EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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ECONOMIC ASSESSMENT OF THE CONVERGENCE PROGRAMME OF LITHUANIA (UPDATE OF DECEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. The most recent update of Lithuania's convergence programme was submitted on 13 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 27 February 2007. Comments should be sent to Lorena Ionita (lorena.ionita@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Lithuania, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2006-2009, was submitted on 13 December 2006.

Lithuania has successfully completed the transition to a functioning market economy and now enjoys one of the highest output growth rates among the EU Member States. GDP per capita was just above 50% of the EU average in 2005. Domestic demand has accelerated rapidly in the last years partly reflecting buoyant credit growth, becoming the main driver of economic growth and leading to higher external deficits. After a period of non-inflationary growth, inflation picked up since mid-2004 reflecting a combination of factors including increases in unprocessed food and energy prices and significant wage increases against the background of a tightening labour market. The government has shown a good track record in meeting its fiscal targets in the last years, while better advantage could have been taken from the good times enjoyed by Lithuania.

Against this background, preserving macro-financial stability is the main challenge in the area of public finances. So far, financing of the external deficits appears to have been unproblematic, but the external position reflects substantial financing needs in the medium term since the high growth of capital goods imports, fuelled by the absorption of EU structural funds and robust domestic demand, is expected to continue putting pressure on the external balance. Moreover, as rapid credit growth continues fuelling consumption and Lithuanian income and price levels converge towards those of the EU, emerging inflationary pressures could ultimately jeopardise the external competitiveness of the economy. Capital inflows need to be channelled to sectors that will contribute to productivity growth. However in recent years, FDI inflows remained relatively modest compared with some neighbouring countries. In order to avoid a too rapid increase in external debt, national savings need to remain at adequate levels. In this context and in the absence of an independent monetary policy, fiscal policy should play an increasing role in supporting more sustainable external deficits in the medium term and help prevent the risk of overheating, including by stepping up fiscal consolidation.

The macroeconomic scenario underlying the updated convergence programme envisages that real GDP growth will decelerate progressively from 7.8% in 2006 to 4.5% in 2009. Domestic demand is expected to slow down but remains the driver for growth. The contribution of external trade to growth is forecast to be negative throughout the programme period. The unemployment rate is expected to sharply decline to 4.9% in 2007 and remain at that level until the end of the programme period. HICP inflation should increase to a peak at 4.7% in 2007 and then gradually decline to just above 3% in 2009. Assessed against currently available information, this scenario appears to be based on cautious growth assumptions from 2007. There are upside risks to the programme's inflation projections after 2007 in the light of recent developments, notably with respect to energy prices, excise duties as well as credit growth and wage developments.

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[1]The analysis takes into account (i) the Commission services' autumn 2006 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

Although the positive output gap, as implied by the Commission services autumn 2006 forecast, is closing and becomes negative in 2008, the overall macroeconomic situation remains favourable with robust growth and domestic demand. Lithuania can therefore be said to be experiencing “good times”.

For 2006, the general government deficit is estimated at 1% of GDP in the Commission services' autumn 2006 forecast against a target of 1.4% of GDP set in the previous update of the convergence programme. The updated programme presents a deficit estimated at 1.2%. However, preliminary data for the whole of 2006 point to an even better deficit outcome. This is due to much higher-than-foreseen economic activity and employment, faster wage growth and improvements in tax collection and was achieved in spite of a budget amendment in July 2006 which increased expenditures by around 0.5% of GDP.

The main goal of the programme is to gradually reduce the general government deficit throughout the programme period so as to achieve the medium-term objective (MTO, see below) by 2008 and a balanced budget in 2009. The primary deficit is expected to be in balance by 2007 and to record a surplus of 0.8% of GDP at the end of the programme period. Compared with the previous update, the planned adjustment is more ambitious, but backloaded against a less favourable macroeconomic scenario towards the end of the programme period. The envisaged fiscal consolidation relies on an increase in the revenue-to-GDP ratio that is higher than the increase in the expenditure-to-GDP ratio (2.6 percentage points compared to 1.4 percentage points). On the revenue side, only 0.5 percentage point is explained by an increase in the tax ratio, which is mainly due to an expected improvement in tax collection. The rest of the increase is not specified in the programme, but seems to be linked to the inflow of EU funds. On the expenditure side, the changes stem from a rise in public investment, social transfers and "other" primary expenditures, which is less than fully offset by a significant cut in government consumption as a percentage of GDP (by more than 2 percentage points).

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to gradually improve from a deficit of 1¾% of GDP in 2006 to a surplus of ½% of GDP in 2009. As in the previous update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 1% of GDP, which the programme aims to achieve by 2008. The MTO is in line with the Pact.

The risks to the budgetary projections in the programme appear broadly balanced until 2007, but budgetary outcomes could be worse than projected in the programme from 2008 onwards. The budgetary strategy relies on a significant increase in the revenues-to-GDP ratio and the substantial cut in public consumption-to-GDP ratio, which could have been better substantiated, taking into account the medium-term framework for the planning and control of public finances which is not sufficiently binding. While the likely carry-over from a lower-than-estimated deficit outcome in 2006 implies that the target for 2007 could be achieved, the lack of detailed information on the envisaged measures introduces considerable uncertainty for the achievement of the budgetary targets from 2008 onwards.

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2008, as envisaged in the programme. However, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme

period. According to the programme, the pace of the adjustment towards the MTO is in line with the Stability and Growth Pact which specifies that the adjustment should be higher in good economic times and could be lower in bad economic times. Nevertheless, in view of the risks identified above, the planned structural adjustment should be strengthened by backing it up with measures so that the annual improvement in the structural balance is 0.5% of GDP as a benchmark, as required for euro-area and ERM II Member States.

The long-term budgetary impact of ageing in Lithuania is lower than the EU average, with a limited increase in pension expenditure over the coming decades, influenced by the pension reforms enacted. The current level of gross debt is very low in Lithuania and improving the budgetary position as planned in the convergence programme update would contribute to containing the risks to the long-term sustainability of public finances. Overall, Lithuania appears to be at low risk with regard to the sustainability of public finances.

The implementation report of the national reform programme of Lithuania, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 13 October 2006. Lithuania's national reform programme identifies as key challenges/priorities: to sustain fast economic growth and a stable macroeconomic environment; to promote the competitiveness of Lithuanian companies; and to promote employment and investment in human capital. The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Lithuania is making good progress in the implementation of the National Reform Programme, in most of the main policy areas across the macro, micro and employment sectors. However, with many important measures at the conceptual stage, there remains much to do in terms of implementation. Against the background of strengths and weaknesses identified, Lithuania was recommended to take action in the areas of R&D and supply of skilled labour. The convergence programme and the National Reform Programme seem well-integrated. In particular, both programmes highlight the ongoing pensions, health care and tax reforms. In order to contain inflation and prevent overheating, the convergence programme foresees a tightening of fiscal policy, which was not reported on in the implementation report of the national reform programme, but was called upon in the Commission December 2006 Annual Progress Report. The general government deficit targets presented in the updated convergence programme are therefore significantly lower than those presented NRP and the IR-NRP.

The overall conclusion is that, in a context of strong growth prospects, the updated convergence programme envisages progress towards the MTO, which is targeted to be reached by 2008. However, there are risks to the achievement of the budgetary targets from 2008 onwards.

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[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery", 12.12.2006, COM(2006)816.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Dec 06**	**7.6**	**7.8**	**6.3**	**5.3**	**4.5**
	COM Nov 2006	7.6	7.8	7.0	6.5	n.a.
	CP Dec 2005	*7.0*	*6.0*	*5.3*	*6.8*	*n.a.*
HICP inflation (%)	**CP Dec 06**	**2.7**	**3.9**	**4.7**	**3.4**	**3.1**
	COM Nov 2006	2.7	3.8	4.6	3.3	n.a.
	CP Dec 2005	*2.7*	*2.7*	*2.7*	*2.5*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2006[1]**	**1.9**	**2.4**	**1.6**	**0.1**	**-1.9**
	COM Nov 2006[5]	1.2	1.4	0.7	-0.6	n.a.
	CP Dec 2005 [1]	*2.9*	*2.1*	*0.5*	*0.6*	*n.a.*
General government balance (% of GDP)	**CP Dec 06**	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0.0**
	COM Nov 2006	-0.5	-1.0	-1.2	-1.3	n.a.
	CP Dec 2005	*-1.5*	*-1.4*	*-1.3*	*-1.0*	*n.a.*
Primary balance (% of GDP)	**CP Dec 06**	**0.3**	**-0.4**	**0.0**	**0.4**	**0.8**
	COM Nov 2006	0.3	-0.2	-0.4	-0.5	n.a.
	CP Dec 2005	*-0.9*	*-0.8*	*-0.7*	*-0.4*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2006[1]**	**-1.0**	**-1.8**	**-1.3**	**-0.5**	**0.5**
	COM Nov 2006	-0.8	-1.4	-1.4	-1.2	n.a.
	CP Dec 2005 [1]	*-2.3*	*-2.0*	*-1.4*	*-1.2*	*n.a.*
Structural balance[2] (% of GDP)	**CP Dec 2006[3]**	**-1.0**	**-1.8**	**-1.3**	**-0.5**	**0.5**
	COM Nov 2006[4]	-0.8	-1.4	-1.4	-1.2	n.a.
	CP Dec 2005	*-2.3*	*-2.0*	*-1.4*	*-1.2*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 06**	**18.7**	**18.4**	**19.2**	**19.0**	**17.7**
	COM Nov 2006	18.7	18.9	19.6	19.8	n.a.
	CP Dec 2005	*19.2*	*19.9*	*19.8*	*18.9*	*n.a.*

Notes:
[1]Commission services calculations on the basis of the information in the programme.
[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3]There are no one-off and other temporary measures in the programme.
[4]There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.
[5]Based on estimated potential growth of 7.9%, 7.7%, 7.8% and 7.9% respectively in the period 2005-2008.
Source:
Convergence programme; Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Lithuanian convergence programme, covering the period 2006-2009, was submitted on 13 December 2006[3]. It was submitted after the deadline of 1 December specified in the code of conduct, because of a change in the approval procedure which now involves the Parliament. Overall, the programme is based on the same macroeconomic scenario and contains the same budgetary targets for 2007 as the 2007 budget.

The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the code of conduct. It provides all compulsory and presents gaps in the optional data prescribed by the code of conduct.[4]

[3] The English translation of the programme was submitted on 20 December.

[4] Regarding the optional data, the following data are missing: in Table 1c (Labour market developments) the data on employment, (hours worked) and labour productivity (hours worked), in Table 2 (General government budgetary prospects), compensation of employees, in Table 4 (General government debt developments), the subcomponents of the stock-flow adjustment, in Table 5 (Cyclical components), the contributions to potential GDP growth by labour, capital and TFP. These gaps do not hamper the

Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

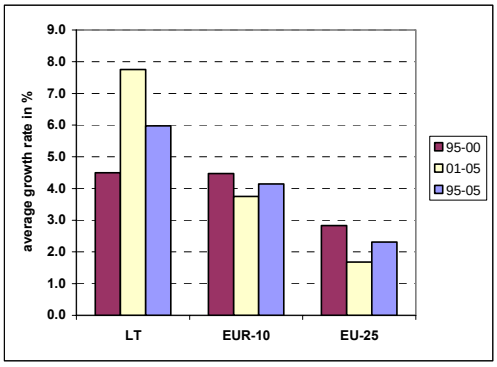
2. ECONOMIC TRENDS AND POLICY CHALLENGES

The section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second presents the results of a growth accounting exercise and tries to identify the main reasons for the difference in average annual economic growth vis-à-vis the EU10. The third looks at the volatility of growth and other key macroeconomic variables and the role of macro-policies. The fourth part focuses on trends in public finances. Based on the picture outlined in the first four parts, the fifth identifies major economic challenges with implications for public finances.

2.1. Economic performance

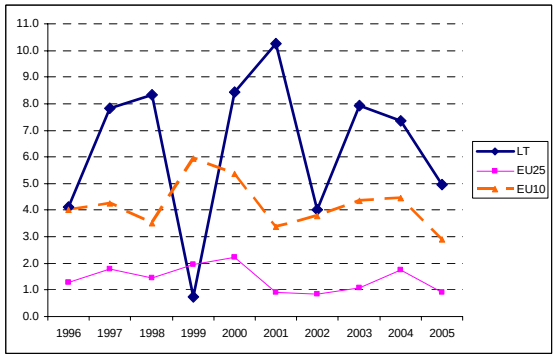
During the past ten years, Lithuania successfully completed the transition from central planning to a functioning market economy and now enjoys one of the highest output growth rates among the EU Member States. The economy went through two crises in the second half of the nineties from which it recovered rapidly, namely a banking crisis in 1995 and the external shock induced by the Russian crisis in 1998. The Lithuanian economy was more affected by the Russian crisis than most of the other EU-10 Member States partly due to its closer trade links with the Commonwealth of Independent States (CIS) area. This translated in somewhat lower average growth during the period 1995-2000 in Lithuania compared with the EU-10, while still relatively high compared to EU-12 (4.1% in Lithuania compared to 4.5% for EU-10 and 2.7% for EU-12). Over the period 2001-2005 real GDP growth averaged 7.6%, twice as high as the average growth in EU-10 for the same period and significantly higher than the average growth of 1.7% for EU-12. This was possible thanks to a sound macroeconomic policy mix, anchored in the currency board arrangement, and the implementation of structural reforms in a wide range of economic areas.

