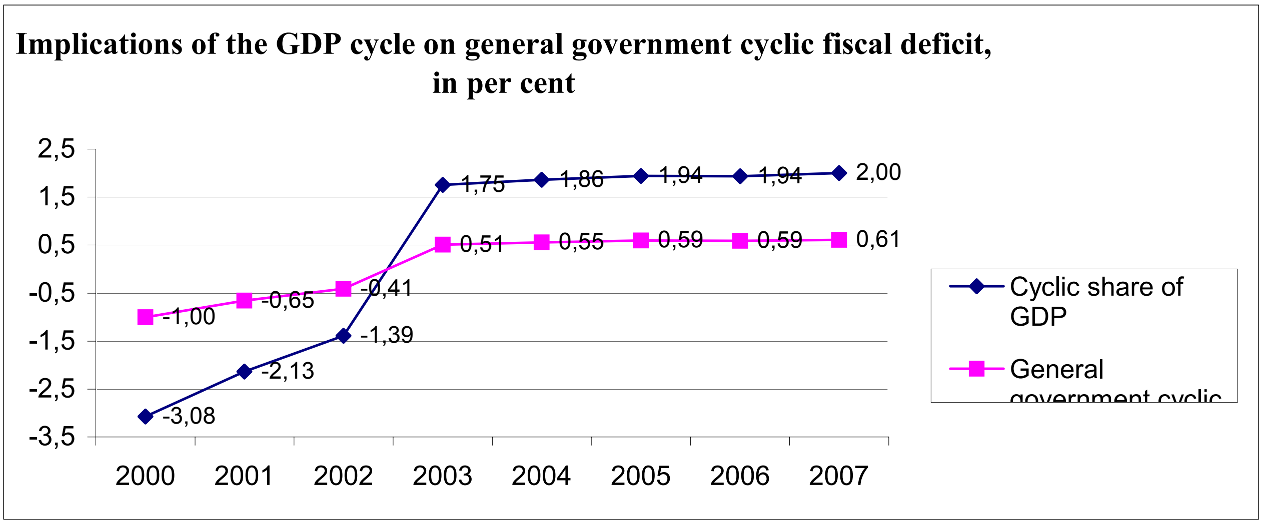
Gross fixed capital formation is expected to grow, due to absorption of EU support, from 3% of GDP in 2003 to 5.2% of GDP in 2006. As the pre-accession aid will be finished in 2007, gross fixed capital formation will drop to 5% of GDP. The rapid growth of investment will improve the quality of public finances.

General government budgetary expenditure on the restitution of private savings and for compensations for restored ownership of real estate will account for 0.6% of GDP in 2003, 1.1% of GDP in 2004, 0.4% of GDP in 2005, 0.8% of GDP in 2006, and 1.2% of GDP in 2007. These figures are subject to changes, should the economic cycle require a more dramatic reduction of the fiscal deficit.

3.3 STRUCTURAL DEFICIT AND SUSTAINABILITY OF FISCAL POLICY

For the calculation of the structural deficit, the updated Convergence Programme uses stricter assumptions about the cyclic character of current expenditures: it is assumed that current expenditures are not responsive to cyclical fluctuations. Figure 19 shows that the highest cyclic fluctuation of general government deficit was -1% of GDP in 2000-2003. Cyclical fluctuation of general government deficit is projected to go beyond 0.6% of GDP in the projected period. By a determined continuation of the expenditure-down and revenue-up policy, efforts will be made to bring the cyclically-adjusted general government deficit down by 1 percentage point over 2004-2007 to 2.1% of GDP by the end of the projected period. The reduction of the cyclically-adjusted deficit will activate automatic stabilisers in the economic cycle.

Figure 19. Implications of the GDP cycle on general government cyclic fiscal deficit, in %



Estimation of the output gap. Having collected additional statistical data, the Statistics Department has recalculated GDP estimates for 2002 and 2003. The GDP cycle was recalculated following the recalculation of actual data of national accounts and the update of medium-term projections.

The GDP cycle was estimated by applying the *Hodrick Prescot* (HP) filter. The results of this estimation suggest that Lithuania's economy is currently in the upswing.

Since 2003, real economic growth has been exceeding the potential GDP growth. The output gap will be 1.86% in 2004, 1.94% in 2005, 1.94% in 2006, and 2% in 2007.

Table 13. Cycles of the economy **(% of GDP)**

	ESA code	2003	2004	2005	2006	2007
1. GDP growth at constant prices	B1g	9.7	6.5	6.5	6.2	6.0
2. Actual balance	B9	-1.9	-2.5	-2.5	-1.8	-1.5
3. Interest payments	D41	1.3	1.1	1.1	1.0	1.0
4. Potential GDP growth		6.3	6.4	6.4	6.2	6.0
5. Output gap, HP filter		1.75	1.86	1.94	1.94	2.0
6. Cyclical budgetary component		0.51	0.55	0.59	0.59	0.61
7. Cyclically-adjusted balance (2-6)		-2.36	-3.09	-3.09	-2.39	-2.11
8. Cyclically-adjusted primary balance (7-3)		-1.06	-1.99	-1.99	-1.39	-1.11

However, due to short time-lines under the *Hodrick Prescot* filter approach or under the production function approach (using *NAIRU*), the estimation of Lithuania's output gap is not completely accurate. Conclusions obtained under the production function approach (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 disadvantage, lying in the fact that it smoothes structural changes even when they show an obvious shift in the output. Moreover, this approach suffers from the so-called "end-point bias". Thus, the weaknesses of the two approaches must be taken into account if they are to be used to estimate the structural deficit.

3.4 BUDGET SENSITIVITY TO GDP CHANGES

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

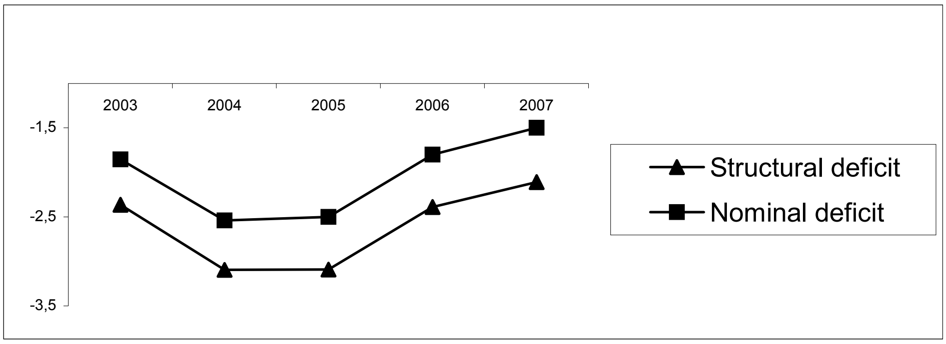
Relying on the actual quarterly figures of general government budget revenues for the period of 1995 to 2002 (period of observations: 7 years), elasticity was estimated for customs duties, value added tax, excises, revenues, profit taxes, and current expenditure.

Table 14. Lithuania's general government budget revenue elasticity estimates

ESA 95 code		Cyclical 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

As the Table 14 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. The Programme calculates deficit by making stricter assumptions about cyclical fluctuations of current expenditures: the elasticity figure has been reduced from 0.97 to 0. If the historic link between general government current expenditures and a slowdown of GDP growth persisted, the share of the cyclical deficit would make as little as one-tenth of the output gap in the medium term.