Figure 1: Average GDP growth: Lithuania vs. EU-10 and EU-25



Source: Commission services

Figure 2: Labour productivity growth: LT vs. EU-25 and EU-10



Source: Commission services

assessment. Potential output calculations in the programme are based on the Hodrick-Prescott filter and not on the commonly agreed methodology.

Despite these high growth rates, GDP per capita expressed in Purchasing Power Standards (PPS) while gradually increasing, remains very low, at just above 50% of the EU average in 2005, indicative of the long catching-up process lying ahead for the Lithuanian economy. Over the past ten years productivity growth ranked among the highest in the EU. Nevertheless, this high growth started from a low base and the productivity level remains significantly below the EU25 average.

After independence, Lithuania experienced triple-digit inflation when the country was still in the rouble zone. The authorities took a determined step towards reducing inflation in 1993 by introducing the new currency, the litas and in 1994 by setting up a currency board arrangement to increase the credibility of the national currency. As a result hyperinflation was halted. Rapid productivity growth, weak domestic demand and the real appreciation of the currency, which restrained import prices, have played a major part in the process of disinflation. In 1997 the average annual inflation rate reached single digit rates and by 1999 it had fallen below 2% and remained below that level until July 2004. Afterwards inflation increased to around 3% in the second half of 2004 and averaged 2.7% in 2005 due to a combination of factors including a pick-up in wage costs, higher unprocessed food and energy prices and increases in indirect taxes and administered prices.

Due to economic restructuring and a relatively low growth, the situation of the labour market worsened constantly over the period 1998-2001, with unemployment reaching the highest level in 2001 (16.4%) since the independence. Afterwards, unemployment was on a steady decreasing trend to 8.3% in 2005. However, the structural nature of unemployment, especially the high rate of long-term unemployment remains a matter of concern. The employment rate decreased constantly from 62.3% in 1998 to 57.5% in 2001, when it started to picked up, and has been on a an increasing trend since, to 62.6% in 2005. The rapidly tightening labour market in recent years was partly due to significant labour emigration after EU accession. It is estimated that the outflows in terms of its working age population from Lithuania (around 3.3%) are the largest among the EU-10.

As in several other new Member States, credit growth in Lithuania has been high and has been a major factor supporting GDP growth since 2001. The private sector absorbs the lion's share of outstanding bank loans (around 90% of the total claims) and recorded an average yearly credit growth of around 40% in the period 2002-2005. Within the private sector, household borrowing grew particularly fast and reached a record 90% year-on-year in 2005, fuelled to a large extent by residential mortgage lending. Credit to enterprises has been expanding most rapidly to non-tradeable sectors, particularly to real estate and construction sectors. The expansion of credit was not only financed by the growth of domestic deposits but also driven by foreign borrowing of banks (most of which are subsidiaries of parent banks abroad, mainly in Scandinavia). Despite this, Lithuania's external debt has not increased significantly and remains at about 50% of GDP. Although the private sector indebtedness as a percentage of GDP remains low, the limited information about this sector's hedging against interest rates and foreign exchange exposure calls for prudence. Moreover, in the light of emerging inflationary pressures, above potential growth and marked increases in real estate and equity prices, risks to macrofinancial stability could emerge.

Box 1: Monetary policy and exchange rate regimes of LITHUANIA	
Currency board *(since April 1994)*	After independence, Lithuania's local currency was pegged to the fast-depreciating Russian rouble. The Lithuanian authorities introduced the new currency, the litas, in several steps. First, the Russian rouble was replaced by the talonas in October 1992, which was allowed to float freely. The talonas initially continued to depreciate, but stabilised after a tightening of monetary policy. In June 1993, the litas was introduced and on 1 April 1994 it was pegged to the US dollar. Simultaneously, a currency board was set up to increase the credibility of the litas. In February 2002, the peg of the litas was changed to the euro.
ERM II participation *(since June 2004)*	The litas has participated in the ERM II since 28 June 2004 and Lithuania has maintained its currency board arrangement as a unilateral commitment within the ERM II. Since then, the litas has remained stable vis-à-vis its ERM II central rate.

During the period 1996-2000, the litas real effective exchange rate based on unit labour costs recorded a large appreciation. This was mainly due to the appreciating trend of the anchor currency, the US dollar and increasing unit labour costs in a context of nominal wage gains and lower productivity growth. The development of wages and unit labour costs since 2000 has reflected the lagged impact of buoyant economic activity on the labour market. Unit labour costs decreased markedly in 2001 and rose moderately in the period 2002-2004. This pattern mirrors the rapid gains in labour productivity in recent years, initially coupled with restrained wage gains. Labour compensation reacted with a lag to productivity developments. The growth of nominal compensation picked up gradually from 3.8% in 2001 to 8-9% in the period 2003-2005 amidst signs of a tightening labour market. Unit labour costs growth picked up in 2005 to 3.8% due to higher wage gains and lower productivity. Overall, the real effective exchange rate appreciated moderately in the period 2001-2005.

Due to a sharp decline of external demand, notably from the traditional exports markets in the CIS countries and the continued appreciation of the litas vis-à-vis the currencies of Lithuania's main trading partners, the external deficit stood at a level just below 10% on average during the period 1995-2000. It then decreased to 5.5% in 2001 thanks to stronger growth in the EU and CIS countries and a decline in import growth as a result of wage moderation, increasing unemployment and a stricter fiscal stance. Strong domestic demand since 2001 led to a higher external deficit which peaked to around 7% of GDP in 2004-2005. This was mainly driven by substantial deficits in goods trade partly offset by positive balances of services and current transfers. While import of consumer goods have been strong reflecting robust private consumption growth, imports content remain mostly driven by investment needs with intermediate and capital goods making a large proportion of total imports. In this context, the external deficits levels have not been regarded as worrying, but the deterioration of the external balance in the last two years calls for prudence.

A significant part of the deficit has been financed by FDI, largely driven by privatisation while the share of greenfield investments remains low. The inward FDI stock has been

below the average for the EU-10 Member States since 2001 (24% of GDP in Lithuania compared to 34% of GDP on average in EU-10).

Despite the real effective appreciation of the litas almost throughout the whole analysed period, competitiveness seems to have been largely preserved as indicated by Lithuania's export growth which has remained relatively robust. After growing in 1996 and 1997 at about 19%, exports declined by almost 17% in 1999 mainly due to a decrease in exports to the CIS. In 2000 exports recovered and despite the weakening of external demand initially, they continued to grow significantly until 2002. In 2003-2004, export grew more modestly partly due to lower exports of capital goods (producers shifted their sales towards the domestic market); export growth picked up by around 14% in 2005. Except for 1999, when imports shrank by 12.4% due to an output decline, strong domestic demand made imports grew faster than exports. As a result, the contribution to GDP from net exports was negative.

Lithuania enjoys a relatively strong comparative advantage in the low technology sector compared to OECD countries as shown by the Balassa index[5]. Nevertheless due to emerging problems in some segments of this sector faced with increasing competition notably from Asia (mainly textile and footwear), since 2001 Lithuania has been loosing market share. At the same time, there has been a strengthening of the competitive position in the medium-low technology sector (notably the manufacturing of petroleum products) thanks to FDIs.

[5] The Balassa index is a common indicator highlighting the pattern and degree of specialisation, defined as the ratio of a country's share in global exports of a given sector and the country's share in global exports of the economy as a whole. A ratio above 1 indicates a revealed comparative advantage of a sector:

$B = \frac{X_{cj} / X_{ct}}{X_{gj} / X_{gt}}$ where X stands for the value of exports in a given period, c indicates the country, g the world as a whole, j the sector and t the economy as a whole (all sectors)

Balassa index	1997	1998	1999	2000	2001	2002	2003	2004
High-technology manufactures	0.17	0.16	0.17	0.18	0.16	0.21	0.24	0.23
Medium-high technology manufactures	0.48	0.49	0.42	0.44	0.37	0.35	0.41	0.38
Medium-low technology manufactures	1.07	1.00	1.23	1.55	1.94	1.96	1.75	2.22
Low technology manufactures	2.89	3.01	3.13	3.01	2.82	2.76	2.70	2.41
ICT manufactures	0.32	0.22	0.22	0.21	0.21	0.26	0.37	0.36

Source: The OECD STAN Bilateral Trade Database

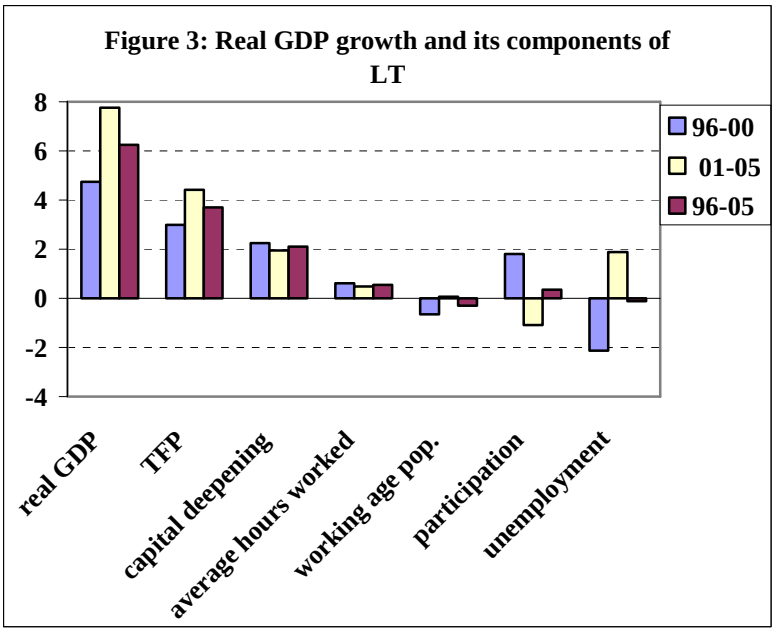
Trade integration with the EU has advanced significantly in recent years. Between 1997 and 2005, the share of Lithuanian exports of goods to the EU increased from 33% to about 65.3% (EU-25 since 2004), while the shares of imports from the EU have increased from 45% in 1997 to 59% in 2005.

2.2. Anatomy of medium-term growth

Decomposing growth into its main components associated with changes in factor inputs on the basis of the Cobb-Douglas production function, we observe that over the last ten years, GDP growth is driven to a very large extent by TFP growth. The transition process involving restructuring, higher competition, FDI inflows and transfer of technologies has enforced a more efficient use of production inputs and better managerial practices. Labour input was not a driver of growth and made both negative and positive contributions depending on the individual elements as follows: unemployment rates played a negative role in the period 1996-2000 and positive after 2001, whereas the decline in the size of the working age population played a small negative role, linked to emigration.

A comparison between the main drivers of growth in Lithuania and EU-10 reveals that the stronger growth in Lithuania can be mainly explained by a much higher contribution of TFP to GDP growth. This could reflect the fact that Lithuania had a lower starting level of productivity especially in the traded sector than most of the new Member States and therefore experienced faster growth. Lower investment rates influenced by a level of FDI flows below the average for EU-10, dampened the contribution from capital deepening in Lithuania compared to the other new Member States.

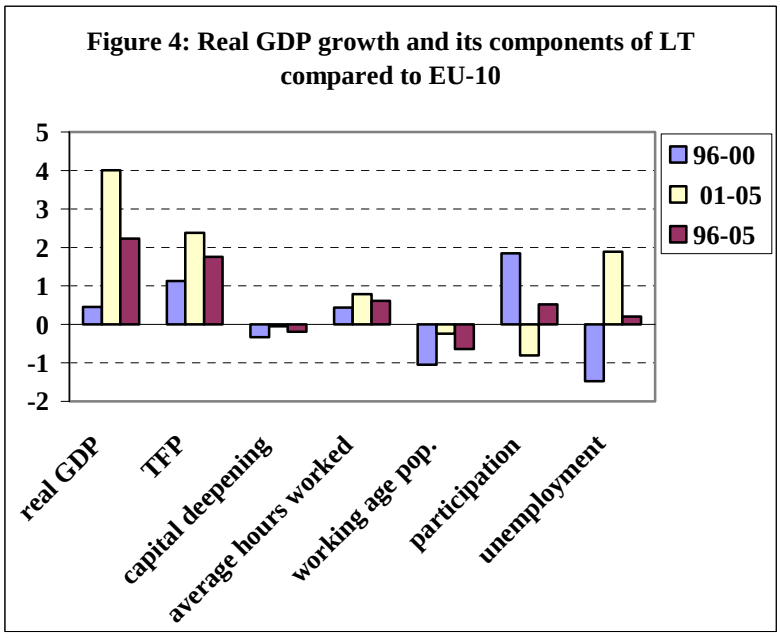
Contrary to EU-10, the working age population contributed negatively in Lithuania reflecting its rapidly shrinking size, while participation rates had a small positive contribution. Over the period 1996-2005, the reduction of unemployment gave a negligible, but negative contribution to growth both in Lithuania and EU-10, with the contribution in Lithuania being more negative than on average in EU-10 in 1996-2001 reflecting the two economic crises (the banking crisis and the Russian crisis).



Note:
Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP*, L employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$ where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.
Source: Commission services



Note: see Note of Figure 3
Source: Commission services

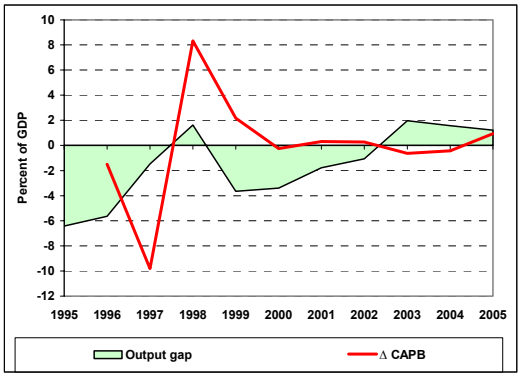
2.3. Macro-policies against the backdrop of the economic cycle

In Lithuania, the business cycle was more pronounced than in the EU-10. Up to 2002, the Lithuanian economy grew mostly below potential as transition and the effects of the Russian crisis were associated with a large negative output gap. The fiscal stance appears to have been counter-cyclical until 2000 and broadly neutral over 2000-2002.

From 2003, the output gap was largely positive due to economic expansion driven by strong domestic demand. Despite an economic upturn, the cyclically-adjusted primary balance (CAPB) deteriorated on the back of a significant increase in the primary deficit resulting in a pro-cyclical fiscal stance. While favourable cyclical conditions continued, the headline deficit increased from 1.2% in 2003 to 1.5% of GDP in 2004 reflecting the introduction of a funded pension system (with an estimated cost of 0.3% of GDP in 2004) and the CAPB deteriorated from 0.5% of GDP in 2003 to 1% of GDP in 2004. In 2005, in a context of positive cyclical conditions better-than-expected revenues were used to step up the budgetary consolidation effort and the CAPB was close to balance.

Under the currency board, the Lithuanian central bank does not set independent policy interest rates. Thanks to the credibility of the Lithuanian macroeconomic policy setting including the currency board arrangement, interest rates have continuously declined over the whole period under analysis. The resulting loose monetary conditions were a key driving force behind the strong increase in private consumption and investments which fuelled growth in the last years.

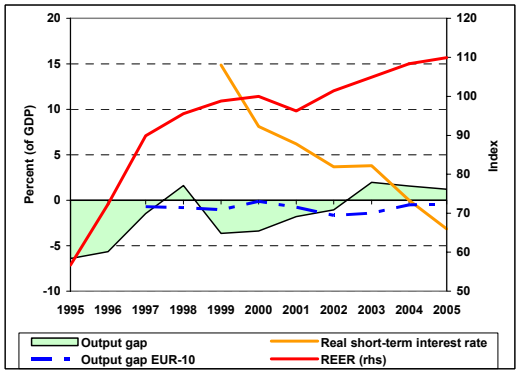
Figure 5: Output gap and fiscal stance



Note: ΔCAPB denotes the change in the cyclically-adjusted primary budget balance.

Source: Commission services

Figure 6: Output gap and monetary conditions



Source: Commission services

2.4. Public finances

During the period 1996-2000, the general government balance suffered a significant deterioration with an average budget deficit of almost 5%. This was due to an expansionary fiscal policy with expenditures increases for state aid to enterprises hit by the Russian crisis and the savings restitution programme which foresaw compensations for private households for losses during the shift from the Russian rouble to the national currency. Afterwards, fiscal consolidation efforts led to a decline of the deficit from

3.6% in 2000 to 1.2% of GDP in 2003. The deficit subsequently increased to 1.5% of GDP in 2004, following a more expansionary fiscal stance and the introduction of a funded pension system[6]. The deficit decreased to 0.5% of GDP in 2005 on the back of stronger-than-expected revenues due to higher growth.

Over the last ten years, the composition of the nominal budgetary adjustment has been mostly expenditure driven as the revenue-to-GDP ratio gradually decreased. The expenditure adjustment was concentrated on primary spending, as privatisation transactions contributed to decrease government spending on wages and a significant reduction of social transfers was implemented. Lower interest payments due to a steady decline in interest rates also contributed to the expenditure decrease. The primary expenditure ratio started increasing in 2004 on the back of a strong increase in social security related spending, agricultural subsidies, public sector salaries and investment. Unlike in previous years, the budgetary improvement in 2005 was revenue-driven. Strong revenue growth reflected buoyant economic activity and improvements in tax collection and enforcement while current expenditures increased significantly.

The government has shown a good track-record in meeting its fiscal targets in recent years, when actual deficits were better than targeted. Reflecting higher-than-expected revenues due to higher growth and a cautious forecasting of revenues by the Lithuanian authorities. Nevertheless, budget amendments implemented in the second half of the year have typically held back a faster deficit reduction.

The government has been taking measures to improve the quality of public finances. A tax reform was approved in June 2005, aiming at improving competitiveness of the Lithuanian economy by reducing labour costs through lower personal income tax, while contributing to a better tax collection. In the same context of the quality of public finances, it has to be noted that Lithuania has one of the lowest expenditure and revenue ratios in the EU, representing about one third of GDP. The government focuses on the essential functions of the state.

Lithuania's government debt ratio remained relatively low at an average of below 20% of GDP during the last decade, well below the 60% of GDP reference value. It increased from a low level of below 17% of GDP during the period 1996-1998 to 23.6% in 2000 in the aftermath of the Russian crisis, mainly due to a deterioration of primary deficits. It then declined steadily to below 19% in 2005. The main factor contributing to the decrease were the financial transactions of the government (stock-flow adjustment). This was mostly influenced by privatisation receipts and positive foreign debt valuation effects related to the nominal appreciation of the litas, which was initially pegged to the dollar until February 2002, and thereafter the euro. The "snow-ball" effect, which is the combined effect of implicit interest rates and nominal GDP growth also contributed, although to a lesser extent to the improvement of the debt ratio.

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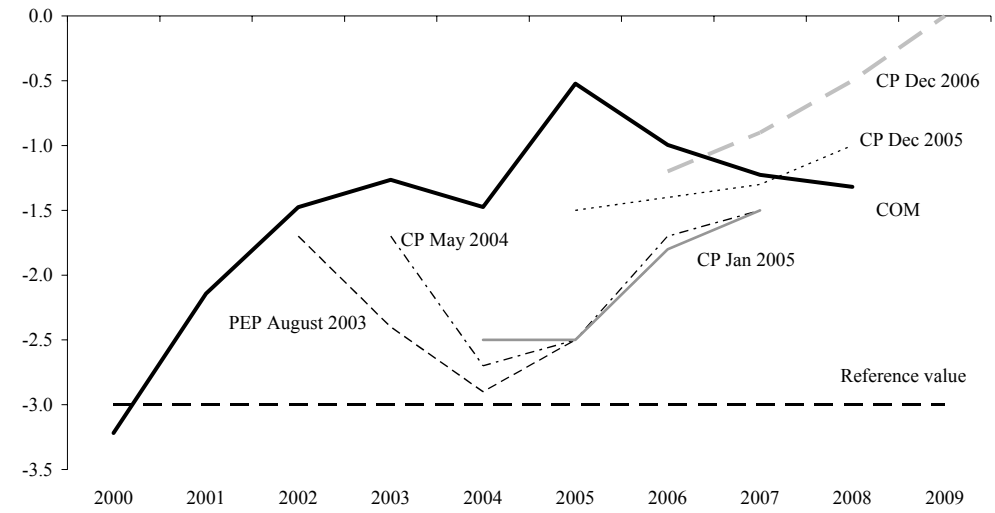
[6] Lithuania already presents the government accounts taking into account the Eurostat decision of March 2004 on the classification of second pillar pension systems and has included the pension reform costs in the deficit. The revenue loss due to the pension reform was estimated to be about 0.3% of GDP in 2004, 0.5% of GDP in 2005.

Figure 7: General government balance projections in successive convergence programmes (% of GDP)



Source : Commission services and national convergence programmes

2.5. Medium and long-term policy challenges for public finances

Lithuania has successfully completed the transition to a functioning market economy and now enjoys one of the highest output growth rates among the EU Member States. GDP per capita was just above 50% of the EU average in 2005. Domestic demand has accelerated rapidly in the last years partly reflecting buoyant credit growth, becoming the main driver of economic growth and leading to higher external deficits. After a period of non-inflationary growth, inflation picked up since mid-2004 reflecting a combination of factors including increases in unprocessed food and energy prices and significant wage increases against the background of a tightening labour market. The government has shown a good track record in meeting its fiscal targets in the last years, while better advantage could have been taken from the good times enjoyed by Lithuania.

Preserving macro-financial *stability* is therefore the main challenge in the area of public finances. So far, financing of the external deficits appears to have been unproblematic, but the external position reflects substantial financing needs in the medium term since the high growth of capital goods imports, fuelled by the absorption of EU structural funds and robust domestic demand, is expected to continue putting pressure on the external balance. Moreover, as rapid credit growth continues fuelling consumption and Lithuanian income and price levels converge towards those of the EU, emerging inflationary pressures could ultimately jeopardise the external competitiveness of the economy. Capital inflows need to be channelled to sectors that will contribute to productivity growth. However in recent years, FDI inflows remained relatively modest compared with some neighbouring countries. In order to avoid a too rapid increase in external debt, national savings need to remain at adequate levels. In this context and in the absence of an independent monetary policy, fiscal policy should play an increasing role in supporting more sustainable external deficits in the medium term and help prevent the risk of overheating, including by stepping up fiscal consolidation.

Table 1: Key economic indicators

	Lithuania						EU-10					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96–'05	'96–'00	'01–'05				'96–'05	'96–'00	'01–'05			
Economic activity												
Real GDP (% change)	6.2	4.7	7.8	10.3	7.3	7.6	4.0	4.3	3.7	4.0	5.1	4.6
Contributions to real GDP growth:												
Domestic demand	8.3	6.9	9.8	12.7	13.6	9.5	4.3	5.3	3.4	4.0	5.6	3.0
Net exports	-2.1	-2.1	-2.0	-2.4	-6.3	-2.0	−0.3	−1.0	0.4	0.0	−0.5	1.6
Prices, costs and labour market												
HICP inflation (% change)	4.8	8.6	0.9	-1.1	1.2	2.7	n.a.	n.a.	3.3	1.9	4.1	2.5
Labour productivity (% change)	6.4	5.9	6.9	7.9	7.4	5.0	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs (% change)	0.3	0.9	-0.3	1.9	0.7	-2.0	−0.8	−0.6	−1.0	−0.7	−2.5	−1.8
Employment (% change)	-0.1	-1.1	0.8	2.3	-0.1	1.4	−0.1	−0.3	0.0	−0.2	0.6	1.7
Unemployment rate (% of labour force)	12.0	11.5	12.4	12.4	11.4	8.3	12.8	11.3	14.2	14.3	14.2	13.4
Competitiveness and external position												
Real effective exchange rate (% change) (1)	6.8	12.0	1.9	3.5	3.4	1.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	2.7	-2.1	7.5	1.8	-4.6	6.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-7.9	-9.5	-6.2	-5.8	-7.1	-7.0	−3.4	−4.2	−2.6	−2.9	−2.6	−1.3
Public finances												
General government balance (% of GDP)	-3.1	-4.9	-1.4	-1.3	-1.5	-0.5	n.a.	n.a.	−4.2	−5.1	−3.7	−3.3
General government debt (% of GDP)	19.7	18.6	20.8	21.2	19.4	18.7	37.9	35.8	40.1	39.9	43.4	41.3
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-1.8	-1.9	-0.8	n.a.	n.a.	n.a.	−4.5	−3.4	−3.0
Financial indicators (4)												
Long term real interest rate (%) (5)	n.a.	n.a.	4.1	6.3	1.8	-2.0	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household debt (% of GDP) (6)	n.a.	n.a.	6.7	5.3	9.1	14.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	31.0	30.4	31.8	36.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes: More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:
Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, overall economic growth, the labour market, costs and prices, sectoral balances and potential output growth. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

The main external assumptions underlying the programme's macroeconomic scenario are in line with those underlying the Commission services' 2006 autumn forecast (until 2008), except for some differences in the short and long-term interest rate assumptions.

3.2. Economic activity

The macroeconomic scenario presented in the programme expects real GDP growth to reach 7.8% in 2006 and to decelerate progressively thereafter to 6.3% in 2007, 5.3% in 2008 and 4.5% in 2009. The projected economic slowdown is based on the key assumption of a drop in credit growth due to an expected correction of real estate prices in Lithuania and on the assumption of a monetary tightening by the ECB. As a result, domestic demand is expected to slow down but remains the driver for growth. The contribution of external trade to growth is forecast to be negative throughout the programme period. Cyclical conditions implied by the programme (as measured by the output gap recalculated by Commission services with the commonly agreed methodology) are favourable although the significant positive gap rapidly closes by 2008 and becomes negative in 2009[7]. They are more favourable than in the Commission services' autumn 2006 forecasts. The assessment of cyclical conditions in successive convergence programmes has become more positive over time for 2006 and 2007.

The macroeconomic outlook is in line with the average growth performance of the past five years in 2006, but assumes a marked deceleration over the period 2007-2009. In particular, private consumption and investment are expected to grow at much lower rates than in past years. At the same time, net exports are expected to give a much smaller negative contribution to growth in 2007-2008 compared with the last five years under the assumption that the growth of exports remains vigorous mainly due to the recovery of the EU market.

The growth outlook for 2006 in the programme is in line with the Commission services' autumn 2006 forecasts. For 2007 and 2008, the programme's forecast is cautious at 0.7 percentage points and 1.2 percentage points below the Commission services' autumn 2006 forecasts (it is also far below the potential growth rates calculated by the Commission services based on the information in the programme as reported in Table 4). The growth projections beyond 2008 are much below the estimate of potential growth in the Commission services' autumn forecast for the period 2006-2008.