Figure 20. The dynamics of general government structural and cyclical budget deficit, 2004-2007



The cyclically-adjusted general government deficit has been estimated by taking account of the macroeconomic and budgetary projections described in this Programme. The results are presented in Table 13.

Table 15 shows that the structural deficit would shrink to 0.9% of GDP in 2004 and 0.3% of GDP in 2005, if euro-integration expenditures and costs of structural reforms were excluded. Structural deficit shows the likely difference between general government revenue and expenditure if the actual GDP equalled the potential GDP. Structural deficit is estimated by eliminating the effect of the business cycle.

Line 9 of Table 15 shows a successful implementation of structural measures for 2004-2006, which serve to reduce general government deficit by 3,0 percentage points of GDP in the total or by 0.8 percentage points of GDP a year.

Table 15. General government structural and cyclical fiscal deficit projections, and the additional financing requirement associated with the EU accession (in % of GDP)

		2003	2004	2005	2006	2007
1.	General government fiscal deficit target	-1.9	-2.5	-2.5	-1.8	-1.5
2.	Cyclical fiscal deficit (-)	0.51	0.55	0.59	0.59	0.61
3.	Structural fiscal deficit	-2.36	-3.09	-3.09	-2.39	-2.11
4.	EC Own Resources	0.00	0.72	1.15	1.10	1.10
5.	Co-financing requirement	0.24	0.33	0.50	0.79	0.76
6.	Expenditure on the pension reform	0.00	0.29	0.45	0.53	0.65
7.	One-off effects: loss of revenue as a result of the new procedure for paying VAT on imports from the EU introduced in 2004 (regain of the revenues since 2005); the growth of personal income tax underpayments in 2003; refunds of profit tax overpayments in 2003-2004.Continuous effect: the abolition of the road tax in 2005-2006	0.17	0.45	0.35	0.66	0.61
8.	Structural deficit reduced by the amount of payments to the EU Own Resources, co-financing requirement and loss of revenue	-2.0	-1.3	-0.6	0.7	1
9.	Structural measures implemented annually in the general government sector, to fulfil the commitments under the Stability and Growth Pact		-0.7	-0.7	-1.3	-0.3

3.5 STOCK OF DEBT AND ITS DYNAMICS

By preliminary data, the general government debt as estimated according to the Excessive Deficit Procedure (EDP) requirements accounted for 21.4% of GDP as of the end of 2003 as compared to the permissible ceiling of 60% under the Maastricht criteria, and was one of the lowest among EU Member States.

Table 16. General government debt according to EDP

	1999	2000	2001	2002	2003
General government debt as of year-end (in LTL M)	9,963.30	10,841.63	11,100.54	11,591.08	12,032.51
% of GDP	23.0	23.8	22.9	22.4	21.4

The government borrowing volumes are strictly regulated by the Law on Approval of Financial Indicators of the State Budget and Municipal Budgets, which sets annual limits on net borrowings by the Government and on newly contracted government guarantees. The net borrowing limit for 2005 is set at LTL 1700M, and no new guarantees are planned at all, except of the repayment of existing government-guaranteed loans.

3.5.1 Goal

The key objective of national debt management is to ensure a full and timely financing of public expenditures and a timely implementation of debt liabilities at the lowest possible cost and with acceptable risks, without exceeding the limits placed on the national debt and on new borrowing and in line with the requirements placed on the EU Member States seeking to join the Economic and Monetary Union.

3.5.2 Actions Planned

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

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

The Government has accumulated over LTL 1.4bn in the Stabilisation Fund. In case of unfavourable developments in financial markets, the Government is authorised to draw on these resources to cover its debt liabilities.

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

- to finance the major share of the government's borrowing requirement by issuing government securities in the domestic and foreign markets;
- to borrow in litas and euros or other currencies to be converted to litas or euros through derivatives;
- to gradually clear government liabilities denominated in those foreign currencies, the fluctuations of exchange rate of which vis-à-vis the litas and the euro can potentially increase debt servicing costs;
- to seek that government securities denominated in foreign currencies accounted for an increasingly larger share of the foreign debt portfolio.

3.5.3. General Government Debt Projections

General government debt (acc. to EDP) (S.13) is projected to shrink by over 1 percentage point of the projected GDP, due to the good collection of taxes and the rapid growth of GDP. In the medium term, the stock of general government debt should settle at 20% of GDP.

Table 17. General government debt projections

% of GDP	ESA code	2003	2004	2005	2006	2007
General government debt as of year-end		21.4	20.1	20.9	20.3	20.1
Change of general government debt		-1.0	-1.3	0.8	-0.6	-0.2
Factors Influencing the Change of National Debt						
Interest	D41	1.3	1.1	1.1	1.0	1.0
Primary balance	B9	0.6	1.5	1.4	0.8	0.5
Nominal GDP growth	B1g	-1.9	-1.9	-2.0	-1.9	-1.8
Other factors influencing the debt ratio		-1.0	-2.0	0.3	-0.5	0.1
Of which: privatisation proceeds: (-) positive proceeds (+) negative proceeds		-1.5	-0.7	-0.8	-0.2	-0.2
p.m. implicit interest rate on national debt (%)		5.5	5.4	5.2	5.1	5.1

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 the positive dynamics of Lithuania's macroeconomic indicators and the tight fiscal deficit reduction policy pursued until 2002. Over the medium term, the Government of the Republic of Lithuania expects to further improve its sovereign credit ratings, which would not only serve to reduce 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 continued to run surpluses: a preliminary surplus of 0.5% of GDP was recorded. Social security funds have fully cleared their arrears in 2003: by the data as of 1 January 2004, the social security sub-sector was clean from arrears.

Better administration of collection of municipal revenues and the reduction of arrears (by the data as of 1 January 2004, local government sub-sector had arrears of 0.4% of GDP), as well as a strict control over municipal borrowing, all have served to form a slight overall surplus of municipal budgets in 2003 (about 0.03% of GDP).

As a result of the structural and tax reforms carried out in recent years, the major share of the total deficit consisted in the central government budget deficit which accounted for 2.4% of GDP in 2003.

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 surplus of social security funds will grow rather slowly; however, the growth of employment and wages will sustain the social sub-sector surplus at about 0.1% of GDP.

The general government deficit mainly consists in the central government deficit. Therefore, the reduction of the central government deficit will accordingly exert a downward pressure on the general government deficit over the medium term.

Should a portion of the allocations for co-financing of the EU support be unspent in the current year (e.g. owing to incomplete absorption of the EU support), the general government deficit projection of the current year would be adjusted down accordingly. The pace at which the general government deficit will approach the balance will be dictated, in the medium term, by the EU support absorption indicators, the performance in repaying debt and discharging other government commitments, the cost of structural reforms, better administration of taxes, and the economic growth.

The downward movement of the general government deficit is shown in Table 12.

3.7. FISCAL RISKS

It is projected that the main sources of fiscal risks will be deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises to banks, savings restitution, and the decommissioning of the Ignalina Nuclear Power Plant.

Deposit insurance. As of 1 September 2004, the total amount of insured deposits was LTL 15,598.9M or 25.6% of GDP.

Savings restitution. As of 1 December 2004, these commitments stood at LTL 1,640M or 2.7% of GDP.