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[7] The calculation of potential growth (and therefore of the output gap) needs to be interpreted with caution, in particular for countries going through a rapid catching-up process.

The programme projects growth of compensation of employees to remain strong, but at a lower rate than that included in the Commission services' autumn 2006 forecast for 2006-2008 and somewhat surprisingly to almost halve in 2009. Overall, in conjunction with the lower assumed GDP growth, the composition of growth in the programme is stronger in tax-rich components than that in the Commission services' autumn 2006 forecast (see also section 4.3 below).

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	7.8	7.8	7.0	6.3	6.5	5.3	4.5
Private consumption (% change)	11.5	10.5	9.5	7.0	8.6	6.6	6.3
Gross fixed capital formation (% change)	12.1	15.0	9.7	6.5	9.5	5.7	6.9
Exports of goods and services (% change)	14.2	13.2	12.5	6.8	10.6	7.8	7.6
Imports of goods and services (% change)	17.2	14.9	14.9	6.5	13.0	7.3	8.7
Contributions:							
- Final domestic demand	11.3	11.0	9.6	7.1	9.0	6.3	6.6
- Change in inventories	-0.5	-0.7	0.2	0.3	0.3	-0.2	0.0
- External balance on g&s	-3.0	-3.2	-2.8	-0.9	-2.7	-0.9	-2.1
Output gap[1]	1.4	2.4	0.7	1.6	-0.6	0.1	-1.9
Employment (% change)	1.9	3.2	0.6	0.5	0.3	0.3	0.3
Unemployment rate (%)	5.9	5.3	5.2	4.9	5.2	4.9	4.9
Labour productivity growth (%)	5.8	8.0	6.4	6.3	6.3	5.3	4.4
HICP inflation (%)	3.8	3.9	4.6	4.7	3.3	3.4	3.1
GDP deflator (% change)	5.0	6.0	6.6	3.5	5.4	2.6	2.5
Comp. of employees (% change)	17.0	14.7	15.2	14.9	13.8	12.1	6.9
Real unit labour costs (% change)	3.2	–	0.6	–	1.0	–	–
External balance (% of GDP)	-7.7	-6.6	-8.1	-7.5	-8.0	-7.0	n.a.

Note:

[1] In percent of potential GDP, with potential GDP growth as reported in Table 4 below.

Source :

Commission services' autumn 2006 economic forecasts (COM); Convergence programme

Table 3: Output gap estimates in successive Commission services' forecasts and convergence programmes

	2006		2007		2008	
	COM	CP	COM	CP	COM	CP
CP Dec 2006	-	2.4	-	1.6	-	0.1
Autumn 2006	1.4	-	0.7	-	-0.6	-
Spring 2006	1.6	-	0.4	-	-	-
CP Dec 2005	-	2.1	-	0.5	-	0.6
Autumn 2005	1.4	-	0.2	-	-	-
Spring 2005	0.8	-	-	-	-	-
CP Dec. 2004	-	0.5	-	-0.1	-	-

Note: Commission services' calculations according to the the commonly agreed method based on the figures of the programme

Source: Commission services' forecasts and national Convergence programme

3.3. Potential growth and its determinants

The estimate of potential output based on the Commission services calculations according to the commonly agreed methodology is lower than that embodied in the Commission services' autumn 2006 forecast. In terms of contributions to growth, the programme assumes a lower contribution from TFP which mainly explains the differences in growth potential. Compared with the last five years when growth was led predominantly by TFP growth due to structural reforms, the programme assumes capital accumulation will become the main growth driver as a result of continued high investment, partly related to higher EU funds inflows.

Table 4: Sources of potential output growth

	2006		2007		2008		2009
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	7.7	7.3	7.8	7.1	7.9	6.9	6.6
Contributions:							
- Labour	1.2	1.3	1.4	1.4	1.5	1.5	1.3
- Capital accumulation	2.8	2.9	2.9	2.8	2.9	2.7	2.7
- TFP	3.4	2.9	3.3	2.7	3.2	2.6	2.4

Notes:

[1]based on the production function method for calculating potential output growth

[2]Commission services' calculations on the basis of the information in the programme

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

Continuing the trend seen in the past five years and against the background of strong economic growth, employment is expected to increase by 3.2 percentage points in 2006, the highest growth rate since 2002. It should continue to grow until 2009 but at much lower rates mainly due to a shrinking labour force driven by continuing emigration. The

projected average labour content of GDP growth is somewhat higher than that projected by the Commission services' autumn 2006 forecasts in the light of similar employment growth projections, but lower real growth projections. This implies a more positive contribution from labour compared to past trends in parallel with a continued tightening of the labour market. Favourable cyclical conditions, in terms of a positive (though declining) output gap, are expected to largely contribute to the decline in the rate of unemployment, which is estimated to have fallen by 3 percentage points to 5.3% in 2006 and to stabilise at 4.9% over the rest of the programme period. The fall in the unemployment rate foreseen by the programme is broadly in line with that projected in the Commission services' forecasts, though the latter assumes a somewhat higher initial level of unemployment in 2006 at around 6%.

3.5. Costs and price developments

The programme expects HICP inflation to accelerate from 2.7% in 2005 to 3.9% in 2006 and 4.7% in 2007 before gradually decreasing to just above 3% in 2009. The main inflationary factors highlighted in the programme are food products, gas and administered prices as well as excise duties. The largest impact on the core inflation is caused by higher prices in the services sector due to increasing unit labour costs. Reacting with a lag to past productivity gains and reflecting a stronger demand for labour force, growth of average monthly wages is expected to continue at rates of almost 15% in 2006 and 2007 and 12% in 2008 before slowing down to around 7% in 2009. Real wage growth is estimated to remain considerably above labour productivity gains until 2008.

In the light of recent developments, there are upside risks to the programme's inflation projections after 2007. Lithuania's Russian single gas supplier announced a further increase in prices for imported gas by 35% as of January 2007, which will have a lagged impact on regulated prices for central heating. The excise duties on cigarettes will be increased by 30% as of March 2007. The excise duties on energy products will also be raised as of 1 January 2008. Continued double digit nominal wage growth and rapid credit expansion adding to domestic demand foster inflationary risks. Moreover, since growth and therefore the positive output gap could be higher than estimated in the programme, inflation could also be higher.

3.6. Sectoral balances

The programme expects the net borrowing vis-à-vis the rest of the world to increase from 6.6% of GDP in 2006 to 7½% in 2007 and to decline to 7% in 2008, mirroring developments of the balance of goods and services and driven by the private sector. This is more favourable than the Commission services' autumn forecast. The programme foresees that one third of the current account deficit will be financed from the capital account partly due to the inflows of EU capital transfers, but does not specify how the other part will be financed. It nevertheless highlights that the external deficit has increasingly been financed through the "other investments" category, mainly long-term liabilities to commercial banks abroad, whereas the FDI share significantly diminished in 2006. The increasing reliance on debt-creating capital inflows needs to be watched closely.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic ‘good’ or ‘bad’ times.

3.7.1. Plausibility of the macroeconomic scenario

The programme expects real GDP growth to gradually decrease over the programme period. The output gap as recalculated by Commission services based on the information in the programme is projected to be large and positive in 2006, close by 2008 and become negative in 2009. The unemployment rate is expected to sharply decline to 4.9% in 2007 and remain at that level until the end of the programme period. The HICP inflation should increase to a peak at 4.7% in 2007 and then gradually decline to just above 3% in 2009.

The programme's growth projections are plausible for 2006 and cautious thereafter. The assumptions are more favourable with respect to the composition of growth and from 2007 there are upside risks to the programme's projections for price developments.

3.7.2. Economic good vs. bad times

Although the positive output gap, as implied by the Commission services autumn 2006 forecast, is closing and becomes negative in 2008, the overall macroeconomic situation remains favourable. Growth remains robust and domestic demand is projected to keep its high momentum. Employment is expected to increase, albeit slowly and the unemployment rate is forecast to remain stable over the period 2007-2008 at a relatively low level. Therefore, Lithuania can be said to be experiencing “good times”.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme’s medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country’s position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The programme estimates the outcome for the 2006 deficit to be at 1.2% of GDP, compared to a target in the previous update of 1.4% of GDP and an estimated outturn of 1% of GDP in the Commission services’ 2006 autumn forecast. Preliminary data for the whole 2006 point to an even better deficit outcome than expected by the programme (the budget deficit in general government terms could be at around 0.5% of GDP), despite a budget amendment in July 2006 which increased expenditures by around 0.5% of GDP. The more favourable expected outcome stems mainly from the surplus in the social security sector. This was possible due to much higher-than-foreseen economic activity and employment, faster wage growth and improvements in tax collection.

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009
General government balance (% of GDP)	**CP Dec 2006**	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0**
	CP Dec 2005	-1.5	-1.4	-1.3	-1.0	n.a.
	CP Dec 2004	*-2.5*	*-1.8*	*-1.5*	*n.a.*	*n.a.*
	COM Nov 2006	-0.5	-1.0	-1.2	-1.3	n.a.
General government expenditure (% of GDP)	**CP Dec 2006**	**33.6**	**34.5**	**34.8**	**35.0**	**35.9**
	CP Dec 2005[1]	35.1	35.2	34.6	34.0	n.a.
	CP Dec 2004	*36.9*	*36.5*	*35.9*	*n.a.*	*n.a.*
	COM Nov 2006	33.6	34.0	32.9	31.9	n.a.
General government revenues (% of GDP)	**CP Dec 2006**	**33**	**33.3**	**33.9**	**34.5**	**35.9**
	CP Dec 2005	33.5	33.8	33.3	33.0	n.a.
	CP Dec 2004	*34.4*	*34.7*	*34.5*	*n.a.*	*n.a.*
	COM Nov 2006	33.0	33.0	31.7	30.6	n.a.
Real GDP (% change)	**CP Dec 2006**	**7.6**	**7.8**	**6.3**	**5.3**	**4.5**
	CP Dec 2005	7.0	6.0	5.3	6.8	n.a.
	CP Dec 2004	*6.5*	*6.2*	*6.0*	*n.a.*	*n.a.*
	COM Nov 2006	7.6	7.8	7.0	6.5	n.a.

Source:
Convergence programme; Commission services' autumn 2006 economic forecasts (COM)

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The main goal of the programme is to reduce the general government structural deficit (i.e. the deficit in cyclically-adjusted terms net of one-off and other temporary measures) to 1% of GDP in 2008, which is the country's medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact (see also Section 4.2.3 below) and further down in later years, so as to achieve a balanced position in nominal terms by 2009. According to the programme, the tightening of fiscal policy aims to contain inflation and prevent overheating.

The general government data presented in the programme include the pension reform cost resulting from the classification of the second-pillar funded pension schemes outside the general government (see footnote 5) estimated at 0.6% of GDP in 2006 and 0.8% annually in 2007, 2008 and 2009.

The programme foresees the general government deficit to gradually decrease from 1.2% of GDP in 2006 to a balanced budget in 2009. The primary deficit is expected to be in balance by 2007 and to record a surplus of 0.8% GDP at the end of the programme period. The most significant general government deficit reduction is planned to occur after 2008. Compared with the previous update, the planned adjustment is faster and

backloaded against a less favourable macroeconomic scenario towards the end of the programme period.

Table 6: Composition of the budgetary adjustment

(% of GDP)	2005	2006	2007	2008	2009	Change: 2009-2006
Revenues	33.0	33.3	33.9	34.5	35.9	**2.6**
of which:						
- Taxes & social contributions	28.9	28.8	29.0	29.0	29.3	**0.5**
- Other (residual)	4.1	4.5	4.9	5.5	6.6	**2.1**
Expenditure	33.6	34.5	34.8	35.0	35.9	**1.4**
of which:						
- Primary expenditure	32.8	33.7	33.9	34.1	35.1	**1.4**
of which:						
Consumption	16.7	17.7	16.3	15.5	15.4	**-2.3**
Transfers other than in kind & subsidies	9.7	9.5	10.3	10.8	10.9	**1.4**
Gross fixed capital formation	3.5	3.7	4.2	4.5	5.1	**1.4**
Other (residual)	2.9	2.8	3.1	3.3	3.7	**0.9**
- Interest expenditure	0.8	0.8	0.9	0.9	0.8	**0.0**
General government balance (GGB)	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0.0**	**1.2**
Primary balance	**0.3**	**-0.4**	**0.0**	**0.4**	**0.8**	**1.2**
One-offs[1]	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0.0**	**1.2**

Note:
[1]One-off and other temporary measures.
Source :
Convergence programme update; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

The envisaged fiscal consolidation relies on an increase in the revenue-to-GDP ratio that is higher than the increase in the expenditure-to-GDP ratio (2.6 percentage points compared to 1.4 percentage points).

On the revenue side, the revenues-to-GDP ratio is expected to increase from 33.3% of GDP in 2006 to 35.9% in 2009. Only 0.5 percentage point of the change is explained by the increases in taxes and social contributions mainly due to an expected improvement in tax collection. The rest of the increase is due to "other revenues" which are not concretely specified in the programme, but seem to be attributed to the inflow of the EU funds. The programme plans a shift of the tax burden from direct to indirect taxation. The reduction of the single personal income tax rate from 33% to 27% as of July 2006 and further down to 24% as of January 2008 is forecast to result in a decrease of 1.1% of GDP in direct taxes over the period 2006-2008. A "social tax" (a *de facto* temporary increase of the corporate income tax) will mitigate the loss of revenues from the tax reform in 2006 and 2007, but it will be abolished in 2008. Indirect taxes are projected to increase by 0.7 percent of GDP over 2006-2009, notably thanks to improved tax administration. The programme also announces increases in excise duties on cigarettes as of 2007 and on energy products in 2008, but does not provide an estimation of the expected impact on the budgetary revenues.

On the expenditure side, the rise of the expenditure-to-GDP ratio from 34.5% in 2006 to 35.9% in 2009 stems from an increase in the primary expenditures, while the interest expenditures ratio remains unchanged. A significant part of the increase is due to a rise of the public investment ratio from 3.7% of GDP in 2006 to 5.1% in 2009. The planned increase in investment is subject to some uncertainty as it assumes an acceleration of absorption of EU structural funds. Social transfers other than in kind (partly due to growing income support to agriculture) are also driving the increase in the expenditure-to-GDP ratio. An increase in "other" expenditure over the programme period by 0.9 percentage point is not explained in the programme. The major offsetting factor moderating the expenditure increase is expected to come from a very significant cut in the collective consumption and social transfers in kind, but there is a lack of information on the measures to achieve the planned decrease in consumption.

Box 2: The budget for 2007

The Lithuanian government adopted the draft budget for 2007 on 9 October 2006, which was approved by Parliament on 7 December 2006. The budget targets a general government deficit of 0.9% of GDP in 2007 in ESA 95 terms.

Total revenues, including EU funds are projected to increase by some 14.9% compared to the budget plans for 2006 estimated in July 2006. Against the background of high consumption and improved tax administration, the main tax will continue to be VAT which is projected to grow by 16.2% and would account for more than one third of the total revenues. Despite the reduction of the personal income tax rate in 2006, personal income tax revenues would increase by some 25% compared to 2006 and would make up 24.8% of total revenues. Corporate income tax revenues would also be up by around 38% (13% of the total revenues). Excise duties are projected to rise by some 17.6%, mainly due to an increase of 30% in the excise duty on cigarettes as of 1 March 2007. It should be noted that the plans for 2007 are based on revenues plans for 2006 estimated in July 2006 which are now expected to have been substantially overachieved. The revenue projections underlying the budget are thus compatible with lower year-on-year growth rates than mentioned above.

Total expenditures are projected to be 12.2% higher. The Public Investment Programme will receive 13% of the expenditure (of which almost one third covered from EU funds) and social security spending from the central government budget is set to increase notably by almost 50% (compared to an increase of 12% in the 2006 budget). Support to agricultural entities financed from national resources will be increased to account over 0.8% of GDP. Education expenditures will also be up by 17.5%.

The information provided above is based on plans made on the case-based national methodology.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
o Reduction of the personal income tax implemented in mid-2006 (-0.8% of GDP) o Improved tax administration (0.4% of GDP)	o Increased public investment (0.5% of GDP) o Higher social transfers other than in kind (0.7% of GDP) o Increased support to agriculture (0.1% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services, the 2007 budget and the December 2006 convergence programme.

4.2.3. The medium-term objective (MTO) and the structural adjustment

The medium-term objective (MTO) for the budgetary position put forward in the programme is a structural deficit of 1% of GDP, which is expected to be achieved by 2008. This remains unchanged from the previous update. The programme explains that the MTO will be tightened after 2008 in order to limit the increase of the general government debt and secure the long-term sustainability of the public finances, notably in the light of the ageing population.

Box 3: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The MTO is more demanding than the minimum benchmark (a deficit of around 2% of GDP for Lithuania), which is the estimated budgetary position in cyclically adjusted terms that provides a safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value. It also respects the lower bound of a structural deficit of 1% of GDP for ERMII countries and euro area members. The MTO is appropriate in view of the debt ratio and average potential growth in the long run.

Based on Commission services' calculations according to the commonly agreed methodology, the structural deficit is estimated to have deteriorated from 1% of GDP in 2005 to 1¾ in 2006. Thereafter, it is projected to gradually improve to 1¼% of GDP in 2007 and ½% in 2008 and a surplus of ½% of GDP in 2009. This implies that, taking the targets at face value, the MTO would be achieved within the programme's period (by 2008). The structural improvement between 2006 and 2009, by about 2¼ percentage points of GDP occurs against the background of favourable cyclical conditions as measured by a large positive output gap that is, however, gradually closing over the programme period and becomes negative in 2009 (see also section 3.7.2 above).[8]

[8] Significant differences between the output gap recalculations reported in the update and the Commission services calculations are due to different methodologies used, as the programme uses the Hodrick-Prescott filter. This results in a significantly higher negative output gap at the end of the programme

The structural balance as recalculated by the Commission services is planned to improve on average by ¾ percentage points of GDP per year. The effort is lower in 2007 (½ percentage points) and higher after 2008 (¾ and 1 percentage points in 2008 and 2009 respectively), i.e. the adjustment is back-loaded.

The fiscal stance based on the recalculation by the Commission services seems expansionary in 2006 and restrictive from 2007 in view of fiscal retrenchment on the side of the structural primary balance.

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	Change: 2009-2006
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance[2]	-0.5	-0.5	-1.0	-1.2	-1.2	-0.9	-1.3	-0.5	0.0	1.2
One-offs[3]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Output gap[4]	1.2	1.9	1.4	2.4	0.7	1.6	-0.6	0.1	-1.9	-4.3
CAB[5]	-0.8	-1.0	-1.4	-1.8	-1.4	-1.3	-1.2	-0.5	0.5	2.3
change in CAB	1.0	:	-0.5	-0.8	0.0	0.5	0.2	0.8	1.0	:
CAPB[5]	0.0	-0.2	-0.6	-1.0	-0.6	-0.4	-0.4	0.4	1.3	2.3
Structural balance[6]	-0.8	-1.0	-1.4	-1.8	-1.4	-1.3	-1.2	-0.5	0.5	2.3
change in struct. bal.	1.0	:	-0.5	-0.8	0.0	0.5	0.2	0.8	1.0	:
Struct. prim. bal.[7]	0.0	-0.2	-0.6	-1.0	-0.6	-0.4	-0.4	0.4	1.3	2.3

Notes:

[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme

[2]The costs of the ongoing pension reform are included in the deficit. The costs are estimated at 0.8% of GDP per year in the period 2007-2009

[3]One-off and other temporary measures. See Table 6 above.

[4]In percent of potential GDP. See Table 2 above.

[5]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.

[6]CAB excluding one-off and other temporary measures

[7]Structural primary balance = CAPB excluding one-off and other temporary measures

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3. Risk assessment

This section presents an assessment of possible risks attached to the achievement of the budgetary targets. It also compares the programme's budgetary projections to those in the Commission services' autumn 2006 forecast, which are derived under the usual no-policy change assumption.

As regards the macroeconomic outlook, the programme's growth projections are cautious from 2007 (see Section 3.7.1 above). Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point higher real

period and a better structural balance on average in the Commission recalculations than reported in the programme.

GDP growth projections in the programme over the 2006-2009 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2009, the cyclically-adjusted balance is around 1 percentage point of GDP above the central scenario. Hence, in the case of persistently higher real growth, the structural improvement would be by around 1 percentage point of GDP higher than targeted in the central scenario.

As regards the credibility and political backing of the targets, it has to be noted that the parties in the Parliament together with the government have signed a fiscal responsibility agreement, which was approved simultaneously with the convergence programme and which commits them to the budgetary targets in the programme. The agreement foresees to use any additional revenues for fiscal consolidation and not to significantly increase expenditures. Given that in recent years budget amendments during the year have typically held back a faster deficit reduction, this provision gives more credibility to the budgetary targets.

Nevertheless, the programme does not provide sufficient information regarding the measures envisaged in order to achieve the fiscal deficit targets, especially as regards the significant drop in the consumption-to-GDP ratio. Indeed, the programme acknowledges that additional measures are needed in order to do so. These additional measures are expected to help reduce the deficit by 0.4% of GDP in 2007 and by 1% in 2008 and 2009. The significant increase in the non-tax revenues-to-GDP ratio is also not sufficiently substantiated in the programme. Moreover, there is no sufficiently binding medium-term framework for the planning and control of public finances.

As mentioned in Section 4.1, the general government deficit outcome in 2006 is likely to be lower than estimated in the programme (by about 1 percent of GDP) and given the likely carry-over to 2007, the target for 2007 could be achieved also thanks to stronger growth.

Taking into account the tax reform, the programme's assumptions with respect to the tax intensity of the economic activity seem optimistic. The programme implies a more favourable composition of growth with respect to tax revenues than the Commission services' autumn 2006 forecast associated mainly with the personal income tax and social security contributions categories (see Table 9 and annex 5).

Overall, although growth could be higher than estimated in the programme, there is a favourable base effect from a better-than-estimated outturn in 2006 and Lithuania has a good track record with meeting its fiscal targets, the lack of detailed information on the envisaged measures introduces considerable uncertainty, while tax projections also seem to be on the optimistic side. In view of this assessment risks could be assumed to be balanced in 2007, but outcomes could be worse than targeted in 2008 and 2009.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009
		COM	CP	COM	CP	COM[1]	CP	CP
Revenues	33.0	33.0	33.3	31.7	33.9	30.6	34.5	35.9
of which:								
- Taxes & social contributions	28.8	29.3	28.8	29.2	29.0	28.6	29.0	29.3
- Other (residual)	4.3	3.6	4.5	2.6	4.9	2.0	5.5	6.6
Expenditure	33.6	34.0	34.5	32.9	34.8	31.9	35.0	35.9
of which:								
- Primary expenditure	32.7	33.2	33.7	32.1	33.9	31.1	34.1	35.1
of which:								
Consumption	16.7	16.3	17.7	15.8	16.3	15.4	15.5	15.4
Transfers other than in kind & subsidies	9.7	9.7	9.5	9.6	10.3	9.4	10.8	10.9
Gross fixed capital formation	3.5	4.2	3.7	4.6	4.2	4.7	4.5	5.1
Other (residual)	2.9	3.0	2.8	2.1	3.1	1.7	3.3	3.7
- Interest expenditure	0.8	0.8	0.8	0.8	0.9	0.7	0.9	0.8
GGB[2]	-0.5	-1.0	-1.2	-1.2	-0.9	-1.3	-0.5	0.0
Primary balance	0.3	-0.2	-0.4	-0.4	0.0	-0.5	0.4	0.8
One-offs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB[2] excl. one-off	-0.5	-1.0	-1.2	-1.2	-0.9	-1.3	-0.5	0.0

Notes:
[1]On a no-policy change basis.
[2]General government balance
Source :
Commission services' autumn 2006 economic forecast (COM); stability/convergence programme update; Commission services' calculations

Table 9: Assessment of tax projections

	2007			2008			2009
	CP	COM	OECD[3]	CP	COM[1]	OECD[3]	CP
Change in tax-to-GDP ratio (total taxes)	0.2	-0.2	-0.3	0.0	-0.7	-0.2	0.3
Difference (CP – COM)	0.4		/	0.7		/	/
of which[2] :							
- discretionary and elasticity component	-0.2		/	-0.1		/	/
- composition component	0.8		/	0.8		/	/
Difference (COM - OECD)	/	0.1		/	-0.4		/
of which[2] :							
- discretionary and elasticity component	/	-0.7		/	-1.0		/
- composition component	/	1.2		/	1.0		/
p.m.: Elasticity to GDP	1.1	1.0	0.9	1.0	0.8	0.9	1.2

Notes:
[1]On a no-policy change basis.
[2]The decomposition is explained in Annex 5. The components do not add up because of an interaction element.
[3]OECD ex-ante elasticity relative to GDP.
Source :
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 10: Overview of compliance with the Stability and Growth Pact

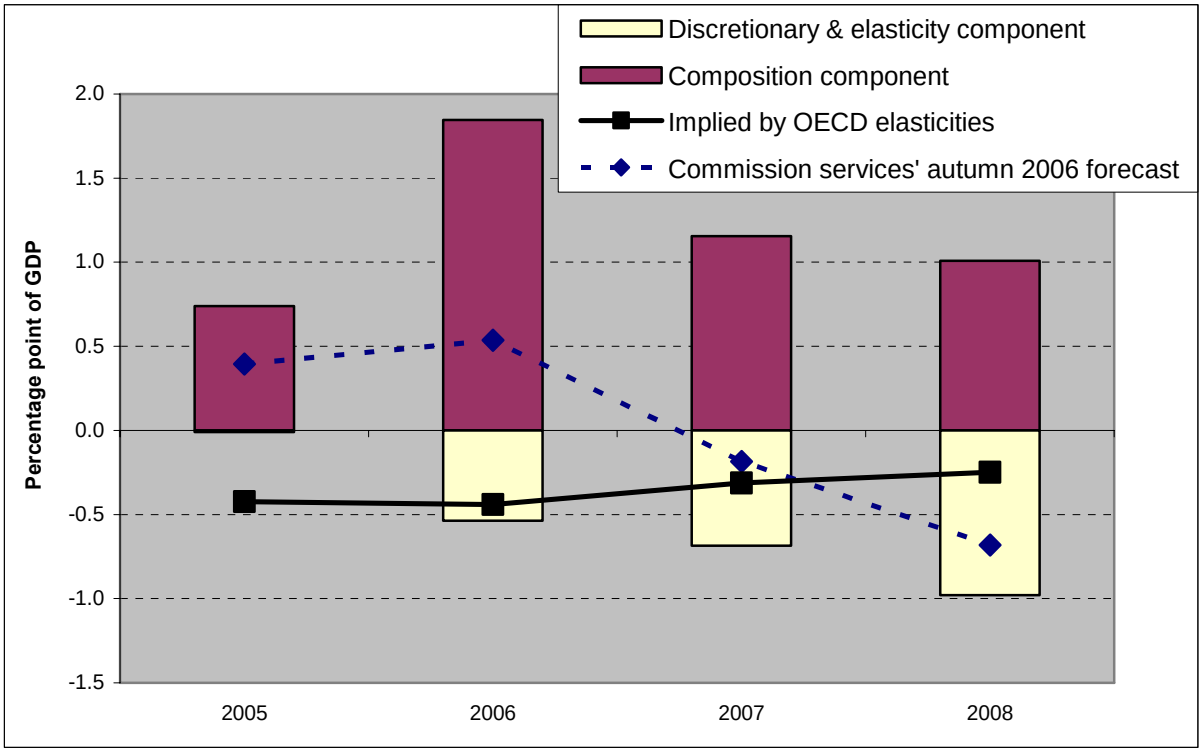
	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout the programme period	throughout the programme period
b. Achievement of the MTO	from 2008 onwards	possibly from 2009
c. Adjustment towards MTO in line with the Pact[2]?	fully in line	should be strengthened by backing it up with measures

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 2% of GDP for Lithuania). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.
Source:
Commission services

Lithuania respects the requirements of the Stability and Growth pact regarding the condition of providing a safety margin against breaching the 3% of GDP deficit reference value. Taking into account risks, the MTO could possibly be achieved from 2009, but most likely not by 2008 as planned in the programme.