Restitution of real estate ownership rights. The financing requirement for compensations to be paid for the land, forest area and water bodies repurchased by the state totalled LTL 1051M or 1.7% of GDP as of 1 December 2004.

As of 1 December 2004, the financing requirement for the restoration of ownership rights for citizens to surviving residential houses, parts thereof or apartments, and for compensations to be paid to religious communities for the real estate repurchased by the state totalled LTL 291M or 0.5% of GDP. Another 0.63% of GDP of liabilities will be covered by issuing securities.

Article 8.2 of the Law on the Amounts, Sources, Terms and Procedure of Payment of Compensations for Real Property which is Bought-Out by the State as well as on Government Guarantees and Privileges Provided in the Law on the Restoration of the Rights of Ownership of Citizens to the Existing Real Property (No VIII-792 of 16 June 1998) provides for compensations to be paid to citizens in the current year shall be adjusted each year for inflation of the previous year.

Decommissioning of the Ignalina Nuclear Power Plant. The operation of the Ignalina NPP and foreign financing for the termination of its operation entail certain risks. A share of the costs of the decommissioning of the Ignalina Nuclear Power Plant will be covered by the EU which has allocated EUR 315M for 2004-2006 for this purpose. It has been estimated that the technical and socio-economic expenditures will require EUR 950M in the period of 2007 to 2013. The financing of these expenditure will depend on the outcome of negotiations about the EU financial outlook for 2007-2013.

Budget arrears. As of 1 October 2004, the stock of municipal budget arrears (including personal income tax, social security contributions, and loans) totalled LTL 218.4M or 0.4% of GDP. Compared to the data as of 1 January 2004, it has shrunk by LTL 44.4M (16.89%). The municipal budget arrears have been continuously reduced in the past years.

A number of measures aimed at the reduction of budget arrears are envisaged: information about municipal budget arrears will be published in the press on a monthly basis; no loans or guarantees will be extended to those municipalities which fail to respect borrowing limits and to reduce their budget arrears; the commission formed by Resolution No 621 of 7 May 2002 of the Government of the Republic of Lithuania will be further supervising the financial position of municipalities.

Government guarantees. One of the Government's medium term borrowing policies is the reduction of the stock of government guarantees (no new government guarantees are extended starting from 2003, except on the repayment of the existing government-guaranteed loans).

As of 1 November 2004, government-guaranteed loan portfolio accounted for about 2% of GDP. This figure is expected to drop to 1.2% of GDP over the medium term.

On-lending the loans taken on behalf of the state, and government-guaranteed loans. With the view to improving credit risk management, loans issued or guaranteed by the state are classified into 5 risk groups (employing commercial bank practices). The risk group is determined by taking account of the borrower's status evaluated with reference to the regularity of repayments, instances of debt restructuring or refinancing, the status of the borrower's financial and economic activities, and the actual implementation of the investment project concerned.

As of 31 September 2004, the stock of outstanding loans on-lent by the state to Lithuanian economic entities in which the state held over 51% of shares totalled LTL 241M or 0.5% of GDP.

As of 30 June 2004, borrowers of the fifth risk group collectively had LTL 586M (0.9% of GDP) worth of outstanding loans on-lent to them by the state and about LTL 157M (0.26% of GDP) worth of outstanding government-guaranteed loans.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

Sensitivity and risk assessment. The degree of sensitivity of general government budget deficit to GDP fluctuations is rather low. In the period of 1995 to 2003, only one-third of cyclical fluctuations in GDP would turn into general government deficit. This feature of general government finances can be explained by a low elasticity of revenues in the face of GDP fluctuations and a historically very low level of expenditure associated with unemployment in Lithuania. The Programme calculates deficit by making stricter assumptions about cyclical fluctuations of current expenditures: the elasticity figure has been reduced from 0.97 to 0. If the historic link between general government current expenditures and a slowdown of GDP growth persisted, the share of the cyclical deficit would make as little as one-tenth of the output gap in the medium term.

A medium-term growth of variable and fixed market interest rates by one percentage point would mean an increase of the interest payable on the central government debt (including new borrowing) of LTL 52M in 2005, LTL 56M in 2006, and LTL 62M in 2007, or about 0.1% of GDP.

Sensitivity of budgetary projections to different assumptions. Assumptions made in forecasting macroeconomic indicators are close to the assumptions about the external environment made by the EU Commission in the 2004 Autumn Forecast.

Lithuanian forecasts are based on the assumption that the absorption of EU support will not deviate much from the historic average EU support absorption rates (not according to payments approved by the Copenhagen Council). A lower absorption would mean a 1 percentage point lower growth of GDP. An almost 100% absorption of the EU pre-accession support allows to expect that the actual absorption will surpass the average rates, thus creating the conditions for GDP to grow at a higher pace than projected in this Convergence Programme.

Comparison with the previous update. GDP projections have been adjusted to reflect the actual figures of the first 9 months of 2004 announced by the Statistics Department and the new assumptions about oil prices. The revision of the 2003 actual figures have accordingly adjusted general government deficit projections.

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

Table 18. Dynamics of general government fiscal deficit and debt projections (% of GDP)

% of GDP	ESA code	2003	2004	2005	2006	2007
Real GDP growth Previous update**	B1g	9.0	7.0	7.3	6.6	6.3
Latest update		9.7	6.5	6.5	6.2	6.0
Difference		0.7	-0.5	-0.8	-0.4	-0.3
Actual budget balance Previous update**	B9	-2.4	-2.7	-2.5	-1.8	-1.5

Latest update		-1.9	-2.5	-2.5	-1.8	-1.5
Difference		-0.5	-0.2	0.0	0.0	0.0
General government debt Previous update**		21.5	22.4	22.2	21.4	21.0
Latest update		21.4	20.1	20.9	20.3	20.1
Difference		-0.1	-2.3	-1.3	-1.1	-0.9

* Preliminary actual data.
** Lithuania's Convergence Programme of May 2004

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 threats so as to ensure a smooth functioning of the economy. As of 1 October 2004, the Reserve (Stabilisation) Fund had LTL 1,031.8M (1.7% of GDP).

5.1 GENERAL GOVERNMENT EXPENDITURE

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

Table 19. General government expenditure, 1998-2003, by ESA'95 (% of GDP)*

Indicators	ESA Code	1999	2000	2001	2002	2003
Total expenditure		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	10.8
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	9.2
Interest payments	D41	1.5	1.7	1.6	1.4	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	3.0
Other		6.1	3.2	1.8	2.1	2.5
Budget balance	B9	-5.6	-2.4	-2.1	-1.5	-1.9

*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 fiscal deficit reduction policy and the increasingly lower involvement of the government in the goods and services market. A steady reduction was recorded in private consumption expenditure (from 13.5% of GDP in 1999 to 10.8% of GDP in 2003) and in collective consumption expenditure and social transfers (from 11.4% of GDP in 1999 to 9.2% of GDP in 2003). The decreasing interest rates on Government of the Republic of Lithuania securities and the favourable conditions on the international securities market have served to reduce 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 has been decreasing since 1999 to reach 2.2% of GDP in 2001, followed by an increase in 2002 to reach 3% of GDP in 2003.

With a view to improving public financial management, a set of legal acts were passed in the period of 2000 to 2003 to set out budget publicity requirements, 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 standards on the levels of long-term revenue. Since 2002, municipalities have been funded 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 arrears.