The planned adjustment path towards the MTO is about 0.8% of GDP per year with most of the effort made from 2008. However, since the programme does not contain sufficient measures which would support such an adjustment effort (cf. risk assessment above), the structural adjustment could be slower than expected by the programme. Given the favourable cyclical conditions ("good times", cf. Section 3.7.2 above), as broadly confirmed by the assessment of tax elasticities (the prevailing effect in 2007 and 2008 comes from the composition component and not from the discretionary and elasticity one), the adjustment towards the MTO should be strengthened by backing it up with measures.

Figure 8: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.[9] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

[9] On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

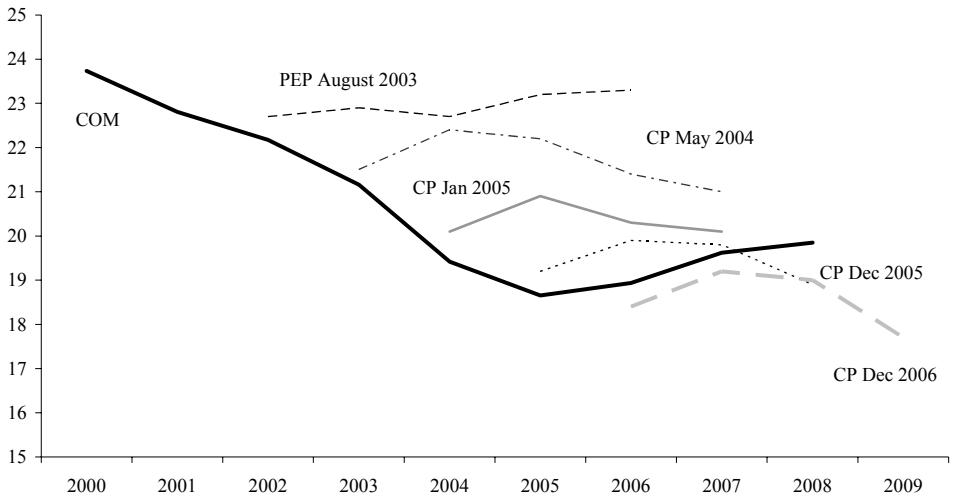
This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the convergence programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The programme estimates Lithuania's government debt ratio to have decreased from 18.7% of GDP in 2005 to 18.4% in 2006. This is only slightly below the Commission services' autumn 2006 forecasts. It is also notably below the target presented in the previous programme update. The debt ratio is expected to remain at around 19% of GDP in 2007-2008 before decreasing significantly to 17.7% in 2009.

Figure 9: Debt projections in successive convergence programmes (% of GDP)



Source: Commission services' autumn 2005 forecast (COM) and successive convergence programmes. PEP stands for Pre-accession economic programme.

Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**21.9**	**18.7**	**18.9**	**18.4**	**19.6**	**19.2**	**19.8**	**19.0**	**17.7**
Change in the ratio	-0.7	-0.8	0.3	-0.3	0.7	0.8	0.2	-0.2	-1.3
Contributions[2] *:*									
Primary balance	0.4	-0.3	0.2	0.4	0.4	0.0	0.5	-0.4	-0.8
"Snow-ball" effect	-0.2	-1.5	-1.4	-1.5	-1.5	-0.8	-1.4	-0.5	-0.4
Of which:									
Interest expenditure	1.3	0.8	0.8	0.8	0.8	0.9	0.8	0.9	0.8
Growth effect (real GDP)	-1.5	-1.3	-1.3	-1.3	-1.2	-1.1	-1.1	-0.9	-0.7
Inflation (GDP deflator)	-0.1	-1.1	-0.9	-1.1	-1.2	-0.6	-1.0	-0.5	-0.4
Stock-flow adjustment	-0.9	1.1	1.5	0.9	1.8	1.6	1.1	0.7	-0.1
Of which:									
Cash/accruals diff.	0.4	1.2							
Acc. financial assets	-0.7	-0.2							
Privatisation	-1.2	-0.3							
Val. effect & residual	-0.6	0.1							

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Convergence programme update (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The primary balance is expected to be a debt-increasing factor only until 2007 before starting turning into a surplus and contributing to increase the debt level. The "snow-ball" effect, that is the combined effect of implicit interest rates and GDP growth, will help reduce the debt ratio over the programme's horizon. The debt-increasing contribution of stock-flow adjustments are expected to progressively fade out after 2007, but this development is not explained in the programme. The debt projections for 2007-2008 are only slightly lower than those of the Commission services' autumn 2006 forecast.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[10]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see box 4), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2009, the final year of the convergence programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2009 provided in the convergence programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2010. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections.[11] Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	changes
Total age-related spending	16.0	15.3	15.1	16.3	16.8	17.4	1.4
Pensions	6.7	6.6	7.0	7.9	8.2	8.6	1.8
Healthcare	3.7	4.0	4.3	4.4	4.5	4.6	0.9
Long-term care	0.5	0.6	0.6	0.6	0.7	0.9	0.4
Education	5.0	4.2	3.2	3.3	3.3	3.3	-1.6
Unemployment benefits	0.1	0.1	0.1	0.1	0.1	0.1	-0.1

Source: Economic Policy Committee and Commission services.

[10] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

[11] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1 (hereinafter Ageing Report).

The projected dynamics in age-related spending in Lithuania is below the EU average; increasing by 1.4% points of GDP between 2004 and 2050. This is mainly due to the projected decline in pension expenditures increasing by 1.8 percentage points of GDP over the projection period, due to the large pension reform enacted a few years ago. The increase in health-care expenditure is projected to be 0.9 percentage points of GDP, below the EU average. For long-term care spending, the projected increase of 0.4 percentage points of GDP up to 2050 is below the EU average, while the expected drop in education expenditure is higher than the EU average.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	1.0	2.4	1.8	-1.4	0.1	1.8
of which:						
Initial budgetary position	1.1	1.3	-	-1.2	-1.1	-
Debt requirement in 2050	-0.7	-	-	-0.8	-	-
Future changes in budgetary position	0.5	1.1	-	0.5	1.1	-

Source: Commission services.

Box 4 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **initial budgetary position (IBP)**; and, (ii) **long-term change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2010-2014) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and

Table 13 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 1% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 2.4% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are somewhat higher in the present assessment, by 0.6% of GDP. This is mainly due to a higher structural primary deficit in 2006 (1% of GDP) compared to the structural primary deficit in 2005 estimated in Spring 2006 (0.3% of GDP) that was used in the Sustainability Report.

The current initial budgetary position and the impact of the increase in age-related expenditure up to 2050 contribute almost equally to the sustainability gap. The budgetary plans in the programme imply a strengthening of the structural balance between 2006 and 2009 by 2.3% points of GDP, which if realised will have a favourable impact on the sustainability gaps, nearly eliminating the S2 sustainability gap. This shows the importance of improving the structural budgetary position to contain risks to the sustainability of public finances.

The required primary balance (RPB) is 1.8% of GDP, somewhat higher than the structural primary balance of about 1.3% of GDP in the last year of the programme's period.

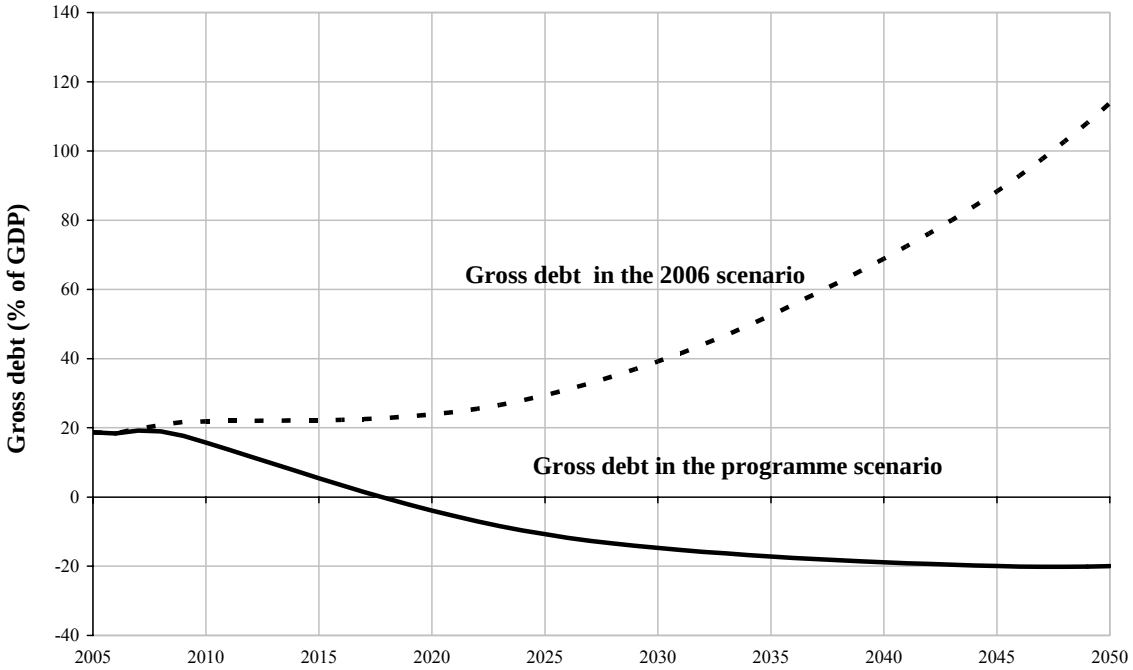
Moreover, the S2 sustainability gap would increase by about 0.2% of GDP in the 2006 scenario if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 10.

The gross debt ratio is currently well below the 60% of GDP reference value, estimated in the programme at just below 20% of GDP in 2006. The gross debt-to-GDP ratio is projected to remain below 60% of GDP reference value in the '2006' scenario until late 2030s and increase faster thereafter. In the 'programme' scenario, the debt/GDP ratio is projected to be declining throughout the projection period.[12]

[12] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

Figure 10: Long-term projections for the government debt ratio



Note: The government debt ratio is usually compiled in gross terms, that is assets are not netted out from government liabilities. Therefore, the gross debt can never be negative. In this chart, the negative values for the debt ratio should be understood as accumulation of financial assets. This issue has no implications on the conclusions drawn from the sustainability assessment.
Source: Commission's services.

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, as mentioned above, Lithuania has a very low stock of debt, below 20% of GDP in 2006, and it is planned to decline further in accordance with the implementation of the budgetary strategy as presented in the convergence programme update. This contributes to reduce the sustainability risks of Lithuania's public finances.

In addition, further changes to the pension systems are envisaged on the basis of the National Strategy Report on Adequate and Sustainable Pensions, notably increasing the retirement age. As recognised by the programme update, their implementation would contribute to the long-term sustainability of public finances.

5.2.3. Assessment

The long-term budgetary impact of ageing in Lithuania is lower than the EU average, with a limited increase in pension expenditure over the coming decades, influenced by the pension reforms enacted. The current level of gross debt is very low in Lithuania and improving the budgetary position as planned in the convergence programme update would contribute to contain the risks to the long-term sustainability of public finances.

Overall, Lithuania appears to be at low risk with regard to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The programme reviews the main structural reforms underway.

Lithuania introduced a funded pension pillar in 2004. The programme presents the budgetary impact of this pension reform during the programme period. Costs are estimated to be 0.6% of GDP in 2006 and 0.8% yearly over 2007-2009 (see footnote 5). The programme states that the reform should improve the quality of public finances in the long run through the expansion of the long-term saving and investment infrastructure and the higher liquidity on the financial markets as well as the sustainability of public finances by reducing the pension liabilities to be paid from the state budget in the long-term. However, as mentioned above (see Section 5), further changes to the pension systems, notably increasing the retirement age as discussed in the programme, would contribute to the long-term sustainability of public finances.

A tax reform is being implemented. The single personal income tax rate was lowered from 33% to 27% from July 2006 and a further cut to 24% will be operational as of 1 January 2008. The programme expects the reform to lead to a better balance between labour and capital taxation, to improve competitiveness due to reduced labour costs and to increase employment and potential GDP, but the programme does not provide a quantitative estimations of these benefits. It does, however, estimate the revenue loss for 2006-2008: 0.6% of GDP in 2006, 1.1% of GDP in 2007 and 2.25% of GDP in 2008. The loss should be partly offset by the introduction of a temporary "social tax" (a *de facto* increase in the corporate income tax) to be collected in 2006 and 2007. This social tax would cover around one third of the revenue loss in 2007. An expansion of the real estate tax base since 2006 is expected to also contribute to the financing of the tax reform, but the programme does not quantify the positive impact on budget revenues.

A health care reform is ongoing, with the main aim of modernisation and guaranteeing the efficiency of the system. It is estimated that the budget of the Health Insurance Fund will be in balance over the programme period, and that health care related expenditure increases gradually as a percentage of GDP up to 2050.

A significant public investment programme is being implemented. The investment ratio is expected to increase from 3.7% of GDP in 2005 to 5.1% in 2009, assuming an increased absorption of EU funds, which might not be realistic in the light of past levels of absorption.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The measures in the convergence programme are broadly in line with the National Reform Programme (NRP) and the progress recorded in the Implementation Report of the National Reform Programme (IR-NRP). The programme does not provide a qualitative assessment of the overall impact of the NRP within the medium-term fiscal strategy. It provides systematic information on the direct budgetary costs of the main reforms envisaged in the national reform programme. Its budgetary projections seem to take into account the public finance implications of the actions outlined in the macroeconomic part of the national reform programme, but do not explicitly mention those in the field of microeconomic and employment policies. The measures in the area of public finances envisaged in the convergence programme seem consistent with those

foreseen in the national reform programme. In particular, both programmes highlight the ongoing pensions, health care and tax reforms. In order to contain inflation and prevent overheating, the convergence programme foresees a tightening of fiscal policy, which was not reported on in the IR-NRP, but was called upon in the Commission December 2006 Annual Progress Report. The general government deficit targets presented in the updated convergence programme are therefore significantly lower than those presented NRP and the IR-NRP.

Box 5: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of Lithuania, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 13 October 2006. The Commission's assessment of this report, which was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The 2005-2008 Lithuanian National Reform Programme (NRP) set three key national priorities: to sustain fast economic growth and a stable macroeconomic environment; to promote the competitiveness of Lithuanian companies; to promote employment and investment in human capital.

Lithuania is making good progress in the implementation of the National Reform Programme, in most of the main policy areas across the macro, micro and employment sectors. However, with many important measures at the conceptual stage, there remains much to do in terms of implementation. Progress has been moderate on fulfilling the commitments agreed at the 2006 Spring European Council.

Among the strengths of the Lithuanian National Reform Programme and its implementation are: the pension, health and tax reforms; measures to upgrade road and rail infrastructure; the adoption of an updated national energy strategy; the reinforcement of active labour market policy, notably the new job rotation measures; and steps to modernise initial education and training.

The policy areas in the Lithuanian National Reform Programme where weaknesses need to be tackled with the highest priority are: reinforcing measures aimed at increasing investment in R&D, which do not so far appear sufficient to reach the ambitious target set; placing a stronger emphasis on measures to promote labour mobility; and taking additional steps to increase participation in lifelong learning, especially by older workers. Against this background, it is recommended that Lithuania:

- continue its efforts to strengthen its R&D system and to reach its ambitious target for overall investment in R&D, by raising public expenditure on this area;

- intensify efforts to increase the supply of skilled labour by improving regional mobility of labour and by promoting lifelong learning, with a special focus on the participation of older workers.

In addition, it will be important for Lithuania over the period of the National Reform Programme to focus on: achieving macro-economic stability and containing inflation; increasing foreign direct investment; facilitating business start-ups; environmental protection; improving youth employability; expanding entrepreneurship education; increasing the availability of childcare; and strengthening occupational health and safety.

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the convergence programme is broadly consistent with the broad economic policy guidelines.

Table 14: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].		X		
– Member States should avoid pro-cyclical fiscal policies[2].				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.	X			
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X			
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X			

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

* * *

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in

relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting,

accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	**66315.4**	**7.6**	**7.8**	**6.3**	**5.3**	**4.5**
2. Nominal GDP	B1*g	**71200.1**	**13.8**	**14.4**	**10.0**	**8.1**	**7.0**
Components of real GDP							
3. Private consumption expenditure	P.3	**44367.6**	**9.8**	**10.5**	**7.0**	**6.6**	**6.3**
4. Government consumption expenditure	P.3	**11927.5**	**4.9**	**6.2**	**2.5**	**2.5**	**2.5**
5. Gross fixed capital formation	P.51	**15517.8**	**9.2**	**15.0**	**6.5**	**5.7**	**6.9**
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	**11.6**	**3.9**	**4.9**	**4.8**	**4.4**	**4.2**
7. Exports of goods and services	P.6	**37850.5**	**14.5**	**13.2**	**6.8**	**7.8**	**7.6**
8. Imports of goods and services	P.7	**47530**	**16.0**	**14.9**	**6.5**	**7.3**	**8.7**
Contributions to real GDP growth							
9. Final domestic demand		**-**	**10.2**	**11.0**	**7.1**	**6.3**	**6.6**
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	**-**	**3.6**	**-0.7**	**0.3**	**-0.2**	**0.0**
11. External balance of goods and services	B.11	**-**	**-6.8**	**-3.2**	**-0.9**	**-0.9**	**-2.1**

Table 1b. Price developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		**107.4**	**5.8**	**6.0**	**3.5**	**2.6**	**2.5**
2. Private consumption deflator		104.8	3.7	4.0	3.8	3.0	2.7
3. HICP[1]		**100.0**	**2.7**	**3.9**	**4.7**	**3.4**	**3.1**
4. Public consumption deflator		99.6	1.0	4.0	3.8	3.0	2.7

5. Investment deflator		92.4	8.9	15.4	6.7	1.0	1.1
6. Export price deflator (goods and services)		**109.6**	**11.0**	**10.2**	**4.0**	**2.5**	**2.5**
7. Import price deflator (goods and services)		**97.8**	**8.1**	**11.2**	**5.5**	**2.5**	**2.5**

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		**1473.9**	**2.6**	**3.2**	**0.5**	**0.3**	**0.3**
2. Employment, hours worked[2]		2750419	5.4				
3. Unemployment rate (%)[3]		**8.3**	**-3.1**	**5.3**	**4.9**	**4.9**	**4.9**
4. Labour productivity, persons[4]		**43231.6**	**7.1**	**8.0**	**6.3**	**5.3**	**4.4**
5. Labour productivity, hours worked[5]		35.92	3.4				
6. Compensation of employees	D.1	**28616.2**	**13.4**	**14.7**	**14.9**	**12.1**	**6.9**

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis rest of the world	B.9	**-5.8**	**-6.6**	**-7.5**	**-7.0**	
of which:						
- Balance on goods and services		-7.3	-9.4	-10.4	-10.2	
- Balance of primary incomes and transfers		0.2	0.9	0.6	1.0	
- Capital account[1]		1.3	1.9	2.2	2.2	
2. Net lending/borrowing of the private sector	B.9	-5.3	-5.4	-6.6	-6.5	
3. Net lending/borrowing of general government	EDP B.9	-0.5	-1.2	-0.9	-0.5	
4. Statistical discrepancy						

[1]Based on Autumn forecasts of 6 November 2006. For 2009 a technical extrapolation of the historical trend.

Table 2. General government budgetary prospects

	ESA code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	**-371.2**	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0.0**
2. Central government	S.1311	**-751.1**	**-1.1**	**-1.6**	**-0.9**	**-0.5**	**0.0**
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	**-36.9**	**-0.1**	**0.1**	**0.0**	**0.0**	**0.0**
5. Social security funds	S.1314	**416.8**	**0.6**	**0.3**	**0.0**	**0.0**	**0.0**
General government (S13)							
6. Total revenue	TR	**23529.5**	**33.0**	**33.3**	**33.9**	**34.5**	**35.9**
7. Total expenditure	TE[1]	**23900.7**	**33.6**	**34.5**	**34.8**	**35.0**	**35.9**
8. Net lending/borrowing	EDP B.9	**-371.2**	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0.0**
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	**585.7**	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**
p.m.: 9a. FISIM							
10. Primary balance	[2]	**214.5**	**0.3**	**-0.4**	**0.0**	**0.4**	**0.8**

Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		**14439.0**	**20.3**	**20.7**	**20.7**	**20.3**	**20.5**
11a. Taxes on production and imports	D.2	**7950.7**	**11.2**	**11.8**	**12.1**	**12.3**	**12.5**
11b. Current taxes on income, wealth, etc	D.5	**6486.0**	**9.1**	**8.9**	**8.6**	**8.0**	**8.0**
11c. Capital taxes	D.91	**2.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
12. Social contributions	D.61	**6088.8**	**8.6**	**8.1**	**8.3**	**8.7**	**8.8**
13. Property income	D.4	**532.6**	**0.7**	**0.5**	**0.6**	**0.6**	**0.6**
14. Other (14=15-(11+12+13))		**2469.1**	**3.5**	**3.9**	**4.3**	**4.9**	**6.0**
15=6. Total revenue	TR	**23529.5**	**33.0**	**33.3**	**33.9**	**34.5**	**35.9**
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]		**20527.8**	**28.8**	**28.8**	**29.0**	**29.1**	**29.2**
Selected components of expenditure							
16. Collective consumption	P.32	**5025.9**	**7.1**	**6.9**	**6.3**	**6.0**	**5.9**
17. Total social transfers	D.62+D.63	**13259.5**	**18.6**	**16.9**	**19.3**	**19.2**	**19.0**
17a. Social transfers in kind	P.31=D.63	6855.0	9.6	10.8	10.0	9.5	9.5
17b. Social transfers other than in kind	D.62	6404.5	9.0	8.8	9.5	10.0	10.1
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	**585.7**	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**
19. Subsidies	D.3	**492.5**	**0.7**	**0.7**	**0.8**	**0.8**	**0.8**
20. Gross fixed capital formation	P.51	**2471.1**	**3.5**	**3.7**	**4.2**	**4.5**	**5.1**
21. Other (21=22-(16+17+18+19+20))		**2065.9**	**2.9**	**2.9**	**2.8**	**3.1**	**3.3**
22=7. Total expenditure	TE[1]	**23900.7**	**33.6**	**34.5**	**34.8**	**35.0**	**35.9**
p.m.: Compensation of employees	D.1						

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[3]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2004**	**2009**
1. General public services	1	4.7	
2. Defence	2	1.4	
3. Public order and safety	3	1.9	
4. Economic affairs	4	3.6	
5. Environmental protection	5	0.5	
6. Housing and community amenities	6	0.4	
7. Health	7	4.1	
8. Recreation, culture and religion	8	0.7	
9. Education	9	5.9	
10. Social protection	10	10.1	
11. Total expenditure (=item 7=26 in Table 2)	TE[1]	33.1	35.9

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		**2005**	**2006**	**2007**	**2008**	**2009**
1. Gross debt[1]		**18.7**	**18.4**	**19.2**	**19.0**	**17.7**
2. Change in gross debt ratio		**-0.8**	**-0.3**	**0.8**	**-0.2**	**-1.3**
Contributions to changes in gross debt						
3. Primary balance[2]		**0.3**	**-0.4**	**0.0**	**0.4**	**0.8**
4. Interest expenditure (incl. FISIM)[3]		**0.8**	**0.8**	**0.9**	**0.9**	**0.8**
5. Stock-flow adjustment		**1.1**	**0.9**	**1.6**	**0.7**	**-0.1**
of which:						
- Differences between cash and accruals[4]						
- Net accumulation of financial assets[5]						
of which:						
- privatisation proceeds						
- Valuation effects and other[6]						
p.m.: implicit interest rate on debt[7]		**4.6**	**4.7**	**5.0**	**4.7**	**4.6**

Other relevant variables						
6. Liquid financial assets[8]						
7. Net financial debt (7=1-6)						

[1]As defined in Regulation 3605/93 (not an ESA cncept).

[2]Cf. Item 10 in Table 2.