In the effort to improve the financial position of municipal budgets and encourage municipalities to streamline the use of state budget funds, the Law on the Budget Structure was amended to allow the possibility of using the unspent targeted appropriations for the purposes specified in the law on the approval of the financial indicators of the state budget and municipal budgets of the year concerned, instead of returning them back to the state budget.

By Resolution No. 345 of 26 March 2004, the Government adopted municipal borrowing rules that are in line with the methodological requirements of the European System of National and Regional Accounts ESA'95, and with the provisions of the Law on the National Debt and the Law on the Budget Structure. According to these rules, municipal debt shall include liabilities assumed by a municipality under loan agreements, leasing (financial lease) contracts and other binding debt instruments. The rules also lay down the procedure for issuing short-term loans from the state budget to municipalities. Loans issued to municipalities from the state budget shall be interest-bearing loans.

The Government of the Republic of Lithuania has also revised the consultation procedure to be followed by the Ministry of Finance and the Association of Local Authorities in Lithuania in discussing relevant indicators and data that are used for the calculation of financial indicators of the state budget and municipal budgets of the year concerned.

Starting from 2005, there is a possibility to negotiate for the covering of under-collection of municipal revenues.

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 budget planning is coordinated with the principles applied in the EU.

With a view to ensuring a more efficient use of EU support, the 2004 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets authorises the Government of the Republic of Lithuania, or another institution authorised by the Government, to reallocate 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 by budget of the republic of Lithuania operating funds or borrowed resources. These provisions are also incorporated in the new Law Amending the Law on the Budget Structure of the Republic of Lithuania passed. The 2004 Law on Approval of Financial Indicators of the State Budget and Municipal Budgets also allows to reallocate the balance of allocations that remained unused (as planned) for EU-funded 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.

Since the accession to the EU, Lithuania has been receiving support from the EU Structural Funds and the Cohesion Fund, the strategy and measures of usage whereof are outlined in the Single Programming Document (SPD) for 2004-2006 and in the Cohesion Fund Strategy for 2004-2006, respectively. The 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, and the Cohesion Funds Strategy for 2004-2006 defines the strategy of the use of the Cohesion Fund and the respective national co-financing as well as the projects financed.

Objectives. In Lithuania, budgetary expenditure targets and priorities are defined in a number of policy papers that are interrelated and form a single integrated set. The key national budget expenditure targets and priorities are defined in the Government Long-Term Development Strategy, (which is in line with Lisbon strategic goals), the Single Programming Document (SPD), the Government of the Republic of Lithuania Program, regional development plans, and the documents on the 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 Resolution No. 330 of 18 March 2003 of the Government of the Republic of Lithuania:

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-styles;

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. Since 2000, expenditure associated with 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 is 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. 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 need to co-finance the EU financial support;

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

to improve financial management in municipalities;

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.

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

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

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

A new version of the Law on the Budget Structure was passed in December 2003. The Law defines new budgetary aspects brought about by the membership in the European Union. Lithuanian's membership in the EU necessitates amendments to Law on the Budget Structure of the Republic of Lithuania in two aspects: firstly, the Republic of Lithuania has committed to ensure an effective and efficient use of the European Union financial support funds and to make payments to the European Union budget; secondly, the European Union system of accounts has to be introduced in administrating national budgetary funds and cash flows.

It is planned that general government expenditure allocations that might remain unused due to delays in co-financing the EU support or for other reasons will be used for further reductions of the fiscal deficit.

5.2 GENERAL GOVERNMENT REVENUE

Government budget revenues declined from 37.3% of GDP in 1999 to 32.3% of GDP in 2003. The decrease was determined by lower income from levies, assets, dividends, interest and other income inherently linked with the possession of assets or government operations. The decline was also stimulated by the implementation of the tax reform (a number of corporate profit tax and personal income tax benefits and exemptions): tax revenues fell from 23% of GDP in 1999 to 19.9% of GDP in 2003. Despite a better than planned tax collection in 2003, general government revenues accounted for an increasingly lower share of GDP due to the rapid GDP growth.

Table 20. General government revenue in 1999-2003, by ESA'95 (% of GDP)*

	ESA code	1999	2000	2001	2002	2003
Total revenue and grants	ESA	37.3	35.8	33.0	32.8	32.3
Taxes	D2+D5	23.0	21.0	20.1	20.0	19.9
Social contributions	D61	9.3	9.4	9.0	8.7	8.7
Other receipts and grants		5.0	5.4	3.9	4.1	3.7

*data from the Statistics Department

A new Law on Income Tax of Individuals that came into force on 1 January 2003 (No. IX-1007 of 2 July 2002) 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 (raised from 250 to 290 Litas per month); 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 non-taxable rates determined individually; and parents with one or two children may make use of an additional non-taxable share of income. The Law also allows a 25% 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, interest paid to banks or other credit institutions on loans taken for the construction or acquisition of housing, tuition fees for studies at a higher school). After the approval of the first Convergence Programme, the Law on Income Tax of Individuals was supplemented with the provision allowing to reduce the taxable income with the expenses on the acquisition, once in the period of three years, of a personal computer with software and/or on the installation of an Internet access together with the costs of acquisition of the required hardware, of up to LTL 4000.

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

A set of secondary legislation was passed in April 2004, as a means to ensure the implementation of the provisions of the Law on Profit Tax of the Republic of Lithuania and the Law on Income Tax of Individuals of the Republic of Lithuania obliging the taxpayer to transact at arm's length and, in the failure to do so, entitling the tax administrator to adjust transaction values, as provided in the relevant European Union and OECD guidelines.

On 13 April 2004, the Seimas of the Republic of Lithuania passed a Law on Tax Administration to improve the regulation of legal aspects of tax administration. The Law defines basic principles of legal regulation of taxation procedures 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 practice 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 every possible assistance to the taxpayer in the field of legal compliance. The new Law on Tax Administration has transposed the EU Council Directive on taxation of savings income in the form of interest payments.

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 created legal preconditions for the effective co-operation between Lithuania and other EU Member States in the field of recovery of tax debts. The Law came into force on 1 May 2004.

In 2004, new pieces of legislation were passed and came into force on 1 May 2004: an amendment to the Law on Value Added Tax and a new version of the Law on Excise Duties, followed by a set of secondary legislation for the implementation of the two laws. This new set of legislation has transposed the provisions necessary for the actual membership in the EU, i.e. laid down, in line with the EU *acquis*, the rules of taxation of transactions between economic entities of different EU Member States.

To facilitate the fulfilment of taxpayers' obligations, tax administrators have taken over certain functions of social security administrators as 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 as the result the budget lost 0.4% of GDP worth of VAT receipts in 2004.

Measures to improve the tax system. In the future, tax legislation will be amended to take into account any changes in the EU tax policies, practices of the European Court of Justice, results of activities of the European Commission working groups and the world's best practice in the field of taxation.

The Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States had to be transposed starting from 1 May 2004; for this purpose, the Law on Profit Tax has been amended and supplemented accordingly.

Taking into account the fact that the transposition of the above-mentioned Directive would adversely affect the level of general government revenues collected as the profit tax and that the principles laid down in the Directive are essentially contrary to those which Lithuania has been consistently applying in recent years in concluding double taxation avoidance agreements, Lithuania was allowed a transitional period for the transposition of the Directive: during this transitional period of six years, the rate of profit tax chargeable on payments of royalties at source shall not exceed 10%, and that chargeable on payments of interest shall not exceed 10 % during the first four years and 5 % during the final two years.

Capital taxation will be increased indirectly, by revising the rates of land and real estate taxes charged on companies and by promoting an economic use of property, particularly land, by discouraging speculative investment and taking measures to prevent a rapid unsustainable rise in real estate and land prices. As part of the corporate real estate taxation reform, there are plans to introduce a market value approach in valuating real estate for tax purposes.

Plans include the introduction of a real estate tax on individuals, with the view to preventing an unsustainable rise in real estate prices and discouraging speculative investment. A real estate tax law will provide levers for socially vulnerable social groups against the increase of the tax burden. If housing prices stabilise as a result of a change in the economic environment and if fiscal deficit targets are secured by other measures, the introduction of a real estate tax for residents will be postponed to a later period.

The medium-term plans include the reduction of disbalances between capital and labour taxation, which will be achieved by reducing taxation of marginal employees and increasing taxation of capital, by promoting the development of labour-intensive industries and the creation of new jobs. Efforts will be made to ensure that a balance between labour and capital taxation is achieved without adding to the fiscal deficit and that is contributes to a sustainable economic development and higher competitiveness and profitability of businesses.

Since 1 May 2004, excise rates applicable in Lithuania have been adjusted to match the minimum EU rates, except the excises on the products for which Lithuania has been allowed a transitional period (such as petrol, gasoline, coal, coke, lignite, electricity, orimulsion, and cigarettes).

In the future, excises on cigarettes and energy products will be gradually raised to reach the minimal EU rates by the end of the transitional period. Coal, coke and lignite will not be taxed until 1 January 2007, and electricity, until 1 January 2010.

To mitigate the impact of oil prices on the consumer price index, no increase in the excises on petrol and gasoline is planned in 2005.

There are plans to eliminate, starting from 1 July 2005, the deductions from gross corporate income to the Road Program, to be replaced by alternative sources of financing.

Financing. It is projected that the implementation of the 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 Income Tax of Individuals that came into force in 2003 brought revenue losses to the general government budget in the amount of approximately 0.23% of GDP in 2004;

according to preliminary calculations, the harmonisation of the VAT Law of the Republic of Lithuania with EU requirements has cost the budget of the Republic of Lithuania approximately 0.16% of GDP, which could have been received as additional revenue in 2004; the change in the procedure for payment of VAT on imports caused a loss of revenue of approximately 0.31% of GDP in 2004;

the introduction of a real estate tax on individuals will bring additional revenues of about 0.2% of GDP a year;

the raising of the real estate tax on companies will bring additional revenues of about 0.3% of GDP a year;

the changes in the land tax are expected to bring additional revenues of up to 0.1% of GDP a year;

the road tax will be partially replaced by a tax on vehicles;

the reduction of the personal income tax that is currently under consideration as a means of achieving a balance between labour and capital taxation in the medium term will cost the general government budget about 0.4 percentage points of GDP. Efforts will be made to match this reform with economic cycles and compensate revenue losses through other tax measures.

Economic Impact. The changes in land and real estate taxation will serve to discourage taking the profit out of the increase in land and real estate prices. Although the successful implementation of Lithuania’s foreign policies had an upward effect on land and real estate prices, over-high expectations about the rise in land and real estate prices inspire unsustainable price increases, curtail the use of land and real estate for productive and social purposes, create unequal opportunities for land and real estate owners to gain, and create preconditions for a financial instability caused by a “price bubble”. The change of real estate taxation at the point where the economy reaches the peak of activity would help to secure economic stability in 2005 and facilitate the reduction of the personal income tax rate over the medium term.

The implementation of the new tax legislation has served to attain a better balance of labour and capital taxation burden. The redirection of a portion of the tax burden from labour onto the capital will be continued in the medium term.

The application of higher non-taxable rates 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. In 2003, the expansion of the profit tax base already yielded additional revenue in the amount of around 1 percentage point of GDP.

6. SUSTAINABILITY OF PUBLIC FINANCES

Pension Reform. The state social security pension system set up 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 budget of the Republic of Lithuania.

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 old age pension was 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 6.3 per cent of GDP (LTL 3,528M) in 2003.

2004 saw the start of the third pillar of privately-funded pension scheme. Contributions to this pillar are made by redistributing a share of the compulsory state social security contributions. Started in 2003, the process of concluding privately-funded pension agreements continued, attracting over 48% of persons covered by state social security for the whole old age pension in 2004.

Although the redistribution of state social security contributions to the current pension system and to the privately-funded pension scheme serves to reduce government liabilities towards future pensioners, today it calls for state budget grants to the social security system. Moreover, the ratio between the average pension and the average wages (the replacement rate) currently stands low at 42% (net); therefore, pensions are being increased faster than wages, with the goal of reaching the net replacement rate of 60% in 2010.

The increase of the retirement age to 65 years would ease the financial burden on the employed population who make social security contributions. If the retirement age were not increased, 10 social security contributors would support 8 pensioners in 2025, and 11 pensioners in 2050 (see Table 21). Similarly, if the retirement age is increased to 65 years, 10 social security contributors will support 7 pensioners in 2025, and 9 pensioners in 2050, and spending on old age pensions will be below 7% of GDP in 2050.

Table 21. Projection of the ratio of pension recipients and contributors

	2002	2025	2050
Population, in thou (beginning of year)	3475	3202	2555
Ratio of population aged 60+ and 18–59, %	34.1	46.3	74.6
Ratio of pension recipients and contributors, if the retirement age is 60/62.5 years,%	86.1	81.3	113.1
Ratio of pension recipients and contributors, if the	86.1	65.3	88.5

	2002	2025	2050
retirement age is gradually increased to 65/65 years, %			

The pension reform will serve to reduce direct financial liabilities of the state towards future pensioners. This will help to prevent a crisis in the pension system that could threaten in the light of demographic changes in the long run.

Table 22. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	38.4	37.0	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	1.1	1.1	0.9	0.7	0.6	0.5
Total revenues	35.8	34.5	37.4	37.4	37.4	37.4	37.4
Of which: social contributions for old age pensions	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	7.9	6.1	5.2	5.0	4.8	4.1	3.7
Real GDP growth	3.9	6.5	5.2	4.6	3.9	3.1	2.4
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	11.4	8.6	6.9	6.9	6.9	6.9

* On the assumption that the pension age to 65 years will start to be increased in 2010.

The third pillar of the privately-funded pension scheme started gaining weight in 2004. It is projected that contributions to this scheme will grow to over 0.1% of GDP in 2005. Participation in the third pillar creates the conditions for cutting the personal income tax by 18 percentage points, which raises expectations that the participation will be growing in later years. The current long-term projections of the pension system are based on the data available only about the participation in the second pillar.

Reform Goal. The main goal of the pension reform is the setting-up and development of the privately-funded pension system, providing a possibility for the people of the Republic of Lithuania to privately save funds for their old-age pensions by setting aside a share of their social security contributions for this purpose.