[3]Cf. Item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Real GDP growth (%)		**7.6**	**7.8**	**6.3**	**5.3**	**4.5**
2. Net lending of general government	EDP B.9	**-0.5**	**-1.2**	**-0.9**	**-0.5**	**0.0**
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 incl. FISIM	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**
4. Potential GDP growth (%)		6.9	6.7	6.4	6.1	5.8
contributions:						
- labour						
- capital						
- total factor productivity						
5. Output gap		1.7	2.8	2.7	1.9	0.6
6. Cyclical budgetary component		0.5	0.8	0.8	0.5	0.2
7. Cyclically-adjusted balance (2-6)		-1.0	-2.0	-1.7	-1.0	-0.2
8. Cyclically-adjusted primary balance (7-3)		-0.2	-1.2	-0.8	-0.2	0.6

Table 6. Divergence from previous update

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

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure[1]	39.1	33.7	35.7	35.3	36.6	38.6
Of which: age-related expenditures		17.3	16.3	16.0	17.3	19.3
Pension expenditure	7.8	6.6	6.1	6.6	7.5	8.8
Social security pension	7.8	6.6	6.1	6.6	7.5	8.8
Old-age and early pensions	6.9	5.6	5.2	5.6	6.5	7.8
Other pensions (disability, survivors)	0.9	0.9	1.0	1.0	1.0	1.1
Occupational pensions (if in general government)						
Health care	4.3	4.5	4.7	4.9	5.3	
Long-term care *(this was earlier included in health care)*	0.5	0.5	0.6	0.6	0.9	
Education expenditure	5.7	5.8	5.1	4.0	4.2	4.3
Other age-related expenditures	0.2	0.1	0.1	0.1	0.1	0.1
Interest expenditure	1.7	0.8	0.6	0.4	0.4	1.6
Total revenue[1]	35.6	33.1	35.9	35.9	35.9	35.9
Of which: property income	1.2	0.7	0.6	0.6	0.6	0.6
of which: from pensions contributions (or social contributions if appropriate)	7.1	7.0	6.9	7.0	7.0	7.0
Pension reserve fund assets	0.1	1.7				
Of which: consolidated public pension fund assets (assets other than government liabilities)	0.0	0.5	4.1	11.5	19.4	33.0
Assumptions						
Labour productivity growth	9.7	7.1	5.3	3.6	2.7	1.7
Real GDP growth	4.1	7.6	6.4	3.0	1.9	0.4
Participation rate males (aged 15-64)[2]	82.1	81.5	85.6	87.6	88.0	86.3
Participation rates females (aged 15-64)[2]	74.2	72.7	77.8	81.4	82.2	79.7
Total participation rates (aged 15-64)[2]	77.9	76.9	81.5	84.4	85.0	83.0
Unemployment rate	16.4	8.3	5.1	7.0	7.0	7.0
Population aged 65+ over total population	13.7	15.1	16.1	17.5	21.4	26.7

[1] These figures have not been published by the AWG. The method is known from the sustainability report 2006: the non-age related revenues and expenditures are kept constant at the 2005 level (taken from tabel a.3.5 of Public Finance Report 2006). Therefore, in this table the non-age related revenues and expenditures are set equal to the 2005 level from the latest economic outlook (MEV 2007). The age related revenues and expenditures are then added to reach the grand total.

[2]In the Code of conduct the age limits are 20-64

Table 8. Basic assumptions

	2005	2006	2007	2008	2009
Short-term interest rate[1] (annual average)	**2.3**	**3.7**	**3.7**	**3.3**	**3.5**
Long-term interest rate (annual average)	**3.6**	**4.1**	**4.1**	**4.2**	**4.2**
for countries in euro area or ERM II: **USD/€ exchange rate (annual average)**	**1.24**	**1.25**	**1.27**	**1.27**	**1.27**
Nominal effective exchange rate	**-0.8**	**0.0**	**0.0**	**0.0**	**0.0**
for countries not in euro area or ERM II: **exchange rate vis-à-vis the € (annual average)**	–	–	–	–	–
World excluding EU, GDP growth	**5.1**	**5.7**	**5.2**	**5.2**	**5.2**
EU GDP growth	**1.7**	**2.8**	**2.4**	**2.4**	**2.4**
Growth of relevant foreign markets	**1.7**	**2.8**	**2.4**	**2.4**	**2.4**
World import volumes, excluding EU	**8.8**	**9.1**	**8.3**	**7.9**	**7.9**
Oil prices (Brent, USD/barrel)	**55.2**	**65.6**	**66.3**	**68.0**	**68.0**

[1]If necessary, purely technical assumptions.

Annex 3: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].		X	
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.	X		
Significant divergences between the national and the Commission services' economic forecasts are explained[2].	X		Only implicitly
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.	X		Targets are better
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	Not from 2008
Information is provided on one-off and other temporary measures.			Not applicable

Guidelines in the code of conduct	Yes	No	Comments
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.	X		
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.	X		Quantitative in terms of costs and more qualitative in terms of benefits.
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X		The sensitivity analysis presented in the programme covers mainly the impact of interest rates, credit growth and real estate prices.
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.		X	
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	The consistency is not explicitly analysed
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		This information is limited.

Notes:
[1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.
[2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the EU10.

Lithuania- Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	6.2	4.7	7.8	10.3	7.3	7.6
Private consumption % change	6.9	5.4	8.4	10.2	12.2	9.8
Government consumption % change	3.0	1.8	4.2	3.8	7.7	4.9
Investment % change	11.6	10.5	12.6	14.1	15.5	9.2
Exports % change	10.2	7.1	13.3	6.9	4.4	14.5
Imports % change	12.3	9.3	15.3	10.4	14.9	16.0
Contributions to real GDP growth						
Demand						
Domestic demand	8.3	6.9	9.8	12.7	13.6	9.5
Net exports	-2.1	-2.1	-2.0	-2.4	-6.3	-2.0
Output gap	-1.1	-2.5	0.4	2.0	1.6	1.2
Prices and costs						
HICP inflation % change	4.8	8.6	0.9	-1.1	1.2	2.7
Unit labour costs % change	4.8	8.5	1.1	0.9	3.4	3.6
Labour productivity % change	6.3	5.9	6.7	7.9	7.4	5.0
Real unit labour costs % change	0.3	0.9	-0.3	1.9	0.7	-2.0
Comparative price levels (EUR25=100)	43.8	39.5	48.2	48.3	48.5	49.5
Labour market						
Employment % change	-0.1	-1.1	0.8	2.3	-0.1	1.4
Employment % of pop work age	62.1	62.9	61.4	62.2	62.1	62.9
Unemployment rate in %	12.0	11.5	12.4	12.4	11.4	8.3
NAIRU in %	10.1	7.5	12.7	13.3	11.9	10.0
Participation rate in %	70.7	71.2	70.1	71.0	70.0	68.7
Working age population % change	-0.3	-0.7	0.1	0.1	0.1	0.0
Competitiveness and external position						
Real effective exchange rate % change (1)	6.8	12.0	1.9	3.5	3.4	1.1
Export performance % change (2)	2.7	-2.1	7.5	1.8	-4.6	6.2
Extern.a.l balance of g & s	-7.9	-9.5	-6.2	-5.8	-7.1	-7.0
Net borrowing v-à-v RoW	-7.6	-9.4	-5.8	-6.4	-7.2	-5.9
FDI	n.a.	n.a.	3.4	1.0	3.4	3.9
Public fin.a.nces						
Total expenditure % of GDP	37.7	41.5	33.9	33.2	33.3	33.6
Total revenue % of GDP	34.6	36.6	32.6	31.9	31.8	33.0
General government balance % of GDP	-3.1	-4.9	-1.4	-1.3	-1.5	-0.5
General government debt % of GDP	19.7	18.6	20.8	21.2	19.4	18.7
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-1.8	-1.9	-0.8
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	n.a.	n.a.	2.1	3.8	0.0	-3.2
Long term real interest rate (4)	n.a.	n.a.	4.1	6.3	1.8	-2.0
Household credit % change	n.a.	n.a.	71.8	77.4	89.5	75.4
Corporate sector credit % change (5)	n.a.	n.a.	15.7	21.2	15.0	32.0
Household debt in % of GDP	n.a.	n.a.	6.7	5.3	9.1	14.0
Corporate sector debt in % of GDP	n.a.	n.a.	31.0	30.6	32.1	37.5

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

EU-10 - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	4.0	4.3	3.7	4.0	5.1	4.6
Private consumption % change	4.2	4.7	3.8	3.9	4.1	3.7
Government consumption % change	2.5	1.9	3.1	5.0	1.8	2.0
Investment % change	5.6	8.4	2.9	1.7	7.2	6.2
Exports % change	10.0	11.0	9.0	9.1	14.5	10.3
Imports % change	10.2	12.7	7.8	8.5	14.6	6.9
Contributions to real GDP growth						
Demand						
Domestic demand	4.3	5.3	3.4	4.1	5.6	3.0
Net exports	-0.3	-1.0	0.4	0.0	-0.5	1.6
Output gap	n.a.	n.a.	-1.0	-1.4	-0.5	-0.4
Prices and costs						
HICP inflation % change	n.a.	n.a.	3.3	1.9	4.1	2.5
Unit labour costs % change	5.7	9.2	2.3	1.3	1.4	0.7
Labour productivity % change	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs % change	-0.8	-0.6	-1.0	-0.7	-2.5	-1.8
Comparative price levels (EUR25=100)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour market						
Employment % change	-0.1	-0.3	0.0	-0.2	0.6	1.7
Employment % of pop work age	58.0	59.4	56.6	56.1	56.2	57.0
Unemployment rate in %	12.8	11.3	14.2	14.3	14.2	13.4
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	66.4	66.7	66.1	65.7	65.6	65.8
Working age population % change	0.3	0.4	0.3	0.4	0.4	0.3
Competitiveness and external position						
Real effective exchange rate % change (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance % change (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s	-3.4	-4.2	-2.6	-3.0	-2.6	-1.2
Net borrowing v-à-v RoW	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances						
Total expenditure % of GDP	n.a.	n.a.	44.2	44.9	43.4	43.6
Total revenue % of GDP	n.a.	n.a.	40.0	39.9	39.6	40.3
General government balance % of GDP	n.a.	n.a.	-4.2	-5.1	-3.7	-3.3
General government debt % of GDP	38.0	35.8	40.1	39.9	43.4	41.3
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-4.5	-3.4	-3.0
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	n.a.	n.a.	3.5	3.3	1.8	1.8
Long term real interest rate (4)	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household credit % change	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[13].

Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[14]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon'_{T_i,B_i}\varepsilon'_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

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[13]Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[14]The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i ex ante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex\,post}\frac{dB_i}{B_i}$.

If $(\varepsilon'_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon'_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i \varepsilon_{B_i,Y} + \beta_i \varepsilon_{T_i,B_i} + \alpha_i \beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i \varepsilon_{B_i,Y} \frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i \varepsilon_{T_i,B_i} \frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i \beta_i \frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i \varepsilon_{T_i B_i} \varepsilon_{B_i Y}$ with w_i the share of the *i-th* tax in the overall tax burden.

Assessment of tax projections by major tax category

	2007			2008			2009
	CP	**COM**	**OECD[1]**	**CP**	**COM[2]**	**OECD[1]**	**CP**
Taxes on production and imports:							
Change in tax-to-GDP ratio	0.3	0.1	0.0	0.2	-0.1	0.0	0.2
Difference CP – COM	0.2			0.3			/
of which [3]:							
- discretionary & elasticity component	0.2			0.2			/
- composition component	0.1			0.3			/
Difference COM – OECD [1]	/	0.1		/	-0.1		/
of which [3]:							
- discretionary & elasticity component	/	0.1		/	-0.1		/
- composition component	/	0.1		/	0.0		/
p.m.: Elasticity							
- of taxes to tax base[4]	1.2	1.0	1.0	1.0	0.9	1.0	1.0
- of tax base[4] to GDP	1.1	1.0	1.0	1.2	1.0	1.0	1.3
Social contributions:							
Change in tax-to-GDP ratio	0.2	-0.1	-0.3	0.4	-0.2	-0.2	0.1
Difference CP – COM	0.3		/	0.6		/	/
of which [3]:							
- discretionary & elasticity component	0.0		/	0.5		/	/
- composition component	0.4		/	0.3		/	/
Difference COM – OECD [1]	/	0.2		/	0.0		/
of which [3]:							
- discretionary & elasticity component	/	-0.1		/	-0.2		/
- composition component	/	0.5		/	0.4		/
p.m.: Elasticity							
- of taxes to tax base[5]	0.9	0.8	1.0	1.1	0.7	1.0	1.2
- of tax base[5] to GDP	1.5	1.1	0.7	1.5	1.1	0.7	1.0
Personal income tax[6]:							
Change in tax-to-GDP ratio	-0.3	-0.2	-0.1	-0.6	-0.3	-0.1	0.0
Difference CP – COM	-0.1		/	-0.3		/	/
of which [3]:							
- discretionary & elasticity component	-0.4		/	-0.6		/	/
- composition component	0.4		/	0.2		/	/
Difference COM – OECD [1]	/	-0.1		/	-0.2		/
of which [3]:							
- discretionary & elasticity component	/	-0.6		/	-0.6		/
- composition component	/	0.7		/	0.6		/
p.m.: Elasticity							
- of taxes to tax base[5]	0.4	0.8	1.5	0.0	0.6	1.5	1.0
- of tax base[5] to GDP	1.5	1.1	0.7	1.5	1.1	0.7	1.0
Corporate income tax[6]:							
Change in tax-to-GDP ratio	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Difference CP – COM	0.0		/	0.0		/	/
of which [3]:							
- discretionary & elasticity component	0.0		/	-0.1		/	/
- composition component	0.0		/	0.0		/	/
Difference COM – OECD [1]	/	-0.1		/	-0.1		/
of which [3]:							
- discretionary & elasticity component	/	0.0		/	0.0		/
- composition component	/	-0.1		/	0.0		/
p.m.: Elasticity							
-of taxes to tax base[7]	0.9	0.9	1.0	0.1	0.7	1.0	1.0
-of tax base[7] to GDP	0.7	0.9	1.4	0.6	0.9	1.4	1.0

Notes:

[1]Based on OECD ex-ante elasticities

[2]On a no-policy change basis

[3]The decomposition is explained in the text above

[4]Tax base = private consumption expenditure

[5]Tax base = compensation of employees

[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period

[7]Tax base = gross operating surplus

Source *: Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)*