Reform Measures. On 3 December 2002, the Seimas of the Republic of Lithuania passed a Law on Pension Reform which set forth that:

the pension reform shall be started on 1 January 2004;

participation in privately-funded pension schemes shall be voluntary;

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

the general rate of social security contributions (i.e. 34%) shall 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 shall 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, capital adequacy, liquidity of equity, separation of the ownership of participants in privately-funded pension schemes from the equity of the company operating the scheme, investment requirements). In 2004, 12 enterprises were engaged in providing the pension saving service.

Financing. It is envisaged that functioning of the current pensions system based on the pay-as-you-go principle should be ensured to both current and future pensioners. Over 441 thou people (36.6%) covered by social security joined the new, privately-funded pension system in 2003, and another 115 thou people joined it in 2004. 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 another 10% of those covered by social security will join the new pension system in 2005, thus injecting to the privately-funded pension schemes another LTL 305M in 2005 and LTL 460M in 2006. The increase of expenditure of the State Social Security Fund as a result of the pension reform will be financed from privatisation proceeds, budget of the Republic of Lithuania and other sources. A portion of this expenditure will also be covered by 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.

Economic impact of the reform. It has been estimated that:

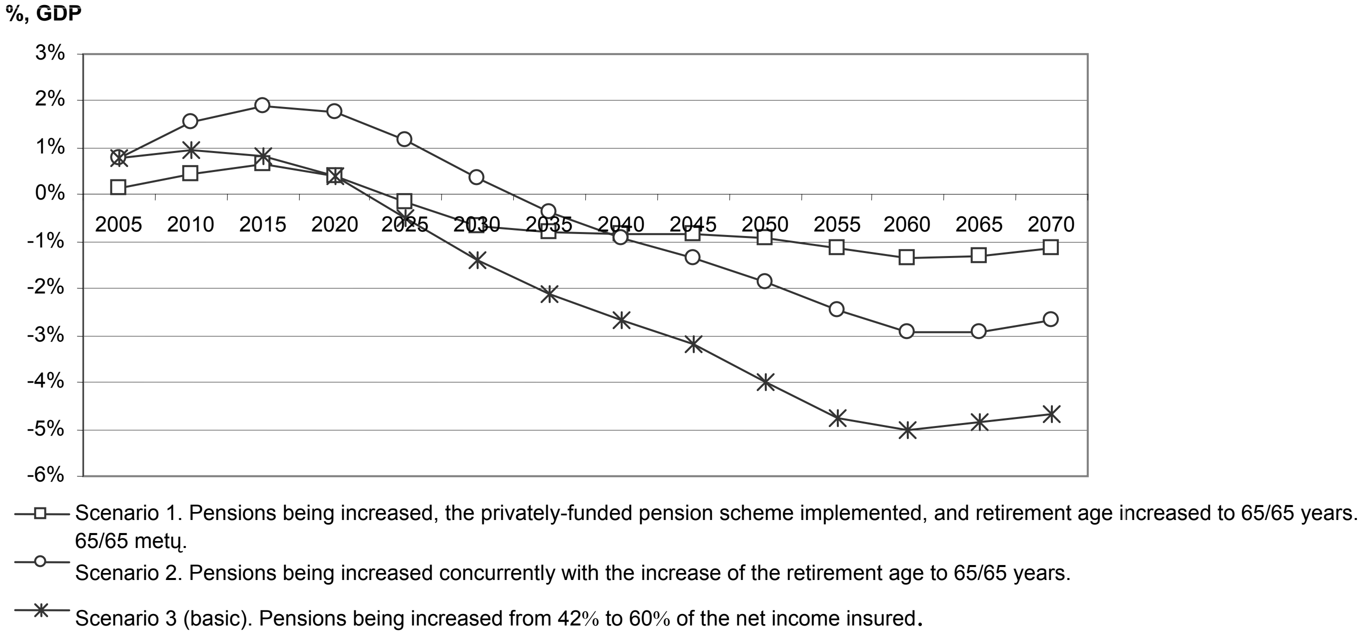
once the pension reform is implemented, a three-pillar pension system will be set up in Lithuania, consisting of a pay-as-you-go pillar, a mandatory privately-funded pillar (when a portion of a social security contribution is transferred to the privately-funded pension scheme) and a volunteer privately-funded pension pillar, 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.

Figure 21 reflects the impact of the budget balance of the pension system on the financial liabilities of the state. Given the fact that pensions currently account for as little as 42% of the net wages, the estimates given in the Figure below reflect implicit general government commitments to attain a replacement rate of 60%. Assuming that participation in the second pillar gradually increases to reach 100% by 2020 and the retirement age reaches 65 years, the multi-yearly (until 2070) impact of the pension system on the general government would not threaten an excessively large impact either on the fiscal deficit or on the size of debt. The third basic scenario shows the likely general government balance in the situation where pensions are increased without implementing any reforms in this area. The calculations are based on Eurostat demographic projections for Lithuania.

Figure 21. Social security budget balance (% of GDP)

7. IMPLICATIONS OF STRUCTURAL REFORMS ON PUBLIC FINANCES



7.1 LABOUR MARKET

Having joined the EU in 2004, Lithuania has committed to implement the Lisbon objectives and the Employment Guidelines adopted by the European Council in 2003. Taking into account European Council recommendations to Lithuania, a range of national measures will be implemented to ensure the implementation of three overarching broad objectives: full employment, quality and productivity at work, and strengthened social cohesion and inclusion.

With the view to achieving full employment, efforts will be made to maintain the current high level of employment among groups of population, coupled with the implementation of the policy promoting active economic participation and employment among other groups of population. Measures will be taken to approximate the level of employment to 70%, and to cut unemployment and keep it low, at no more than 6 to 7%; however, with full account taken of the economic potential of the country and the country's political, social and economic goals, this target will not be achieved earlier than within 12 to 15 years.

Table 23. Lisbon employment objectives

Employment rates, %	2003		2005		2010	
	EU- 25	Lithuania	EU- 25	Lithuania*	EU- 25	Lithuania*
Total	62.9	60.9	67.0	63.5	70.0	68.0
Women	55.1	58.4	57.0	59.3	60.0	61.0
People aged 55-64	40.2	44.5	-	46.2	50.0	48.0

* forecast

Lithuania's Single Programming Document for 2004-2006 approved by Decision C(2004) 2120 of 18 June 2004 of the European Commission and by Resolution No 935 of 2 August 2004 of the Government of the Republic of Lithuania sets out a set of priority measures aimed at the implementation of European Commission guidelines:

facilitate the adaptability of workers and firms to changes in the labour market,

increase labour market participation and facilitate a free choice of jobs, more extensively and effectively invest in human resources and lifelong learning.

Table 24. Consolidated financing requirement for the implementation of the 2003 Employment Guidelines approved by Council Decision, 2004-2006, in LTL M

Measures	Funds			
	Total	EU structural funds	General government expenditure	Private funds
Total	1,901.1	1,024.7	821.9	54.5
Guideline 1:				
Promotion of employability	431.31	146.3	277.7	7.2
Development of services infrastructure	569,6	296.0	273.6	-
Guideline 2:				
Promotion of self-employment and improvement of business environment	210.5	156.3	54.2	-
R&D and innovation in the quality of human resources	121.8	90.4	31.4	-
Guideline 3:				
Promotion of labour competences and the adaptability in the labour market	179.4	108.7	36.2	34.5
Guideline 4:				
Development of lifelong learning	211.1	158.4	52.8	-
Guideline 7:				
Prevention of social exclusion, and promotion of social integration	122.1	56.6	65.6	-
Guideline 10:				
Support to local employment initiatives	55.3	12.1	30.54	12.8

Source: Ministry of Social Security and Labour

7.2 Small and Medium-Sized Enterprises

Lithuania attaches great importance to the improvement of conditions for businesses, particularly small and medium-sized enterprises (hereinafter – "SME"); direct support is allocated for the development of existing enterprises and the establishment of new ones. State aid is given to economic entities to support their participation in exhibitions, preparation of various informative publications, innovations; the state also co-finances a number of other business promotion measures.

In addition to national funds, SMEs have been supported, since 2004, from the EU structural funds. For the period of 2004 to 2006, over EUR 100M has been allocated, as direct support for businesses, for enterprise development, modernisation, innovation and other projects.

With the view to ensuring a maximum absorption of the EU structural funds allocated for businesses, a Lithuanian Business Support Agency was established in 2003 with the primary function of administering the European Union and national support for the development of national industries and businesses.

To help businesses to successfully apply for EU structural support funds (particularly the European Regional Development Fund), small enterprises were given assistance, in the end of 2003 and beginning of 2004, for the preparation of project documentation.

To provide SME with better financing possibilities in all regions, the private limited liability company *Investment and Business Guarantees* (hereinafter – "*INVEGA*") established in 2001 issues guarantees in favour of banks on a portion (up to 80%) of loans taken by SMEs and covers up to 50% of interest on guaranteed loans. INVEGA's guarantee liabilities are secured by the State, which reduces credit risks and opens opportunities for more SMEs to draw on banks.

Lithuania is an active participant in the EU Multi-Annual Program for Enterprise (particularly for small and medium businesses) and Entrepreneurship. Within the framework of this Program, Lithuania continues a dialogue with the European Investment Fund (EIF) concerning new instruments aimed at improving SME financing possibilities. In the first quarter of 2004, an agreement was signed with the European Investment Fund for counter-guaranteeing the INVEGA's liabilities.

INVEGA's services are quite in demand: over the first eleven months of 2004, it has issued 154 guarantees on LTL 39.4M worth of loans to small businesses and covered LTL 1,286.5 thou worth of interest paid by small businesses to banks, which was 67.5% more than over the corresponding period of 2003. The implementation of business projects for which INVEGA-guaranteed loans were taken during this eleven-month period of 2004 will serve to create about 840 new jobs, i.e. 26% more than in the corresponding period of 2003.

7.3 Healthcare

With the view to improving health of Lithuanian people by ensuring accessible, high-quality and effective healthcare, by implementing the principle of social justice, and by creating equal access for every citizen of the country to the required medical aid, the following measures are being implemented:

public healthcare system is being strengthened to implement the EU policies in this field: public health centres have been restructured by delegating certain healthcare functions to country governors' administrations; a network of test laboratories has been optimised; three regional laboratories have been certified for public health research. It is planned to reorganise public health centres established in counties into public administration institutions, by separating public administration from the provision of services, and to optimise the network of institutions providing specialised public healthcare services. The required state budget allocation for the public healthcare reform is estimated at LTL 3.5M for the next few years;

the quality of personal healthcare services is being further improved;

pursuant to the Healthcare Institutions Restructuring Strategy approved by the Government of the Republic of Lithuania by Resolution No 335 of 18 March 2003, healthcare institutions undergo restructuring. Restructuring plans have been approved for 10 healthcare institutions in counties. In the process of streamlining the personal healthcare network in terms of its coverage, structure and layout, priority is attached to the development of the primary healthcare and ambulatory services; the improvement of medical nursing and long-term/palliative treatment services; the streamlining of in-patient services and the development of alternative forms of activities; and the preservation and improvement of children's and youth's health. The required state budget allocation for the implementation of the Healthcare Institutions Restructuring Strategy is estimated at LTL 104.3M for the period of 2005 to 2008. Funds will also be taken from the EU structural funds allocated for the implementation of Measure 1.4 D*evelopment and Upgrading of Health Care Institutions* included in Lithuania's Single Programming Document for 2004-2006 approved by Decision C(2004) 2120 of 18 June 2004 of the European Commission and by Resolution No 935 of 2 August 2004 of the Government of the Republic of Lithuania. This measure is being implemented by following two main directions: the development and modernisation of the infrastructure of general practitioner services, and the strengthening and development of cardio-healthcare services by upgrading healthcare institutions;

the development of the healthcare system is continued, in the effort to ensure an effective healthcare by improving the administration and financing of the healthcare system. Government capital investment is made use of in continuing the ongoing or starting new health programmes and projects for the restructuring of healthcare institutions implemented by counties and municipalities, aimed at implementing new medical technologies, upgrading and restructuring healthcare institutions, and creating an integrative, development-supportive information system;

the national pharmaceuticals policy is being implemented: the goal is to ensure that Lithuanian market offers only high quality, safe and effective as well as affordable pharmaceuticals, and that the pharmacy sector reformed according to the EU requirements provides only high quality services. The system of reimbursement for medicines is being further improved by removing certain restrictions: more reimbursable medicines are prescribed, the assortment of reimbursable medicines is increased;

health insurance system is being improved: efforts are made to improve the quality of healthcare services and their accessibility for everybody, to increase the efficiency of the health system, and to implement more efficient forms of use of the available resources. 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. The right of a patient to select a medical institution they prefer are being implemented; competition among medical institutions is promoted; prices of services are revised annually.

It has been estimated that state budgetary expenditure on insurance contributions for persons insured at the state's cost will total LTL 570.1M in 2005, which is 17.3% more than in 2004 (a contribution per person will increase from LTL 221.4 in 2004 to LTL 264.2 in 2005).

Table 25. Projected MHIF budgetary receipts and expenditure, 2004-2007

Year	2004	2005	2006	2007
Receipts				
LTL M	2,043.8	2,360.8	2,463.1	2,599.9
% of GDP	3.3	3.5	3.4	3.3
Expenditure				
LTL M	2,043.8	2,360.8	2,463.1	2,599.9
% of GDP	3.3	3.5	3.4	3.3

According to the estimation of the financial impact on the budget of the Mandatory Health Insurance Fund of the implementation of Regulation (EEC) No 1408/71 of the Council of 14 June 1971 on the application of social security schemes to employed persons and their families moving within the Community and Regulation (EEC) No 574/72 of the Council of 21 March 1972 fixing the procedure for implementing Regulation (EEC) No 1408/71 on the application of social security schemes to employed persons and their families moving within the Community, after the free movement of persons is ensured, a budget allocation has been provided for covering the costs of healthcare services provided to those covered by the mandatory health insurance during their stay in another EU Member State. Since 1 May 2004, the date of Lithuania's accession to the European Union, visitors to Lithuania covered by mandatory health insurance in any EU state are entitled to the first medical aid and reimbursable medicines.

7.4. Agriculture, Food Industry, and Rural Development

To ensure the implementation of the EU common agricultural policy, to develop a competitive agricultural and food sector, and to promote a sustainable economic and social development of rural areas, the following measures are being implemented:

strengthening of institutional and administrative capacities;

implementation of the measures aimed at securing income for entities engaged in agricultural activities, and market regulation measures (direct payments according to a simplified scheme, quota systems, intervention buying, private storage systems, import/export mechanisms, product marketing standards, etc.);

implementation of the measures set forth in the Rural Development Plan (early retirement from commercial farming, less favoured areas and areas with environmental restrictions, afforestation of agricultural land, environmentally friendly agricultural methods, support to semi-subsistence farms, support for meeting EU standards), the Single Programming Document (SPD) (investment in agricultural holdings, setting up of young farmers, improving processing and marketing of agricultural products, promoting adaptation and development of rural areas, forestry, LEADER+ type measure, training, modernising fishing fleet, aquaculture);

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

the process of restitution of ownership rights to land, forest and water bodies is approaching the end, to be followed by the next stage of land management process associated with a promotion of a rational use of land, by preserving the ecologic stability of the landscape and by developing a required rural infrastructure. Also, authorities are addressing the issue of authorising the selling agricultural land to Lithuanian legal persons and foreign citizens;

promotion of the development of a competitive food industry, restructuring of the food sector, taking measures to ensure that only safe food is supplied to the market, food control in the whole chain from the field to the table.

Allocations to agriculture and rural development will account for one-third of the total EU support. EU funds will be used to finance market regulation and rural development measures. A portion of allocations for rural development measures will be used for direct payments. Moreover, structural support will be provided for rural development and fisheries in 2004-2006.

With the view to implementing agricultural strategic goals and becoming equal partners in the EU market, the state budget will continue to annually finance state support to agriculture, land reform, land reclamation, market development, infrastructure, quality management, science and education, information and other needs.

Table 26. Estimates of measures aimed at achieving strategic agricultural policy goals, in LTL million

Measures	Funds			
	2004	**2005**	**2006**	**2007**
Revenue				
LTL M	619.0	1,076.2	1,345.4	1,061.9
% of GDP	1.0	1.6	1.9	1.4
Expenditure				
LTL M	1,422.4	1,739.7	2,047.5	1,715.1
% of GDP	2.3	2.6	2.8	2.2
Net direct budgetary impact				
LTL M	-803.4	-663.6	-702.2	-653.1
% of GDP	1.3	1.0	1.0	0.8

Once the process of restitution of ownership rights to land, forest and water bodies is finished, a further process of land administration in Lithuania will be associated with land consolidation, i.e. rearrangement of land plots by changing their abbutals and location at landowners' requests, with the aim of consolidating land plots, forming a rational use of land, improving its structure, setting up the required infrastructure and implementing other goals and objectives of agricultural and rural development and environmental policies. This process will be carried out by implementing land consolidation projects to be co-financed by the European Union and national funds.

7.5 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.

Environmental policy. With the view to ensuring an adequate quality of water in all water bodies of Lithuania, authorities have started a reform in the field of governmental regulation of the protection of water resources: management of water resources will be organised by river basin districts, water supply and wastewater management system will be reorganised. With the view to setting up a streamlined waste management system that ensures a good quality of the environment and operates under the principles of market economy, 10 regional waste management systems will be established in Lithuania. By 2010, about 800 existing landfills will be closed, 10 to 12 new regional landfills opened, and waste collection and management systems implemented. As part of implementation of the commitments under the Kyoto Protocol, authorities have drafted a national allocation plan for 2005 to 2007 regulating the emission of greenhouse gasses.

In the effort to improve the economic regulation of the environmental protection by following the "polluter pays" principle, Lithuania introduced, in 2003, a tax on pollution with product and packaging waste (the Republic of Lithuania Law No IX-720 of 22 January 2002 Amending the Law on Pollution Tax). The tax is chargeable on all types of primary, filled packaging and certain products (such as tiers, batteries, galvanic batteries, mercury vapour lamps, fuel and oil filters for internal combustion engines, intake filters and hydraulic dampers for cars); the Law clearly defines producer and importer responsibility for handling product and packaging waste.

Table 27. Projected revenues to the national budget from pollution taxes, 2004-2007

Pollution taxes	Year			
	2004	2005	2006	2007
Water pollution (LTL M)	14	11	11,5	12
Tax on products and packaging (LTL M)	15	15	14	13
Air pollution (LTL M)	33	20	15	15
Total (LTL M) % of GDP	62 *0.1*	46 *0.1*	40,5 *0.1*	40 *0.1*

Rates of the tax on pollutants discharged to the atmosphere and water set in the Law on Pollution Tax for the period of 2005 to 2009 will remain unchanged during this entire period and stay at the 2004 level. Therefore, no increase in the related business sector expenditures or in the prices of goods and services is likely in the period concerned.

As the stock of residential houses tears and wears and energy becomes more and more expensive, the issue of a rational use of energy becomes increasingly painful. Homeowners cannot solve this problem individually. It is therefore being tackled by legislating: a set of legal acts passed in 2004 have created conditions for modernising residential houses and boosting energy consumption efficiency by drawing on commercial bank resources, public funds, state budget support for low-income families (individuals) and homeowners' fund pools. The reduction of energy consumption will ease the burden on the state budget for compensating heating and hot water costs to low-income families (individuals) and will thus have a direct impact on the current account deficit. As renovation will help to cut household expenditure on heating by 25 to 50 per cent, energy product prices will have less implications for the current account deficit and for the dynamics of the demand by the end of the medium term period.

Transport sector. One of the key priorities of Lithuania's transport sector is the creation of a modern north-south transport axis that will be developed within the framework of Pan-European transport corridor #I (Tallinn-Riga-Kaunas-Warsaw) and will connect the Baltic States to Poland. One of the most important projects aimed at developing the above-mentioned axis and implementing the Rail Baltica Project is the construction of a modern railway line Tallinn-Warsaw via Kaunas. The Rail Baltica Project appears among priority projects listed in the Trans-European Transport Network Guidelines adopted by the European Parliament in April 2004.

The new Long-term Transport System Development Strategy will create favourable conditions for a further implementation of Lisbon strategy goals. By 2025, Lithuania plans to set up a modern and balanced multi-modal transport system that measures up, by it technical parameters, safety and the quality of services, to the level of old member states of the EU. Lithuanian transport sector will become an important element in the transport system of the southern Baltic Sea region and will effectively serve, by providing high quality services, the common needs and interests of Lithuania and the enlarged European Union.

Knowledge society. The Government of the Republic of Lithuania approved, by Resolution No 488 of 28 April 2004, a Strategy for the Development of Public Administration for the period until 2010, which aims at modernising the public administration system with an ultimate goal of developing a transparent and result-oriented public administration focussed on providing high quality services to citizens and other people and built on information technologies.

In pursuance of Lisbon strategy goals, the Government of the Republic of Lithuania approved, by Resolution No 1646 of 22 December 2003, a Long-term Research and Development Strategy accompanied by a Program for the Implementation of the White Book on Science and Technology in Lithuania. The Strategy sets a goal of strengthening the scientific-technical potential of the country, seeking its most efficient use in advancing progress and increasing competitiveness.

As an incentive for businesses to develop innovation and invest in research and development, the state co-finances innovation projects carried out by businesses and supports their participation in the European R&D and Cooperation projects within the EUREKA framework. For the implementation of innovation projects, businesses are entitled to subsidies of up to 50% of their eligible project expenditure. The European Union structural funds open new possibilities for supporting the development of innovation and technologies. Businesses will be supported both directly (through subsidies to enterprises) and indirectly (by subsidising services to businesses and improving business climate) from the European Regional Development Fund.